Rolls-Royce plc
Directors' report and financial statements 2012

Rolls-Royce

Directors' report

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Directors' report
The Directors' report which includes the Business review is set out on pages 1 to 39.

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

"In the full year, underlying profits increased for the tenth consecutive year. We have established this record of consistent delivery while continuing to invest in people, technology and facilities."

John Rishton, Chief Executive

Rolls-Royce is a global company, providing integrated 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.

	2012	2011	% change
Order book – firm and announced	**£60,146m**	£57,630m**	**+4%**
Underlying revenue*	**£12,209m**	£11,277m	**+8%**
Profit before financing	**£2,072m**	£1,189m	**+74%**
Underlying profit before tax*	**£1,429m**	£1,158m	**+23%**

* See explanation in note 2 on page 54
** Restated 2011 year-end data excluding International Aero Engines (IAE) order book of £4,571 million

Group at a glance

The priorities of the Group remain: deliver on the promises we have made; decide where to grow and where not to; and improve financial performance.

Civil aerospace

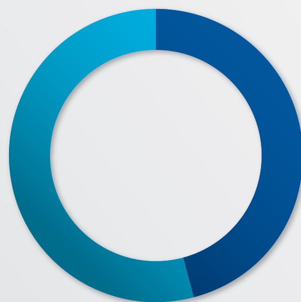
£6,437m
Underlying revenue 2012

£727m
Underlying profit 2012

- Trent XWB achieved certification
- Trent 1000-TEN introduced
- BR725 enters service and IAE restructure completed

The Civil aerospace business is a major manufacturer of aero engines for the airline and corporate jet market. Rolls-Royce powers more than 30 types of commercial aircraft and over 12,500 engines are in service with customers around the world.

Revenue mix



- 46% OE revenue
- 54% Services revenue

Defence aerospace

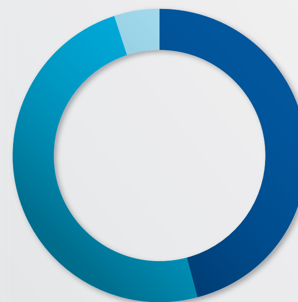
£2,417m
Underlying revenue 2012

£404m
Underlying profit 2012

- Over US$1 billion in contracts from US DoD and UK MoD
- US$315 million contract for F-35B STOVL LiftSystems™
- Adour engines ordered by Royal Saudi Air Force for Hawks

Rolls-Royce is the second largest provider of defence aero-engine products and services globally with 18,000 engines in service with 160 customers in 103 countries.

Revenue mix

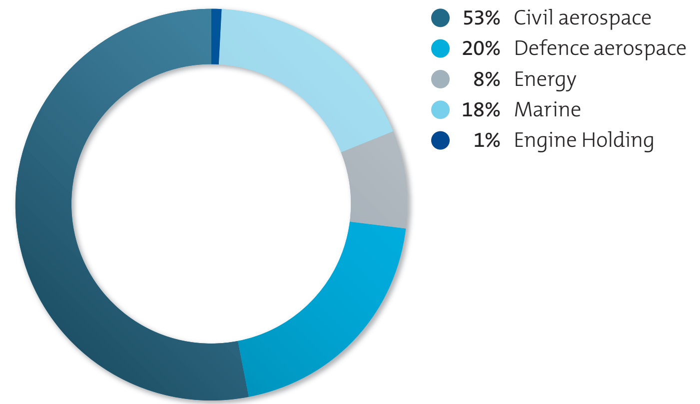


- 46% OE revenue
- 49% Services revenue
- 5% Development

Group overview 2012

- The order book increased to £60.1 billion, up four per cent, adjusted for the IAE disposal. Order intake was £16.1 billion in the year.
- Underlying revenue increased eight per cent to £12.2 billion, including 12 per cent growth in original equipment (OE) revenue and five per cent growth in underlying services revenue.
- Underlying services revenue increased in all four business segments: Civil, Defence, Marine and Energy and, in Engine Holding.
- Underlying profit before tax increased 24 per cent to £1,429 million reflecting revenue growth, revenue mix, unit cost reduction, a contribution from Tognum and IAE restructuring.

2012 revenue by business segment



Marine

£2,249m Underlying revenue 2012

£294m Underlying profit 2012

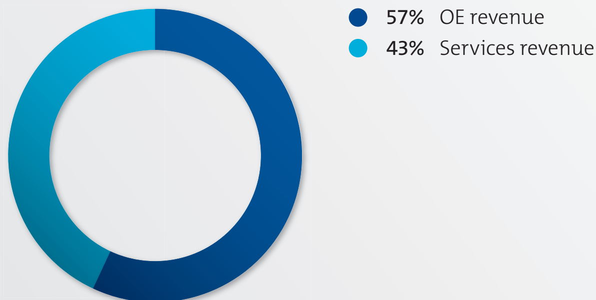
£147 million orders from Brazil for drill ships and offshore vessels

MT7 chosen to power US Navy future hovercraft

£1.1 billion order for UK naval nuclear reactor core programme

Rolls-Royce has a world-leading range of capabilities in the marine market, encompassing the design, supply and support of power and propulsion systems. We provide comprehensive through-life support from a global network of service facilities.

Revenue mix



Energy

£962m Underlying revenue 2012

£21m Underlying profit 2012

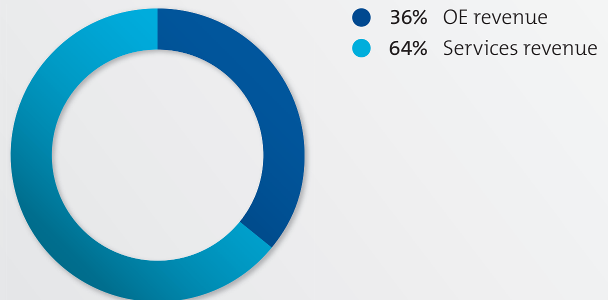
Six RB211s ordered by PetroChina for pipeline project

Services grew and investment 24/7 support desk completed

Nuclear agreements signed with AREVA and Hitachi

With over 4,800 gas turbines sold, and more than 130 million hours of operating experience gained, our Energy business plays a critical role in supporting global infrastructure. Our technology powers offshore platforms, transports oil and gas through pipelines and generates dependable electricity.

Revenue mix



Chief Executive's review

In 2012, Rolls-Royce continued to build the capacity required to deliver our £60 billion order book. Among these investments, we opened a new engine test and assembly facility at Seletar in Singapore that is now producing Trent 900 engines. We announced an expansion of our facilities at Crosspointe in Virginia, US, where we will produce turbine blades and nozzle guide vanes. In South America, construction of a new assembly plant to support our Energy and Marine businesses is well advanced and will open later this year. In the UK, as well as having opened our new apprentice academy in Derby, we are developing a new turbine blade facility in Rotherham and a new disc factory in Washington, Tyne and Wear.

In the past decade, Rolls-Royce has transformed its business. Today we are more global, with over half our order book from the Middle East and Asia. Our portfolio has become more diversified, both through organic growth and acquisition, and we have significantly increased the revenues generated from servicing the power systems we produce. During 2012, we changed the way we describe our vision, values and strategy to reflect better the Group we have become, to set clear direction for the future and to reinforce standards in the way we conduct business:

Values –	**trusted to deliver excellence**
Vision –	**better power for a changing world**
Strategy –	**understanding our customers, innovation, profitable growth**

These are described on pages 6- 7.

As well as looking at the expression of our vision, values and strategy, we have made an important structural change, bringing together our Civil and Defence businesses to create one Aerospace division with an integrated supply chain. This change, effective from 1 January 2013, will improve accountability and align our business more closely with our customers' requirements.

The priorities for the business remain the same as last year:
1. Deliver on the promises we have made
2. Decide where to grow and where not to
3. Improve financial performance.

In 2012, we have made progress towards these objectives.

1. Deliver on the promises we have made
The quality of the products and services we supply is measured across the Group and has shown steady improvement. Increased focus on delivery has led to significant improvement in widebody engines in Civil aerospace and in our Marine products. Across the Group, we are investing in a wide range of projects that will improve operational performance and reduce cost. This includes continuing investment in modernising our IT infrastructure that is a key enabler for our business.

Significant milestones have been achieved in our major programmes.

These include: in Civil aerospace, the certification of the Trent XWB engine (in February 2013) that will power the Airbus A350 XWB, the launch of the Trent 1000-TEN that will power Boeing 787s entering service from 2016 and, the entry into service of the BR725 engine powering the new Gulfstream G650 corporate jet. In Defence aerospace, the short take-off and vertical landing (STOVL) variant of the F-35B Lightning II Joint Strike Fighter entered service with the US Marine Corps and deliveries were made to the UK MoD.

In Marine, gas turbine power and propulsion equipment was delivered for the US Navy's Littoral Combat Ship and the UK's Queen Elizabeth class aircraft carriers. And, in Energy, we expanded our fleet of gas turbine compressor units through contracts for China's West-East Pipeline Project (WEPP) and the Uzbekistan section of the Asia Trans Gas (ATG) pipeline.

2. Decide where to grow and where not to
We continue to invest in capacity to fulfil our order book and in technology to expand our portfolio.

In Civil aerospace, we are committed to investing in the widebody, narrowbody and corporate market segments. In Defence aerospace, we continue to see opportunities both in developing economies and in our traditional markets, despite the pressure on government spending. In Marine, offshore oil and gas remains a fast growing market and, in Energy, we continue to invest in our Civil Nuclear business where we believe Rolls-Royce can play an important part supporting both existing and new build nuclear capacity. Our acquisition of Tognum, in a joint venture with Daimler, expands our Marine and Energy portfolios and brings significant opportunities for synergies.

Areas where we have decided not to invest include the sale of our tidal power generation business to Alstom in January 2013 and the sale of a 51 per cent stake in our fuel cell business to LG.

3. Improve financial performance

We continue to focus on margin progression. In 2012, margins at Group level improved to 12.2 per cent (2011 10.7 per cent). The Tognum and the IAE restructuring, together contributed 1.1 percentage points, with 0.4 percentage point improvement coming from the underlying business. Overall, profits grew by 24 per cent.

Cost and cash generation remain areas of intense focus for the Group, as we seek to improve quality, on-time delivery and working capital while continuing to invest to meet the rising load. Around £50 million of unit cost improvements were realised in 2012.

As noted in the Chairman's statement, we have passed information to the Serious Fraud Office (SFO) relating to concerns about bribery and corruption involving intermediaries in overseas markets. This follows a request for information from the SFO about allegations of malpractice in Indonesia and China. We have significantly strengthened our compliance procedures in recent years, including new policies for Global Ethics and Intermediaries. We have also expanded the Compliance function. As a further measure, we have appointed Lord Gold to lead a review of current procedures and report to the ethics committee of the Board.

In February 2013, we announced that Sir Simon Robertson will retire as Chairman at the Rolls-Royce Holdings plc annual general meeting (AGM) in May. Simon has made an exceptional contribution to Rolls-Royce over the past eight years. He has worked tirelessly on behalf of the Group and his energy and enthusiasm have been an example to us all. He has led the Board with distinction and has made the time to offer guidance and encouragement to colleagues all around the world and at every level of the business. Simon has been a great support to me during my first years as Chief Executive and I wish him every success in the future. I am delighted to welcome Ian Davis as our new Chairman and look forward to working closely with him.

During 2012, the Group has once again increased its profits, revenues and its order book, providing a solid foundation for further progress in the year ahead. Our cash inflow of £137 million, prior to acquisitions and disposals, was delivered after a heavy year of investment in technology, capability and infrastructure.

The achievements of Rolls-Royce are made possible by the more than 40,000 employees whose combined expertise and enthusiasm give us the ability to do extraordinary things. I am constantly impressed by their commitment and am grateful for their hard work and customer focus.

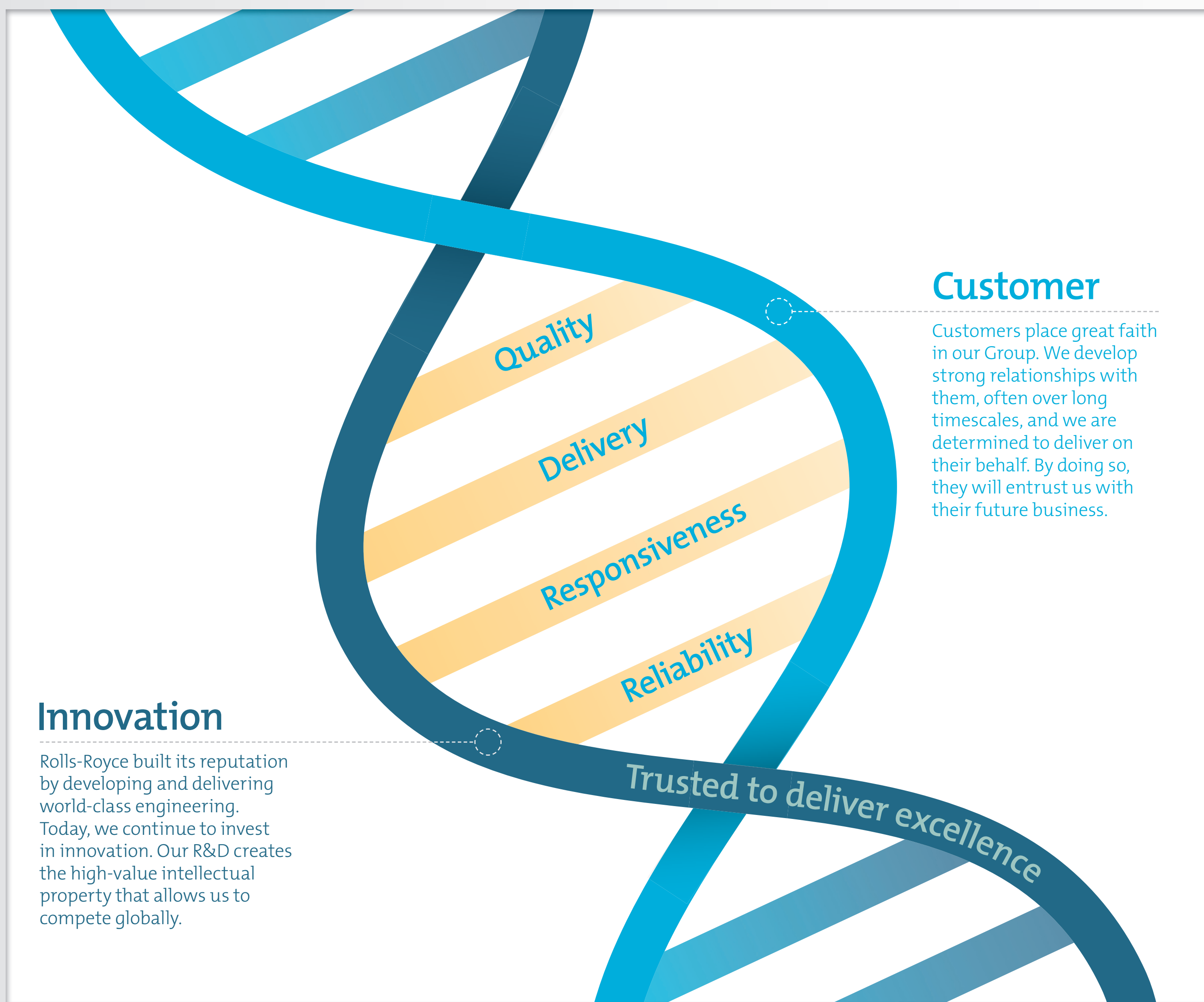
John Rishton
Chief Executive

13 February 2013

Values, vision and strategy

A customer-focused business

Our business model and strategy place the customer at the heart of our business. The DNA of the organisation is built around innovation and responding effectively to the needs of customers. Rolls-Royce will be relentless in the pursuit of quality, reliability and on-time delivery.



Customer

Customers place great faith in our Group. We develop strong relationships with them, often over long timescales, and we are determined to deliver on their behalf. By doing so, they will entrust us with their future business.

Innovation

Rolls-Royce built its reputation by developing and delivering world-class engineering. Today, we continue to invest in innovation. Our R&D creates the high-value intellectual property that allows us to compete globally.

Values, vision and strategy

Values

trusted to deliver excellence

Who we are and how we behave matter to our people and the many external groups that have an interest in our business. We have a proud heritage, one of the world's most powerful brands and a responsibility to hand on to future generations a business that is strong and successful.

Everyone at Rolls-Royce must be trusted to deliver excellence, this is a statement of values everyone can understand, take confidence from, be inspired by and always strive to achieve.

Vision

better power for a changing world

We are committed to innovation and a continuous pursuit of improvement. At the forefront of science and technology, and with a deep customer insight, we believe we are in a strong position to meet the demands of, and create opportunities in, our fast-changing world.

Strategy

understanding our customers, innovation, profitable growth

Our ambition is to be world class and competition-beating in our relationships with our customers, and in the delivery of world-class technologies and services. To achieve this, we apply lean and cost effective processes, simple and efficient operations, and a strong commitment always to operate to high ethical standards.

Future opportunity

A 20-year market outlook of US$3 trillion

The Group operates in four long-term global markets: Civil and Defence aerospace; Marine; and Energy. These markets contain a total business opportunity worth in excess of US$3 trillion over the next 20 years. The size of these markets is generally related to world Gross Domestic Product (GDP) growth, global security and defence budgets.

Civil aerospace

We predict emerging markets such as Asia, the Middle East and Africa will experience the fastest rates of growth. Factors affecting demand include GDP growth, aircraft productivity and retirements, operating costs and environmental issues. Civil engine demand over the next 20 years is forecast at US$975 billion, creating a services opportunity of US$700 billion over the same period.

US$975bn
Civil engine market

US$700bn
Civil engine services market

Marine

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 product market

US$125bn
Marine services market

Defence aerospace

Despite the challenging environment, we continue to see opportunities both in our traditional markets and the developing economies. Demand for engines over the next 20 years is estimated at US$155 billion. 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

Energy

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

Based on the International Energy Agency's latest World Energy Outlook we estimate that demand for nuclear mission-critical equipment, systems and engineering services could reach US$370 billion over the next 20 years, while demand for associated reactor support services could amount to US$240 billion.

US$120bn
Energy engine and services market

US$610bn
Civil nuclear market

Chief Financial Officer's review

Our financial performance continues to improve and we are increasing investment to meet future commitments.

Summary

	2012	2011	Change
Order book £m	**60,146**	57,630*	+4%
Underlying revenue** £m	**12,209**	11,277	+8%
Underlying profit before tax** £m	**1,429**	1,158	+23%
Reported revenue £m	**12,161**	11,124	+9%
Reported profit before financing £m	**2,072**	1,189	+74%
Net cash £m	**1,316**	222	
Average net cash £m	**(144)**	341	

* Restated 2011 year-end data excluding IAE order book of £4,571 million
** See explanation opposite and on page 54

The pace of recovery of the global economy remains uncertain and some of our customers continue to operate in challenging budgetary environments. However, our customers operate across a broad range of businesses and markets and our relatively young and competitive installed portfolio of power systems and products will generate demand for aftermarket services for many years to come. Demand from existing customers remains strong, as it does from the new customers included in our growing order book.

Our investments in technology, operations and people are underpinned by the significant growth inherent in our order book. These investments will safeguard our competitive advantage, support our commitments to customers and improve our operational effectiveness.

The Group's 2012 performance was achieved after absorbing a 27 per cent increase in the net R&D charge to £589 million and a ten per cent increase in capital expenditure, including software, to £610 million.

Engine Holding (EH), our collaboration with Daimler, owns over 99 per cent of Tognum. We transferred Bergen Engines to EH on 2 January 2012, which resulted in a £167 million cash inflow to the Group. We continue to consolidate Bergen. We will consolidate the whole of EH, including Tognum, from 1 January 2013.

EH's contribution of £287 million to 2012 revenue came wholly from Bergen. EH's profit contribution of £109 million comprised £32 million from Bergen and £77 million from the equity accounted contribution from Tognum.

The Group's sale of its 32.5 per cent programme share and related goodwill in IAE in 2012, generated a profit before tax of £699 million and a cash inflow of £942 million. The profit is excluded from our underlying results. The Group continues 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 proposed joint venture with Pratt & Whitney to develop an engine to power the next mid-size aircraft is subject to regulatory approval and had no material effect on 2012's 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 and the effects of acquisition accounting are excluded. In 2011, adjustments were made to exclude one-off past-service credits on post-retirement schemes. 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	2012	2011	Change	
Revenue	**12,209**	11,277	932	+8%
Civil aerospace	**6,437**	5,572	865	+16%
Defence aerospace	**2,417**	2,235	182	+8%
Marine	**2,249**	2,271	(22)	-1%
Energy	**962**	1,083	(121)	-11%
Engine Holding	**287**	331	(44)	-13%
Intra-segment	**(143)**	(215)	72	
Profit before financing costs and taxation	**1,490**	1,206	284	+24%
Civil aerospace	**727**	499	228	+46%
Defence aerospace	**404**	376	28	+7%
Marine	**294**	287	7	+2%
Energy	**21**	16	5	+31%
Engine Holding	**109**	80	29	+36%
Intra-segment	**(11)**	–	(11)	
Central costs	**(54)**	(52)	(2)	+4%
Net financing costs	**(61)**	(48)	(13)	+27%
Profit before taxation	**1,429**	1,158	271	+23%
Taxation	**(318)**	(261)	(57)	+22%
Profit for the year	**1,111**	897	214	+24%
Other items				
Other operating income	**33**	70	(37)	
Gross R&D investment	**919**	908	11	
Net R&D charged to the income statement	**589**	463	126	

Underlying revenue increased eight per cent to £12.2 billion. This includes a five per cent growth in services revenue to £6.3 billion and a 12 per cent increase in OE revenue to £5.9 billion. OE performance included strong 31 per cent growth in Civil aerospace and 12 per cent growth in Defence aerospace offset by reductions in each of Marine, Energy and EH. Underlying services revenue continues to represent more than half (52 per cent) of the Group's underlying revenue. In 2012, services revenue grew in all businesses as the installed base of products continued to grow and the services network expanded.

Underlying profit before financing costs and taxation increased 24 per cent to £1.49 billion. This was due to a number of factors: increased revenue; better mix; unit cost reduction; a full year's benefit from Tognum (compared to four months' contribution to Group results in 2011); and improved trading following the IAE restructuring settlement completed during the year. These improvements were partly offset by a significant increase in the R&D charge and lower other operating income.

Further discussion of trading is included in the business segment reports on pages 16 to 23.

Underlying financing costs increased 27 per cent to £61 million, including an increase in net interest charges reflecting lower average net funds after funding the Tognum acquisition in the second half of 2011.

Underlying taxation was £318 million, an underlying tax rate of 22.3 per cent compared with 22.6 per cent in 2011.

Other operating income relates to programme receipts from Risk and Revenue Sharing Partnerships (RRSPs), which reimburse past expenditure. These receipts decreased by 53 per cent in 2012 due to the phasing of major programmes such as the Trent XWB.

Net R&D charged to the income statement increased by 27 per cent to £589 million reflecting a combination of increased spend of £56 million and lower net capitalisation of £69 million due to the phasing of major new programmes. This investment and the ten per cent increase in capital expenditure including software to £610 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 data – £ million	2012	2011
Intangible assets	**2,901**	2,882
Property, plant and equipment	**2,564**	2,338
Net post-retirement scheme deficits	**(545)**	(397)
Net working capital	**(556)**	(942)
Net funds	**1,316**	222
Provisions	**(461)**	(502)
Net financial assets and liabilities	**50**	(714)
Joint ventures and associates	**1,800**	1,680
Assets held for sale	**4**	178
Other net assets and liabilities	**(248)**	(67)
Net assets	**6,825**	4,678
Other items		
USD hedge book (US$ million)	**22,500**	22,000
Net TotalCare assets	**1,312**	956
Gross customer finance contingent liabilities	**569**	612
Net customer finance contingent liabilities	**70**	124

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 with additional development, certification and software costs being offset by annual amortisation charges. 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 significant impairments in 2012. Further details are given in note 7 of the financial statements.

Property, plant and equipment increased by ten per cent to £2.6 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 increased 37 per cent to £545 million. This was principally due to the movements in the assumptions used to value the underlying assets and liabilities in accordance with IAS 19 – in particular the discount rate which is derived from AA corporate bond yields. The impact of the revisions to IAS 19 is described in note 18 of the financial statements.

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, and the exposure to equities has reduced to around 12 per cent of scheme asset. This has been achieved against the headwind of increasing life expectancy assumptions.

A modest reduction in the Group's cash contribution to the overall funding level of the schemes is expected in 2013.

Net funds increased by £1.1 billion to £1.3 billion largely due to the £0.9 billion proceeds received on the restructuring of IAE. Average net funds fell by £485 million to (£144) million due to the timing of the Tognum acquisition in the second half of 2011 and the restructuring of IAE in June 2012.

Investment – joint ventures and associates increased by seven per cent, largely as a result of the capitalisation of a loan to EH in respect of the acquisition of Tognum.

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 the fair value of foreign exchange, commodity and interest rate contracts, and financial RRSPs, set out in detail in note 16 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 two per cent to US$22.5 billion. This represents around five 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 22 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 2012, the Group's gross exposure remained stable at £569 million. On a net basis, exposure reduced by £54 million to £70 million predominantly due to an indemnity from United Technologies for all Airbus A320 commitments following the restructuring of IAE. Whilst some banks, particularly European institutions, continue to find circumstances challenging and offer limited participation in financing new aircraft deliveries, the Group expects that other providers of US dollar funding and ongoing support from the export credit agencies will largely fill the gap left by these banks.

Engine Holding

EH made progress towards achieving full ownership and management control of Tognum. At the end of 2012, EH owned over 99 per cent of the shares in Tognum. A squeeze-out process to acquire the remaining shares is ongoing, and is expected to conclude in 2013. During the year, EH registered a domination and profit and loss transfer agreement with Tognum, which provides a greater degree of management control and flexibility to pursue initiatives together. By bringing together Tognum and Bergen and leveraging the skills from Rolls-Royce and Daimler, we see significant opportunities for synergies.

In our Marine business, our design and integration skills will be further enhanced by the additional product range that Tognum's high-speed diesel engines will bring. And in the aftermarket, by combining the installed bases of equipment, we see good opportunities to leverage our customer support networks. Recently, we announced a contract to design and power four offshore supply vessels where, for the first time, we were able to incorporate Tognum's engines into our integrated design. Similarly, Tognum's high-speed diesels will add additional capabilities to our Energy portfolio, allowing us to offer both gas and diesel products as well as options for primary and stand-by power.

Group 2013 guidance excluding Engine Holding

For the full year 2013, we expect the Group to see modest growth in underlying revenue and good growth in underlying profit, with cash flow around breakeven as we continue to invest for future growth.

In Civil aerospace, we anticipate modest growth in revenue and strong growth in profit. In Defence aerospace we expect modest growth in revenue and a modest reduction in profit. In Marine, we expect modest growth in revenue and profit. And in Energy, we expect some improvement in revenue and profit.

This guidance excludes the impact of EH. The Group cannot provide financial guidance on EH while Tognum is still listed. Further information about Tognum's business and future prospects can be found on its website at www.tognum.de/investors.

Additional financial information can be found on pages 31 and 32.

Dividend

An interim dividend of £900 million will be paid on 15 February 2013.

Mark Morris
Chief Financial Officer

13 February 2013

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.

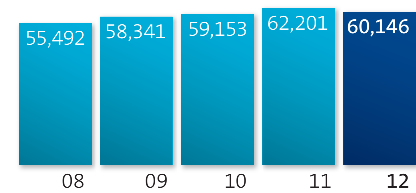
Other non-financial key performance indicators are shown in the sustainability section.

note: prior years are not restated for the 2012 IAE restructuring

Order book

-3%

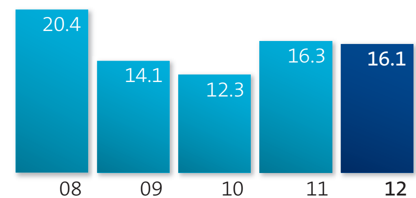
The order book provides an indicator of future business. It is measured at constant exchange rates and list prices and includes both firm and announced orders. In Civil aerospace, it is common for a customer to take options for future orders in addition to firm orders placed. Such options are excluded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



Order intake

-1%

Order intake is a measure of new business secured during the year and represents new firm orders, net of the movement in the announced order book, between the start and end of the period. Any orders which were recorded in previous periods and which are subsequently cancelled, reducing the order book, are included as a reduction to intake. Order intake is measured at constant exchange rates and list prices and consistent with the order book policy of recording the first seven years' revenue of long-term aftermarket contracts, order intake for any given year includes the seventh year of revenue.

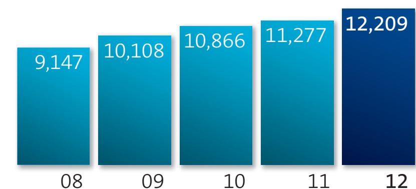


Underlying revenue

+8%

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

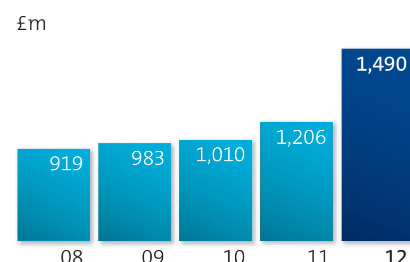


Key performance indicators

Underlying profit before financing

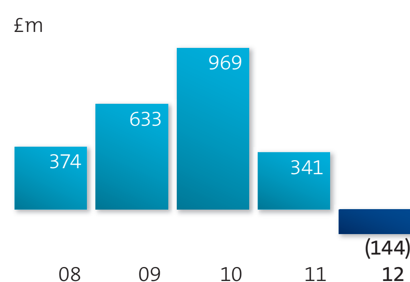
+24%

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.



Average cash

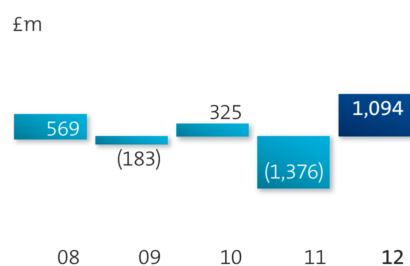
The Group reports the balance of net funds/debt on a weekly basis and average cash is therefore the average of these weekly net balances. These balances are reported at prevailing exchange rates and in recent periods, year-on-year movements in average cash balances reflect the significant acquisitions and disposals which have taken place, most notably Tognum in 2011 and IAE restructuring in 2012. The impact on average cash balances will depend on when these transactions took place during the year.



Cash flow

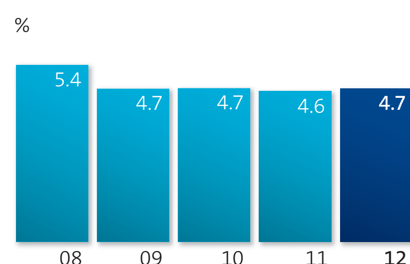
The figure for 2011 includes investment of £1,496 million in Tognum.

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.



Net R&D expenditure as a proportion of underlying revenue

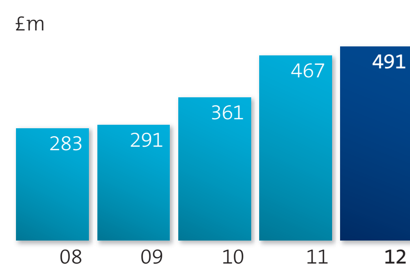
R&D is measured as the self-funded expenditure both before amounts capitalised in the year and amortisation of previously capitalised balances. The Group expects to spend approximately five per cent of revenues on R&D although this proportion will fluctuate depending on the stage of development of current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



Capital expenditure

+5%

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.



Principal risks and uncertainties

Effectively managing our risks helps us to deliver our objectives and maximise the returns of the Group while managing our reputation.

The following table describes the risks that the risk committee of Rolls-Royce Holdings plc, with endorsement from the Board, considers would have the most material potential impact on the Group and are 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.

The risk committee's discussions have been focused on the nature of these risks and the actions that are being taken to manage them.

Risk or uncertainty and potential impact	How we manage it
Product failure Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.	• Operating a 'safety first' culture • Our engineering design and validation process is applied from initial design, through production and into service • A safety management system has been established by a dedicated team, which is subject to continual improvement based on experience and industry best practice • Plan to accelerate quality improvements launched, including involvement from our suppliers • Crisis management team chaired by the Director – Engineering and Technology or General Counsel as appropriate
Business continuity Complete breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, financial insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results.	• Continued investment in adequate capacity and modern equipment and facilities • Identifying and reducing single points of failure • Selection of stronger suppliers, developing dual sources or dual capability • Developing and testing site level incident management and business recovery plans • Customer excellence centres provide improved response to supply chain disruption
Competitor action The presence of large, financially strong competitors in the majority of our markets means that the Group is susceptible to significant price pressure even where our markets are mature or the competitors are few. Our main competitors have access to significant government funding programmes as well as the ability to invest heavily in capability.	• Accessing and developing key capabilities in technology and service offerings which differentiate us competitively • Focusing on our customers and partnering with others effectively • Driving down cost and improving margins • Protecting credit lines • Investing in innovation, manufacturing and production • Understanding our competitors
International trade friction Geopolitical factors that lead to significant tensions between major trading parties or blocs which could impact the Group's operations. For example: explicit trade protectionism; differing tax or regulatory regimes; potential for conflict; or broader political issues.	• Where possible, locating our domestic facilities in politically stable countries and/or ensuring that we retain dual capability • Diversifying global operations to avoid excessive concentration of risks in particular areas • Regional director network proactively monitors local situations • Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base • Understanding our supply chain risks • Proactively influencing regulation where it affects us

Principal risks and uncertainties

Risk or uncertainty and potential impact	How we manage it
Major product programme delivery Failure to deliver a major product programme on time, to specification or technical performance falling significantly short of customer expectations would have 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.	• Major programmes are subject to Board approval • Major programmes are reviewed at levels and frequencies appropriate to their performance against key financial and non-financial deliverables and potential risks • Technical audits are conducted at pre-defined points performed by a team that is independent from the programme • Formal independent gated reviews are conducted throughout a programme's lifecycle to review non-technical risks • Programmes are required to address the actions arising from reviews and audits and progress is monitored and controlled through to closure • Knowledge management principles are applied to provide benefit to current and future programmes
Compliance Non-compliance by the Group with legislation or other regulatory requirements in the heavily regulated environment in which it operates (for example: export controls; use of controlled chemicals and substances; and anti-bribery and corruption legislation) compromising the ability to conduct business in certain jurisdictions and exposing the Group to potential: reputational damage; financial penalties; debarment from government contracts for a period of time; and/or suspension of export privileges (including export credit financing), each of which could have a material adverse effect.	• An uncompromising approach to compliance is now, and should always be, the only way to do business • The Group has an extensive compliance programme. These programmes and the Global Code of Business Ethics are promulgated throughout the Group and are updated and reinforced from time to time, to ensure their continued relevance and, to ensure that they are complied with both in spirit and to the letter • A legal and compliance team has been put in place to manage the current specific issue through to a conclusion • The appointment of Lord Gold to lead a review of the Group's current compliance procedures and report to the ethics committee
Market shock The Group is exposed to a number of market risks: some of which are of a macro-economic nature, for example, foreign currency exchange rates, and some which are more specific to the Group, for example, liquidity and credit risks or disruption to aircraft or other operations. Significant extraneous market events could also materially damage the Group's competitiveness and/or credit worthiness. This would affect operational results or the outcomes of financial transactions.	• Maintaining a strong balance sheet, through healthy cash balances and a continuing low level of debt • Providing financial flexibility by maintaining high levels of liquidity and an investment grade 'A' credit rating • The portfolio effect from our business interests, both in terms of original equipment to aftermarket split and our different segments provide a natural shock absorber since the portfolios are not correlated • Deciding where and what currencies to source in, where and how much credit risk is extended or taken and hedging residual risk through the financial derivatives markets (foreign exchange, interest rates and commodity price risk)
IT vulnerability Breach of IT security causing controlled data to be lost, made inaccessible, corrupted or accessed by unauthorised users, impacting the Group's reputation.	• Establishing 'defence in depth' through deployment of multiple layers of software and processes including web gateways, filtering, firewalls, intrusion and advanced persistent threat detectors • Establishment of security and network operations centres • Active sharing of information through industry, government and security forums

Civil aerospace

The order book increased by five per cent* including new orders of £10.3 billion (2011 £11.0 billion). We continue to grow our widebody market share, with Trent engines making up around 75 per cent of our order book. We remain committed to the mid-size market both as a supplier to IAE and via our planned new joint venture with the IAE partners to develop the next generation of engines for this market segment. Our continued success in the corporate market is being driven primarily by our BR700 series of engines for large cabin Gulfstream and Bombardier aircraft.

*when compared to the 2011 Civil order book of £47,370 with IAE orders of £4,571 million excluded

Highlights

- Order book now stands at £49.6 billion
- Trent XWB gained certification
- Trent 1000-TEN launched
- Major new Trent XWB orders from Cathay Pacific and Singapore Airlines
- BR725 enters service on new Gulfstream G650 business jet
- IAE restructuring completed

Key financial data

	2008	2009	2010	2011	**2012**
Order book £m*	43,524	47,102	48,490	51,942	**49,608**
	+21%	+8%	+3%	+7%	**-4%**
Engine deliveries*	987	844	846	962	**888**
Underlying revenue £m	4,502	4,481	4,919	5,572	**6,437**
	+11%	0%	+10%	+13%	**+16%**
Underlying OE revenue £m	1,776	1,855	1,892	2,232	**2,934**
Underlying service revenue £m	2,726	2,626	3,027	3,340	**3,503**
Underlying profit before financing £m	566	493	392	499	**727**
	0%	-13%	-20%	+27%	**+46%**

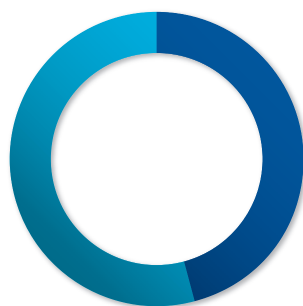
*all years prior to 2012 include IAE order book and engine deliveries include IAE V2500

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 has 12,500 engines in service with customers around the world. Demand for our products remains robust and underpins strong performance.

Revenue increased by 16 per cent. There was a 31 per cent growth in OE revenue, primarily reflecting higher deliveries of Trent and corporate engines. Services revenue grew by five per cent, consistent with growth in the installed base of thrust.

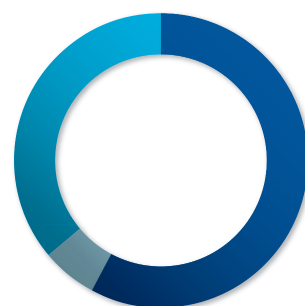
Profit increased by 46 per cent, including £92 million related to the restructured trading arrangements with IAE. Excluding these, profit increased by 27 per cent due to increased OE volume, better OE mix, services growth and unit cost improvements. This growth was tempered by a higher R&D charge due to higher spend and lower capitalisation related to major new programme activity and by lower entry fees related to the Trent XWB

Revenue mix



- 46% OE revenue
- 54% Services revenue

Revenue by market sector



- 58% Widebody
- 6% Narrowbody
- 36% Corporate and regional

In 2012, the airline industry saw overall passenger traffic growth at around five per cent. Airlines were careful to match capacity to demand and the industry as a whole will record a profit on passenger business despite the rising price of oil. The air cargo sector faced a tougher year as shippers moved away from air freight due to the impact of increasing fuel prices on shipment costs.

The large-cabin business aircraft market, which is characterised by a diverse customer base of large global corporations and high net worth individuals, remained resilient. The demand for small and medium-sized business aircraft continued to be subdued in 2012 but our exposure to this sector is relatively small.

Widebody

The Trent XWB engine flew for the first time in February 2012, on an Airbus A380 test aircraft in Toulouse, France. It went on to complete a successful flight-test programme and gained certification on 7 February 2013. This is the fastest selling Trent engine ever, with more than 1,200 engines sold to 35 customers.

During 2012, Singapore Airlines ordered 20 Trent XWB-powered Airbus A350-900s, while Cathay Pacific ordered ten A350-1000s and converted previously announced orders for 16 A350-900s to A350-1000s.

The Trent 1000 completed one year in service powering Boeing 787 Dreamliners with Japan's All Nippon Airways (ANA). The engine also entered service with South American airline LAN (the first Boeing 787s in the Americas), and with Polish flag-carrier LOT, the first in Europe. During the year, Trent 1000 orders were received from Avianca and Air New Zealand.

In July, we launched the Trent 1000-TEN (Thrust, Efficiency and New technology) that is due to enter service in 2016. This engine, which incorporates proven next generation technology from the Trent XWB, will be capable of powering all versions of the Boeing 787.

Trent 900-powered Airbus A380s entered service with two of Asia's leading airlines, Malaysia Airlines in July and Thai Airways in September. Skymark of Japan ordered the engine and Singapore Airlines, who launched the engine in service five years ago, ordered five more Trent 900-powered aircraft to add to the 19 A380s it already has in service.

The first Trent 900 engine to be completed at our new Seletar campus in Singapore was delivered in September. The engine was unveiled to an audience of VIPs and international media by Their Royal Highnesses The Duke and Duchess of Cambridge during their visit to Seletar.

The Trent 700 continues to be popular, winning orders in 2012 to power 54 Airbus A330 aircraft for China Eastern, Etihad, Avianca, Synergy, Garuda Indonesia, Air Pacific and Skymark. We announced plans to make performance improvements to the Trent 700 by incorporating proven technologies from the Trent 1000, Trent XWB and BR725 engines to deliver further increased efficiency. These enhancements will complement the improvements to the A330 aircraft that Airbus announced in 2012.

Narrowbody

In June 2012, we completed the restructuring of our participation in IAE, which produces the V2500 engine for the Airbus A320 family of aircraft selling our equity and programme shares to Pratt & Whitney.

We remain committed to the mid-size market through our new joint venture with the IAE partners. We will also continue to be responsible for the manufacture of high-pressure compressors, fan blades and discs as well as providing engineering support and final assembly for 50 per cent of IAE V2500 engines.

Corporate and regional

The flight-test programmes for two new Rolls-Royce powered business jets continued through the year. The BR725-powered Gulfstream G650 entered service in December 2012. The AE 3007C-powered Cessna Citation TEN is due to enter service in 2013.

Services

Revenue from services increased by five per cent in 2012, reflecting growth in the fleet of wide-bodied engines, 92 per cent of Trent engines are sold with TotalCare agreements.

Over 1,200 aircraft are covered by CorporateCare® and more than 70 per cent of customers for new Rolls-Royce powered business jets enrol in CorporateCare.

Defence aerospace

The order book contracted by 15 per cent reflecting the budgetary pressures on our major customers in Europe and North America. The net order intake of £1.6 billion (2011 £1.8 billion) includes cancellations of £0.4 billion, principally the proposed cancellations of a number of contracts for C-27J aircraft, including those by the US Department of Defense. Despite the challenging environment, we continue to see opportunities both in our traditional markets and the developing economies.

Highlights

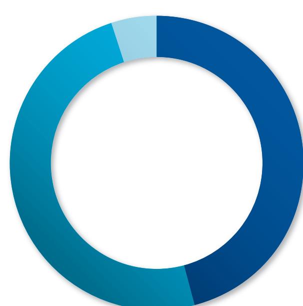
- US$1 billion of contracts for OE and services for military transport, trainer and helicopter engines for the US Army, US Air Force, US Marine Corps and US Navy
- A US$315 million contract for LiftSystems for the F-35B STOVL variant of the Lightning II aircraft
- Launch of fuel-saving initiative with the Royal Australian Air Force on C-130 operations and a £100 million contract extension to maintain engines for C-130 and VC-10 aircraft from the UK MoD
- An order for new Adour engines to power Hawk trainers for the Royal Saudi Air Force

Key financial data

	2008	2009	2010	2011	**2012**
Order book £m	5,527 +23%	6,451 +17%	6,506 +1%	6,035 -7%	**5,157** **-15%**
Engine deliveries	517	662	710	814	**864**
Underlying revenue £m	1,686 +1%	2,010 +19%	2,123 +6%	2,235 +5%	**2,417** **+8%**
Underlying OE revenue £m	739	964	1,020	1,102	**1,231**
Underlying service revenue £m	947	1,046	1,103	1,133	**1,186**
Underlying profit before financing £m	223 +12%	253 +13%	309 +22%	376 +22%	**404** **+7%**

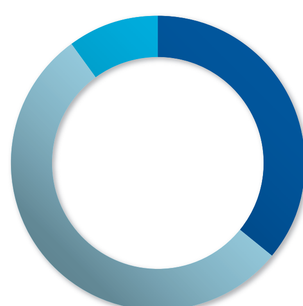
Rolls-Royce remains the second largest provider of defence aero-engine products and services globally with 18,000 engines in the service of 160 customers in 103 countries. Our engines power aircraft in every major sector, including: transport; combat; patrol; trainers; helicopters; and unmanned aerial vehicles (UAVs).

Revenue mix



- 46% OE revenue
- 49% Services revenue
- 5% Development

Revenue by market sector



- 36% Combat
- 54% Transport
- 10% UAV/trainer

Revenue increased by eight per cent, reflecting a 12 per cent increase in OE revenue and a five per cent increase in services revenue. However, adjusted for the non-recurrence of the £60 million Strategic Defence and Security Review (SDSR) benefit in 2011, services revenue increased by 11 per cent. This highlights how our large installed base continues to provide services opportunities, as customers seek to optimise the efficiency of their aircraft.

Profit increased by seven per cent. Adjusted for the SDSR benefit in 2011, profit increased by 28 per cent due to increased OE volumes and mix, growth in services, unit cost improvements and a lower R&D charge.

Transport/Patrol

We are a world leader in the military transport/patrol market with over 8,000 engines in service. The AE 2100 engine fleet for the Lockheed Martin C-130J, the Alenia C-27J, and other transport/patrol aircraft, expanded in 2012.

The TP400 engine for the Airbus A400M military transport aircraft has amassed over 16,000 engine flying hours in its flight-test programme. Engine deliveries for the first production aircraft began in 2012, with entry into service planned for 2013.

Flight-tests of a technology upgrade for the T56 engine were successfully concluded by the US Air Force. Our '3.5 upgrade' kit will provide operators of legacy variants of the C-130 and P-3 aircraft with significant fuel savings and, therefore, reduced operating costs.

Combat

2012 was a significant year for the Rolls-Royce LiftSystem® which provides the STOVL capability for Lockheed Martin's F-35B Lightning II Joint Strike Fighter. The US Marine Corps and the UK MoD received their first deliveries of their STOVL aircraft. The F-35B exceeded the 500th short take-off milestone early in the year and the US Marine Corps commissioned its first operational squadron of F-35Bs in Yuma, US.

We delivered the 300th EJ200 engine built by Rolls-Royce for the Eurofighter Typhoon programme, which has significant export opportunities in the Middle East and Asia. The Kingdom of Saudi Arabia is already a major export customer and at the end of 2012 Oman announced its intention to purchase 12 Typhoon aircraft.

In the US, we initiated testing on a new, advanced technology engine compressor, focusing on reducing fuel consumption as part of our involvement in the Highly Energy Efficient Turbine Engine (HEETE) programme for the US Air Force.

Together with Snecma, we signed a contract to study the architecture and characteristics required for the next generation of UK and French combat aircraft engines.

Unmanned vehicles

The fleet of AE 3007H engines which power the Northrop Grumman Global Hawk high-altitude long-endurance and Triton platforms continues to grow, with 67 engines delivered and about 50 additional engines projected.

Rolls-Royce is to power the US Navy's Broad Area Maritime Surveillance (BAMS) aircraft and we also see opportunities in the US Navy's Unmanned Carrier Launched Airborne Surveillance and Strike (UCLASS) aircraft programme.

The first flight of the Adour-powered nEUROn, an unmanned combat air vehicle developed by six European partners, took place. The stealth technology demonstrator will undergo testing in France before moving to Sweden, in 2014 for operational trials, and also to Italy to measure stealth characteristics and undergo live-firing tests.

Small engines

We delivered the first production M250 engines to Grob for its new G120TP trainer aircraft, while in helicopters the RR300 achieved its first 30,000 hours flight time on the Robinson R66 and the CTS800 engine surpassed 100,000 in-service flight hours. The M250, which has now amassed over 200 million flight hours, powered the first flight of the GippsAero GA10, while the CTS800 achieved FAA certification for the Turkish T129 ATAK helicopter.

Services

The provision of engine support through MissionCare™ continues to generate significant revenues across a wide range of engines. The US Armed Forces placed contracts to support engines powering C-130, V-22, T-45 Goshawk aircraft and Kiowa Warrior helicopters totalling over US$560 million.

The Royal Australian Air Force became the first military customer to implement fuel usage analysis and modelling techniques, to help improve the fuel efficiency of its C-130 transport fleet. The techniques were first developed by Rolls-Royce for civil airline customers.

We opened our first US Operations Centre in Indianapolis, US. The US$2 million investment will offer technical support from a 50-strong team of technical and engineering experts. We also opened the first Defence Service Delivery Centre at RAF Marham in the UK.

Marine

The order book increased 44 per cent including new orders of £3.3 billion (2011 £2.1 billion). This includes the £1.1 billion order by the UK MoD to deliver reactor cores for its future fleet of nuclear-powered submarines. Offshore orders reflected improved demand in the oil and gas sector, especially for drill ships and support vessels in Brazil. This was partially offset by continued weak order flow in the merchant sector.

Highlights

- £147 million in new orders from Brazil for drill ships and highly complex offshore vessels
- £119 million of contracts to design and equip ten offshore supply vessels for COSCO, Farstad and Hyundai
- First contract for MT30 gas turbine outside of US and UK home markets – chosen by Republic of Korea Navy for future frigate
- US Navy contract to power the two latest Littoral Combat Ships
- MT7 gas turbines chosen for US Navy's future hovercraft fleet
- World's first gas-powered tug commissioned and world's first gas-powered cargo vessel entered service
- £1.1 billion order for naval nuclear reactor core programmes

Key financial data

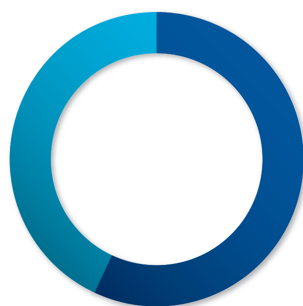
	2008	2009	2010	2011*	**2012**
Order book £m	5,190	3,526	2,977	2,737	**3,954**
	+10%	-32%	-16%	-8%	**+44%**
Underlying revenue £m	2,204	2,589	2,591	2,271	**2,249**
	+42%	+17%	+0%	-12%	**-1%**
Underlying OE revenue £m	1,492	1,804	1,719	1,322	**1,288**
Underlying service revenue £m	712	785	872	949	**961**
Underlying profit before financing £m	183	263	332	287*	**294**
	+62%	+44%	+26%	-14%	**+2%**

* 2011 figures restated due to transfer of Bergen to new Engine Holding segment

Rolls-Royce has a world-leading range of capabilities in the marine market, encompassing the design, supply and support of power and propulsion systems.

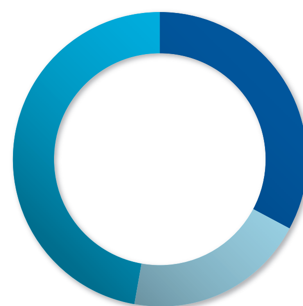
We are leaders in the integration of technologically complex systems for offshore oil and gas, merchant and naval surface and submarine vessels. Comprehensive through-life support for our customers is provided through an expanding global network of service facilities.

Revenue mix



- 57% OE revenue
- 43% Services revenue

Revenue by market sector



- 33% Naval
- 20% Merchant
- 47% Offshore

Revenue reduced by one per cent, reflecting increased pricing pressure and adverse foreign exchange movements. Both OE and services revenue improved in the second half, reflecting improvement in the offshore sector and a better capture of the services market resulting from the recent expansion of our global network of services centres.

Profit increased by two per cent due to better revenue mix and cost reduction, partially offset by pricing pressures and adverse foreign exchange movement.

Increased price pressure had an effect on trading, there was a reduced order flow in some merchant sectors and challenges to naval budgets in developed economies. Despite these headwinds, the Marine business continued to perform well in 2012.

We remain well positioned to capitalise on opportunities in the highly specialised offshore oil and gas sector. In addition, we are leveraging our global support network to service an increasing proportion of the installed base of equipment.

We continue to strengthen our position in new markets, including Brazil and Korea.

Marine

Offshore
We further consolidated our strong position in the oil and gas sector with encouraging growth in order intake, revenues and profitability. This was largely based on the success of our specialist UT vessel design capabilities, which now includes highly efficient wave-piercing vessels.

As the industry continues to explore deeper and more challenging environments, like those in the South Atlantic off the coast of Brazil and in the Arctic region, our core product and systems capabilities enable us to be a strong partner for our offshore customers.

Merchant
We continue to invest in technology that addresses the need for cleaner, more efficient and environmentally sustainable power and propulsion systems. Our market leading LNG-fuelled C engine positions us well for opportunities that arise from stricter environmental standards from 2016. Ship design enhances our ability to offer integrated solutions.

Naval
In our surface naval activities, we are developing greater design capabilities for auxiliary craft. Our innovative commercial ship design capability was extended with a new team to design ships for navies, coastguards and other maritime agencies.

In 2012, we delivered gas turbine-based power and propulsion equipment for the US Navy's Littoral Combat Ship and the Royal Navy's Queen Elizabeth class aircraft carriers. The MT30 gas turbine's success on both of these programmes has generated strong interest from navies in Europe, South America and in Asia where the Republic of Korea Navy chose the MT30 to power its next generation frigate programme.

The MT7 gas turbine was selected to power the US Navy's future fleet of up to 73 hovercraft.

Underlining the high level of confidence that the MoD has in our technology and our people, the Submarines business secured a contract worth £1.1 billion for the regeneration of the reactor core manufacturing facility at Derby and the continued delivery of reactor cores for the UK's nuclear powered submarine fleet.

Rolls-Royce continued to deliver against key milestones in the programme to replace the current Vanguard class of nuclear submarines, ensuring further long-term stability for the naval reactor business.

The opening of the new Primary Components Operations facility in the UK during the year, allowed the Group to rationalise its component manufacturing capability, delivering improved efficiencies for our customer.

Services
In 2012, we enhanced our capacity to realise better the significant opportunity that our large installed base of equipment represents. We expanded our service centre network through the opening of new facilities in China, and introduced a streamlined global spare parts distribution network and 24/7 service desks to improve customer delivery and responsiveness. In addition, we also opened a state-of-the-art technology and training centre to provide closer customer support.

Energy

The order book reduced by nine per cent, with new orders of £0.8 billion (2011 £1.3 billion). In the oil and gas market, high oil prices and global growth continue to sustain bid activity, albeit with pricing pressures and order deferrals by some customers. While the power generation market in mature economies remains suppressed, we are seeing growth in developing countries. We continue to invest for future growth in Civil Nuclear.

Highlights

- Six RB211 gas turbine packages ordered by PetroChina
- Service revenue up 11 per cent, 333 engines under management
- LG acquired 51 per cent of Rolls-Royce Fuel Cell Systems (US) Inc.
- Tidal Generation Ltd sold to Alstom in January 2013
- RB211-Gzero launched
- £1.5 million investment 24/7 global Operational Service Desk completed
- Enhanced agreement with AREVA for UK civil nuclear new build
- Collaboration agreement with Hitachi following its acquisition of Horizon Nuclear Power
- Expanded global footprint with acquisition of US-based nuclear services business

Key financial data

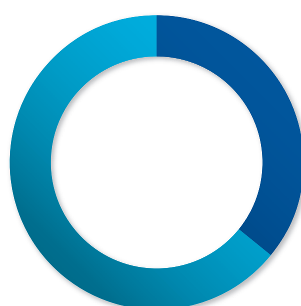
	2008	2009	2010	2011*	**2012**
Order book £m	1,250	1,262	1,180	1,420	**1,290**
	+45%	+1%	-6%	+20%	**-9%**
Engine deliveries	106	87	95	48	**49**
Underlying revenue £m	755	1,028	1,233	1,083	**962**
	+35%	+36%	+20%	-12%	**-11%**
Underlying OE revenue £m	385	558	691	527	**344**
Underlying service revenue £m	370	470	542	556	**618**
Underlying profit before financing £m	(2)	24	27	16	**21**
	-140%	+1300%	+13%	-41%	**+31%**

* 2011 figures restated due to transfer of Bergen to new Engine Holding segment

With over 4,600 industrial gas turbines sold, recording over 180 million hours of operating experience, our Energy business plays a critical role in supporting global infrastructure.

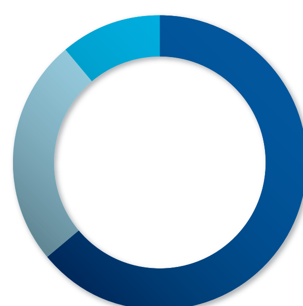
Our technology powers offshore oil platforms around the world and transports oil and gas through 35 pipelines in 24 countries. Our power generation technology solutions ensure that reliable, dependable and flexible electricity supplies are efficiently met, without comprising emissions performance. We have also established a strong position in the civil nuclear sector.

Revenue mix



36% OE revenue
64% Services revenue

Revenue by market sector



64% Oil and gas
25% Power generation
11% Civil Nuclear/other

Revenue fell by 11 per cent due to a significant reduction in OE revenue and adverse revenue mix in oil and gas, and in power generation. The OE reduction was partially offset by an 11 per cent increase in services revenue. Services revenue, particularly in oil and gas, benefited from a better penetration of the aftermarket from the installed base across all sectors.

Oil and gas

In total, ten RB211 gas turbines were ordered for oil and gas applications, nine of which are for pipeline compression projects. We secured a US$75 million contract to supply PetroChina with an additional six RB211-driven pipeline compressor units and related services to power the flow of natural gas through Line 3 of the West-East Pipeline Project (WEPP), the world's longest pipeline and a crucial element of China's drive towards cleaner energy consumption. When completed in 2015, the 7,000km WEPP Line 3 will link China's western Xinjiang autonomous region to Fuijan province in the south-east, transporting up to 30 billion cubic metres of gas per year. The contract significantly increases our supply to the WEPP network, bringing the total number of RB211 units sold for this huge infrastructure project to 37.

In addition, we secured a £24 million contract to supply three RB211 units for duty on the Uzbekistan section of the Asia Trans Gas (ATG) pipeline, and a contract to supply PTT's Ethane Separation Plant in Rayong, Thailand, with an additional unit to extend our scope at the site.

Construction of our new purpose-built packaging, assembly and test facility at Santa Cruz outside Rio de Janeiro, Brazil, is on track. The facility will open in 2013, positioning us for long-term growth from within Brazil. The first units to be delivered from Santa Cruz will be in fulfilment of the US$650 million contract awarded by Petrobras in 2011 which requires 32 RB211 gas turbine units to support its offshore production activities in the pre-salt, ultra-deepwater oil fields.

Power generation

Despite subdued demand for new power generation capacity in mature economies, £62 million in orders were received for four industrial Trent 60 gas turbines. Two units will support production expansion of LUKOIL's Stavrolen petrochemicals plant in Russia, and single units will respectively support Empresa Nacional de Electricidad's El Alto power plant in Bolivia, and textile and chemicals conglomerate CYDSA's processing plants at Coatzacoalcos Veracruz, México. We successfully completed several landmark installation and commissioning projects, including eight Trents for the Bayonne Energy Centre electric power plant in Bayonne, NJ, US, which supplies electricity to 400,000 homes in New York City at peak times.

Service

Our strategy to strengthen our aftermarket products and services capability delivered solid revenue growth. Excluding the land-based reciprocating engines that are now reported in Engine Holding, there are a total of 333 units, or 19 per cent of the core engine fleet, under long-term service agreements. We launched the RB211-Gzero, a retrofit upgrade product for the RB211-G gas generator, which provides many existing users of industrial RB211 aero-derivative gas turbine engines with a nominal power increase of ten per cent depending on ambient temperature and engine type.

Our new Operational Service Desk provides 24/7 technical support to customers, considerably enhancing our global service and parts delivery capabilities.

Civil Nuclear

During 2012, Rolls-Royce maintained its focus on the global and strategic growth of its Nuclear business and made solid progress in strengthening its position in this market.

We signed a strategic collaboration agreement in support of AREVA's plans to build new nuclear reactors and continued our collaboration with Rosatom on the development of global civil nuclear programmes. We have an agreement to support Hitachi, with its plans to build nuclear power stations at two sites in the UK.

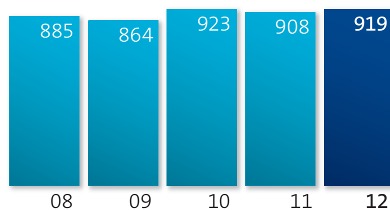
The Group is modernising safety-critical instrumentation and control (I&C) systems on EDF's 1,300MW nuclear fleet in France and we are delivering I&C solutions to eight new nuclear power stations being built in China.

Our Nuclear Services business delivered a multi-million dollar package of automated handling, transportation and storage technology to Atomic Energy of Canada Ltd and secured a contract to provide specialist inspection solutions to Canadian nuclear utility, Bruce Power. At the end of 2012, we acquired PKMJ Technical Services, a specialist US-based software and nuclear engineering services company.

Excellence in technology

In 2012, Rolls-Royce invested £919 million in gross research and development of which £577 million was funded from the Group's own resources. We create intellectual property which is then embedded in our products and services. This year, 475 patents were filed.

Gross research and development



Rolls-Royce has a track record of innovative products and services founded on a robust investment in technology. During 2012, we launched an Innovation Strategy which put in place a number of mechanisms to encourage our people to share and develop new ideas, ensuring that the flow of future technology remains strong. Through 'open innovation' we also invited other organisations to contribute to our technical challenges.

This year we invested significantly on our high-performance computing (HPC) capability and on several Design Key Systems which automate much of the design and make process for components, freeing up engineers to apply their skills to more complex and critical tasks.

Research and technology

We have an engineering resource inside the Group of 14,700 engineers. Many work as integrated teams across international borders on our major programmes and a number of our top engineers, or Rolls-Royce Fellows, are recognised as world-renowned experts in their fields.

In addition to our in-house R&D capability, Rolls-Royce undertakes advanced research via a global network of 28 university technology centres. Each centre is funded by the Group and undertakes specialist work in a particular engineering field, led by world-class academics. In 2012, we celebrated the 21st anniversary of this network.

In 2012, we invested £139 million in research and technology in addition to the significant government funding. In October 2012, together with the University of Birmingham, we announced a new £60 million centre for research into high-temperature metallurgy. This is the latest in a series of seven new research and advanced manufacturing centres the Group has helped to establish in the past four years. We believe our leading position in these centres will deliver significant benefit for the future in technologies and advanced manufacturing processes.

Civil aerospace

Our newest large engine programme, the Trent XWB for the Airbus A350 XWB family was successfully certificated on 7 February 2013. It began its flight-test programme in February 2012 on a modified A380 and completed over 150 flying hours. The initial engine entering service will be rated at 84,000lb thrust. The more powerful 97,000lb thrust engine for the later A350-1000 aircraft programme is progressing into the design and definition phase.

The new Trent 1000 engine was the first to enter service on the Boeing 787 Dreamliner and completed its first year in service with launch customer ANA, in October 2012.

Gulfstream's ultra-large-cabin, ultra-long-range G650 business jet aircraft with the BR725 engine, has received its final certification from Federal Aviation Administration and entered into service.

We successfully completed the E3E programme in 2012 which demonstrated core technology for our future two-shaft engine portfolio. Offering significant improvements in fuel consumption, unit cost, weight and emissions, it provides technologies for our BR700-NextGen and into our wider portfolio.

Defence aerospace

Since the T56 entered production in 1954, over 18,000 T56/501-D turboprops have been installed on a wide variety of propeller-driven aircraft. We recently successfully created a technology insertion package to significantly improve fuel efficiency on the US Air Force's C-130H Hercules transporter. In tests, our T56 Series 3.5 Enhancement Package demonstrated an eight per cent fuel consumption improvement. Once certified, the T56 Series 3.5 will help extend the life of this ageing fleet.

Our T56-A427A engine, with a modern electronic engine control and fuel pump metering unit replacing the previous hydro-mechanical control, is now ready for full production after receiving US Navy military qualification and successfully completing the initial operational test and evaluation. Two of these engines power the US Navy's E-2D Advanced Hawkeye airborne early warning and electronic warfare systems aircraft.

The Rolls-Royce LiftSystem for the F-35B Lightning II STOVL fighter aircraft entered service with the US Marine Corps in late 2012.

Marine

The Far Solitaire, a Rolls-Royce designed platform supply vessel for the offshore oil and gas industry, was named ship of the year at the Shipbuilding, Machinery and Marine Technology exhibition, the leading international maritime trade fair. This is the third time in five years a Rolls-Royce designed vessel has won the award.

We have delivered our first permanent magnet tunnel thruster. This new design reduces noise and vibration and increases power by 25 per cent, compared to traditional models of the same size.

Design of the PWR3 nuclear power plant for the UK Trident Successor Programme is progressing well. The new reactor plant design was selected by the UK MoD to provide easier operation, longer service life and lower through-life costs. A UK Government decision on the successor to Trident is planned for 2016.

Energy

The successful industrial version of the RB211 gas turbine is used all over the world in oil and gas and power generation markets. Over 700 industrial RB211s have been sold, achieving more than 30 million operating hours. In 2012, we announced the launch of the RB211-Gzero a retrofit upgrade product that provides the engine with a nominal power increase of ten per cent.

The distinctive power and efficiency of the industrial Trent were strengthened in 2012, together with its capability on low emissions and its operational flexibility for oil and gas applications.

Excellence in operations

We continue to invest globally in capacity and capability that will help our customers and our business succeed.

Manufacturing technology and infrastructure
Through the year, good progress has been made on the introduction of a broad spectrum of technology projects that will reduce operational costs, increase output and improve product performance.

Manufacturing capacity
We have added significant manufacturing capacity to meet our customers' needs and to successfully deliver our substantial order book.

Rolls-Royce has opened 19 new facilities in the past three years in locations including the UK, Germany, Norway, US, Singapore, China and Brazil.

In 2012, we opened our largest facility in Asia, at Seletar Aerospace Park in Singapore, and delivered our first Trent 900 engine from the site. At full capacity, this facility will be capable of producing a Trent engine every working day and 6,000 fan blades each year.

Other major projects include: construction of an advanced blade casting facility in Rotherham, UK, and our advanced blade and vane machining facility at our Crosspointe campus in Virginia, US. We also made a significant extension to our engine testing facility in Dahlewitz, Germany and developed a major facility for assembly and test in Rio de Janeiro, Brazil, that will support our Marine and Energy businesses.

Advanced centres
Five advanced manufacturing research centres are now all fully operational in the UK with the number of research projects doubling over the past 12 months to more than 160.

The sixth centre of the network, in Virginia, US, opened its doors in September and building work has started in Singapore on an advanced remanufacturing and technology centre.

These centres, which are the result of collaboration between governments, universities and industrial partners, form a vital bridge between the creation of a concept and industrial application. This allows us to work with suppliers, university research teams and technology providers to develop and prove manufacturing processes before making major investment decisions.

Suppliers
As an increasingly global business, we continue to develop our supply base in emerging markets, whilst also deepening our relationship with existing suppliers.

In the UK, we are taking a leading role in the UK Government's 'Sharing in Growth' initiative which will provide around 30 UK suppliers with a tailored, in-depth training and development programme. The aim is to create a competitive group of UK suppliers to help achieve sustainable, competitive performance as the industry continues to grow.

As we work alongside our suppliers, we also have to make sure we strike the right balance between what we choose to do ourselves and what we buy. We have acquired the Aero Engine Controls (AEC) business, in order to strengthen our offering in the increasingly important engine control systems market.

Information technology
In 2012, we invested over £100 million in IT as part of our ongoing investment programme. This programme is addressing the need to modernise data centres, improve networks, and upgrade personal computers and software across more than 265 sites in 39 countries.

Continuous improvement
We continually apply technology and operational improvements to drive productivity and the efficiency of the power systems we produce.

We apply lean techniques to our design, manufacture and our suppliers so that the actions of everyone involved will drive efficiency, quality and safety in all we do.

Sustainability – better power for a changing world

As a leader in technology, we believe that advanced engineering has a critical role to play in achieving a sustainable future. We are committed to developing the most efficient power systems in the world. This helps the environment and our customers by enabling them to do more, using less. Focusing on the environmental performance of our products and operations, investing in our people and, engaging with our communities helps grow our business.

CARBON DISCLOSURE PROJECT

Carbon Disclosure Project (CDP)
We continue to be one of the leading companies in the CDP Index. Our 2012 carbon disclosure score was 72 and our performance band 'B'. We led the Global 500 industrials in governance and strategy, emissions management and reporting.

Dow Jones Sustainability World and European Indexes (DJSI)
We have retained our position in the DJSI for the eleventh consecutive year, with an overall score of 74 per cent, well above the average of 42 per cent in the aviation and defence sector.

Environment

We apply our knowledge and technology to develop the best solutions for the environment and our customers. Our environmental strategy has been revised in 2012 to reflect the main focus of investment and effort applied by the Group, concentrating on three areas:

1. support customers by further reducing the environmental impact of our products and services;

2. develop new technology for future low-emission products; and

3. maintain our drive to reduce the environmental impact of our business activities.

1. Support customers by further reducing the environmental impact of our products and services

We have a strong track record of reducing the emissions of our products through significant investment in R&D. In 2012, we invested £919 million in R&D, of which around two thirds is aimed at reducing the environmental impact of our products. Since the first jet airliners of around 50 years ago, on a per passenger-kilometre basis, aircraft burn 70 per cent less fuel and are 75 per cent quieter. An Environmental Advisory Board of distinguished academics and leading authorities in their respective fields, provides independent expert advice to inform business strategy and design processes.

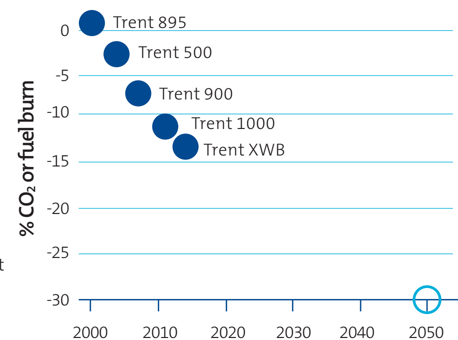
The Advisory Council for Aviation Research and Innovation in Europe (ACARE) has set challenging goals for aviation to meet by 2050 (base year 2000). In 2012, we helped define the priorities for Strategic Research and Innovation in aviation to meet the ACARE goals:

- reducing aircraft CO_2 emissions by 75 per cent per passenger kilometre;
- reducing noise by 65 per cent; and
- reducing oxides of nitrogen (NO_X) by 90 per cent.

Innovation provides increasingly efficient products worldwide
The Trent XWB – due to enter service in 2014 – is proving to be the most efficient large civil aero engine ever produced, burning 16 per cent less fuel per passenger kilometre than our first Trent engine which entered service in 1995.

CO_2 (Engine)

ACARE Target:
75% overall reduction in CO_2 per passenger kilometre 30% engine contribution (Rolls-Royce engine long-term goals).



We are investing in technology to provide more efficient marine power and propulsion systems as well as 'whole ship' integrated designs. In 2012, we delivered our first lean-burn gas-powered platform supply vessel cargo ship and announced orders for our first gas-powered tugs. We introduced new propulsor technologies, including our first permanent magnet tunnel thruster and our first thruster to make extensive use of composite materials.

Innovative vessel designs use the Environship concept, incorporating wave-piercing hull features. A liquefied natural gas engine and an integrated rudder and propeller system combination can reduce fuel consumption, and cut CO_2 emissions by up to 40 per cent compared to conventional vessels.

In energy markets, our Trent 60 is the most advanced aero-derivative gas turbine available today, establishing a new benchmark for fuel economy and cost savings. Our RFA36 and RFA24 are the most efficient pipeline compressors available today with field-proven efficiencies of up to 91 per cent, saving energy costs for our customers.

2. Develop new technology for future low emission products

Nuclear power can make a significant contribution to future low carbon electricity generation.

As a key player in the industry for 50 years, we have extensive knowledge of nuclear technology, its safety and control. Our nuclear capabilities span the reactor life-cycle, from concept design through to obsolescence management and plant life extension.

Our expertise including component manufacturing, licensing, project and supply chain management as well as world-class engineering, positions us well to support nuclear power growth.

We are also 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 greenhouse gas (GHG) emissions.

3. Maintain our drive to reduce the environmental impact of our business activities

Greenhouse gas emissions

In 2009, we set three year GHG reduction targets for our facilities and can now report that we have exceeded these (see table below).

2012 final target achievement

Target area	Targeted reduction by end 2012 [1]	Actual [2]
Facility GHG emissions (absolute) excluding product test and development	5%	6.5%
Total Group GHG emissions (normalised by turnover) including product test and development	10%	16%

[1] Based on 2009 GHG emissions
[2] Energy/GHG data has been forecast based on data collected during January to October 2012. The 'Basis of Reporting' is available at www.rolls-royce.com

Our total GHG emissions (including product test and development) was 550 ktCO_2e in 2012, a reduction of four per cent compared with 572 ktCO_2e in 2009 (see table below). This reduction has been achieved, despite a growth in our global facilities footprint, through a sustained investment in new and more efficient manufacturing facilities. In 2012, we invested over £3 million in energy reduction projects such as the upgrade of compressed air plant, furnace controls and, lighting systems and controls within our existing facilities.

GHG emissions breakdown

Total ktCO_2e (includes emissions associated with product development and testing)	2009	2010	2011	2012
Direct emissions	215	236	229	213
Indirect emissions	357	365	346	337
Total	572	601	575	550

We continue to recognise the need to reduce the emissions of our operations and we are reducing our reliance on fossil fuels. We are seeking to make wider use of more sustainable energy sources, like renewable and other low carbon technologies, where cost effective and practical.

New energy and GHG reduction targets aimed at sustaining our improvement will be set for the next three years.

Certification

Our business segments have certification to the environmental management systems standard ISO 14001.

Global supply chain

During 2012, we expanded the application of lean techniques across the supply chain. Our suppliers increased their metal recycling and further engaged in paperless purchasing practices. We continue to request key suppliers are ISO 14001 certificated and support them to meet their obligations under the European REACH (Registration, Evaluation and Authorisation of Chemicals) legislation.

Our people

We support business growth by creating an inclusive working environment that attracts and retains the best people.

We employ 42,800 people in more than 50 countries across our four global market sectors:

Average number of employees	2012	2011
By region		
United Kingdom	22,800	21,600
Rest of the world	20,000	18,800
Total	42,800	40,400
By sector		
Civil aerospace	21,500	19,800
Defence aerospace	7,800	7,600
Marine	8,800	8,600
Energy	3,700	3,500
Engine Holding	1,000	900
Total	42,800	40,400

Rolls-Royce is committed to creating a working environment which helps people to perform at their best. Great value is placed on giving a voice to our workforce and we engage and involve people in improving the business and welcome their feedback. Information on business and work issues is shared with our employees and their representatives through established communication channels. We reward and recognise high performance and encourage our employees to become investors in the Company.

Human rights are reflected in our policies and standards covering Business Ethics, Health and Safety, the Environment, Employees, and Community Investment. We oppose any form of child labour or practices which inhibit the development of children. We believe employment should be freely chosen and commit to refrain from using forced or involuntary labour.

Encouraging diversity

Our Global Diversity and Inclusion Steering Group is comprised of main board directors and senior executives. It promotes an inclusive workplace in which individuals feel they are respected, valued and have an equal opportunity to progress.

The Group's global workforce is 15 per cent female with eight per cent female senior executives. About two thirds of our workforce is in engineering or manufacturing with historically low female representation. We actively work with schools and universities to increase interest and encourage diversity amongst those taking STEM subjects, and to broaden the career aspirations of individuals from under-represented groups.

Our female and international graduate recruitment has increased steadily over recent years, 26 per cent of overall graduate development programme participants are female and 38 per cent are non-British. Around 50 per cent of participants are female in our non-engineering and non-manufacturing programmes.

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

Resourcing and development

In 2012, we recruited over 2,800 experienced professionals to support the growth of our business, nine per cent higher than in 2011. We recruited 318 apprentices. We engage with universities globally, and in 2012 recruited 312 graduates on to our corporate graduate programme from 89 universities and 36 nations. To support long-term growth objectives, we plan to further increase our graduate programme in 2013.

In 2012, we supported 47,500 employees and sub-contract personnel through our learning management system, MyLearning. A total of 249,000 training courses were completed during the year. Learning investment for 2012 was £39 million.

In November, the Chancellor of the Exchequer, George Osborne, opened the new apprentice academy in Derby. The £6 million investment, supported by the Skills Funding Agency, provides capacity for Rolls-Royce to double the number of apprentices it trains. They will provide an additional source of skilled employees to our supply chain. In the UK, the academy won the Gen II Macro Employer of the Year category of the National Apprenticeship Awards.

Our regional training centre strategy places product training close to our customers. A new training centre in Ålesund, opened by the Crown Prince of Norway in November, complements the existing facilities in Derby, Bristol, Singapore and Indianapolis.

Demand for customer training continues to increase with a 35 per cent growth in 2012. On-line learning is available to all our customers through the Group's website at www.rolls-royce.com.

Health and safety

Rolls-Royce is committed to continual improvement in the standards of health and safety in the workplace. A main board director has responsibility for this. The Board receives regular reports on progress against targets and improvement programmes.

Employees receive mandatory health and safety training. As a result of this focus, health and safety performance has shown steady improvement over many years. However, tragically, in 2012 we suffered two employee fatalities. In the first incident, an employee was fatally injured whilst working on electrical equipment at a customer site. In the second, an employee drowned in a river during a company organised event. Thorough investigations for both incidents were carried out. These are the first fatalities since 2008.

We continued to make progress on our major global improvement programmes. We reviewed machinery guarding and lifting programmes at 30 sites as part of our review of process safety management.

Business segments have global certification to OSHAS 18001, confirming our commitment to globally consistent health and safety standards.

Exposure monitoring confirmed that existing controls should meet the new exposure and release standards under the EU Registration, REACH regulations.

We further engaged our employees in improving health and safety with focused activities during HS&E Week and over 5,000 employees taking part in a global wellness programme.

Our total reportable injury (TRI) rate continues to decline – a 23.5 per cent drop in 2012 gives a 28 per cent reduction over the past three years from 0.72 TRI per 100 employees to 0.52. This fell short of our target of a 50 per cent reduction by the end of 2012. Our primary focus has been on high potential incidents which could lead to significant injury or harm, rather than the broader measure of TRI which also includes minor incidents.

Engaging with governments and communities

Working with governments

We engage in dialogue to align our business needs with the political, social, and commercial requirements of host governments in our key markets. Where we achieve such alignment, for example in Singapore, the benefits for both the Group and the country can be considerable.

In the UK, the Government has made strategic investments in the aerospace industry through the Aerospace Growth Partnership. In 2012, they announced a £40 million investment, matched by industry, in the Rolls-Royce led SILOET II programme (Strategic Investment in Low-carbon Engine Technology). We expect this programme to deliver improvements in engine fuel economy for both widebody and narrowbody civil aircraft.

A further Government investment of £25 million was added to the £40 million from industry to support a series of research and technology projects including SAMULET II (Strategic Affordable Manufacturing in the UK through Leading Environmental Technologies). This Rolls-Royce led collaborative programme aims to accelerate the development of manufacturing and product technologies.

This year the Business Secretary, Vince Cable, performed the groundbreaking ceremonies for our new factories at Rotherham and Washington, Tyne and Wear, UK.

In view of the importance of EU regulation and funding for the Group's activities, Rolls-Royce enlarged its EU Affairs team in Brussels. Our main EU affairs activities in 2012 focused on two areas: financial regulation and the future framework for EU R&D funding.

We continued to monitor EU legislation on financial regulatory reform for its impact on non-financial companies like Rolls-Royce. Throughout the year, we provided input to the decision-making procedure on Horizon 2020 – the EU Research and Innovation funding framework for 2014-2020. Other policy areas have also required our attention, such as: REACH; the future monitoring, reporting and verification system for maritime emissions; revised noise rules in the field of aviation; alternative fuel policies; and international free trade agreement negotiations. We organised high-level meetings with relevant EU Commissioners during the year; gave evidence to the 'Liikanen group', the EU's high-level group on reforming the structure of the EU banking sector; and submitted responses to a number of Commission consultations. Rolls-Royce is registered in the EU's Transparency register where more information about our activities and involvement in associations can be found.

In North America, our relationships with a variety of domestic industry and government bodies provide an essential platform to communicate on a broad array of issues from aviation emissions to energy-related appropriations.

We engage with Congress (in both the House of Representatives and the Senate) at the Committee, District and State level. Our Political Action Committee (PAC) operates in accordance with all legal and ethical requirements.

We have hosted a number of Congressional visits including President Obama's visit to our new Crosspointe facility, Virginia, US.

Our membership of North American major trade associations (including the Aerospace Industries Association, Organization for International Investment and the US Chamber of Commerce), enables us to support broader coalition efforts. This guards against any potential protectionist measures which may be detrimental to Group interests.

Community investment

We have a long-standing commitment to the communities we operate in around the world and during 2012 the Group's total contribution (including money, employee time and gifts in kind) was £8 million.

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

The main areas of support defined in our global charitable contributions and social sponsorships policy are:

- education and skills, particularly Science, Technology, Engineering and Mathematics (STEM) which are key to our future success;
- environment activities linking into our environment strategy;
- social investment, making a positive difference to the communities in which we operate; and
- arts, culture and heritage, contributing to the cultural vibrancy in the areas we operate.

A clear governance structure ensures a consistent approach and visibility of our contributions globally.

2012 charitable contributions, sponsorship and payroll giving

	£ million
Charitable contributions and social sponsorships:	
UK	2.3
Asia and Middle East £0.1m, Americas £0.8m, Europe £0.3m	1.2
Total	**3.5**
Commercial sponsorship – global total, including: UK £0.3m, Asia and Middle East £0.3m, Americas £1.3m, Europe 0.2m	2.1
Employee time	2.2
Gifts in kind	0.2
Total	**8.0**
Payroll giving UK £0.5m, North America £0.2m	0.7

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:

		2012	2011	Change
USD per GBP	Year end spot rate	**1.63**	1.55	+5%
	Average spot rate	**1.59**	1.60	-1%
EUR per GBP	Year end spot rate	**1.23**	1.20	+3%
	Average spot rate	**1.23**	1.15	+7%

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 16 to the financial statements. The Frc is chaired by the Chief Financial Officer.
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	2012	2011
Total equity	**6,825**	4,678
Cash flow hedges	63	52
Group capital	**6,888**	4,730
Net funds	**1,316**	222

Operations are funded through various shareholders' funds, bank debt, bonds and notes. 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.

During the year, the Group drew down a further £200 million loan from the European Investment Bank. Following the acquisition of the 50 per cent of AEC that we did not already own (see note 24 of the financial statements), the Group repaid AEC's external bank funding of £78 million.

At year end, the Group retained aggregate liquidity of £3.6 billion. This liquidity comprised net funds of £1.3 billion and aggregate borrowing facilities of £2.3 billion, of which £1.0 billion remained undrawn.

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. The only facility to mature in 2013 is the US$230 million private placement. 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 2012, the maturity date on the £1.0 billion revolving credit facility was extended from 2016 to 2017.

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 debt is further outlined in note 9 to the financial statements.

Credit rating

	Rating	Outlook	Grade
Moody's Investor Service	A3	Stable	Investment
Standard & Poor's	A	Stable	Investment

The Group's holding company, Rolls-Royce Holdings plc, subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings. At 31 December 2012, it 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 these 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 2012, the Group has adopted revisions to IAS 1 *Presentation of Financial Statements* that require items of other comprehensive income to be classified depending on whether they may be potentially reclassified to the income statement. There is no net impact. There were no other revisions to IFRS that became applicable in 2012 which had a significant impact on the Group's financial statements.

A summary of changes which have not been adopted in 2012 is included within the accounting policies in note 1 to the financial statements.

Governments and regulators around the world continue to implement reforms to the financial markets with the aim of improving transparency and reducing systemic risk. Although the reforms are predominantly directed at financial institutions, they will also affect non-financial institutions such as the Group. The primary concern has been the reform of the over-the-counter (OTC) derivatives market, and in particular a proposal in the EU European Market Infrastructure Regulation (EMIR) that parties to future OTC derivative transactions would be required to use an exchange to clear the transactions and post cash collateral to reduce counterparty risk. The proposal could adversely affect the Group's future funding requirements and make cash flow more volatile. The final EMIR rules have now been released, which exempt non-financial institutions engaged in hedging activity from this requirement.

Board of directors

Sir Simon Robertson (71)
Non-executive Chairman, appointed January 2005

Skills and experience: Sir Simon brings to the Board an international corporate advisory background 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. He is the former Managing Director of Goldman Sachs International and former Chairman of Dresdner Kleinwort Benson. 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 Robertson Robey Associates LLP and Deputy Chairman and Senior Independent Director of HSBC Holdings plc. He is a non-executive director of Berry Bros & Rudd Limited, The Economist Newspaper Limited and Troy Asset Management. He is a Trustee of The Eden Project and of the Royal Opera House Endowment Fund.

John Rishton (54)
Chief Executive, appointed March 2011

Skills and experience: John began his career in 1979 at Ford Motor Company and held a variety of positions in the UK and in Europe.
In 1994 he joined British Airways Plc, where he was Chief Financial Officer from 2001 to 2005. In 2006, he was appointed CFO at Royal Ahold and became CEO in 2007. John was appointed as a non-executive director of Rolls-Royce in 2007 and served as chairman of the audit committee and a member of the ethics and nomination committees. He is a former non-executive director of Allied Domecq.

External appointments: Unilever have announced that John will be proposed to join the boards of Unilever NV and Unilever plc at the AGMs of those companies in May 2013.

Iain Conn (50)
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 Group Managing Director and Chief Executive of Refining and Marketing, BP p.l.c. He is Chairman of the Advisory Board of The Imperial College Business School and a member of the Imperial College Council. Iain is also a member of the Energy and Climate Change Board, CBI and a member of the advisory boards of the Centre for European Reform and of the Centre for China in the World Economy at Tsinghua University.

Dame Helen Alexander (56)
Non-executive director, appointed September 2007

Skills and experience:
Dame Helen was Chief Executive of the Economist Group until 2008, having joined the company in 1985. She was President of the CBI until 2011 and Deputy President until June 2012; she has also been a non- executive director of Northern Foods plc, BT plc and Centrica plc. Dame Helen was awarded a CBE for services to publishing in 2004 and was made a Dame Commander of the Order of the British Empire for her services to business in June 2011.

External appointments: Dame Helen is Chairman of UBM plc, the Port of London Authority (PLA) and Incisive Media. She is also deputy chairman of esure Group Holdings, senior adviser to Bain Capital and a Director of the CBI. Dame Helen is Chancellor of the University of Southampton and she is currently involved with a number of other not-for-profit organisations in media, the internet, the arts and education.

Lewis Booth CBE (64)
Non-executive director, appointed May 2011

Skills and experience: Lewis is the former Executive Vice President and Chief Financial Officer (CFO) of Ford Motor Company, a position he held for over three years until his retirement from the company in April 2012. During his 34-year career at Ford he held a series of senior positions in Europe, Asia, Africa and the United States. Lewis began his career with British Leyland, before joining Ford in 1978. He was awarded a CBE in June 2012 for services to the UK automotive and manufacturing industries.

External appointments: Lewis is a director of Mondelez International, Inc., Gentherm Inc. and of University of Liverpool in America Inc.

Peter Byrom (68)
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 (59)
Non-executive director,
appointed November 2011

Skills and experience: Sir Frank has worked in the oil and gas industry for 38 years including appointments within Royal Dutch Shell plc and BP p.l.c. He was Chief Executive of BG Group plc for 12 years until December 2012. Sir Frank graduated with first class honours in Mechanical Engineering from Queen Mary College, London University and is a Fellow of the Royal Academy of Engineering, the Institution of Mechanical Engineers and the Energy Institute.

Board of directors

John McAdam (64)
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 and is a former non-executive director of Severn Trent plc and Sara Lee Corporation.

External appointments: John is Chairman of United Utilities Group PLC and Rentokil Initial plc and the Senior Independent Director of J Sainsbury plc.

John Neill CBE (65)
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 formerly a Director of the Bank of England and a non-executive Director of the Royal Mail and Charter International plc. He was awarded a CBE in June 1994.

External appointments: John is the Chairman and Group Chief Executive of the Unipart Group of Companies.

Jasmin Staiblin (42)
Non-executive director, appointed May 2012

Skills and experience: Jasmin is the CEO of Alpiq Holding AG and was CEO of ABB Switzerland Ltd until December 2012. She has lived and worked in Switzerland, Sweden and Australia.

External appointments: Jasmin is a non-executive director of Georg Fischer AG, ETH Domain and Neue Aarguer Bank (a member of the Credit Suisse Group).

Ian Strachan (69)
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 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 (67)
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.

External appointments: Jim is Chairman of PrivateBancorp Inc., of Chicago, Illinois and he is lead independent director of priceline.com Inc of Norwalk, Connecticut. He is also Chairman of the Smithsonian National Air & Space Museum, Washington DC.

Mark Morris Age (49)
Chief Financial Officer, appointed January 2012

Mark joined Rolls-Royce in 1986. He has held a number of senior positions throughout the Company and prior to his appointment as Chief Financial Officer was Group Treasurer from 2001.

Colin Smith CBE (57)
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. He is also a Member of the Council for Science and Technology. In June 2012 he was awarded a CBE for services to UK engineering.

Nigel Goldsworthy (47)
Company Secretary & Head of Legal appointed December 2012

Skills and experience: A solicitor, Nigel has held a number of senior legal and company secretary roles within the Company and, before his appointment as Company Secretary & Head of Legal, was Deputy General Counsel from 2008. Before joining Rolls-Royce in 2004, Nigel was a partner in the banking group of Lovells (now Hogan Lovells).

At 31 December 31, 2012, all the directors were also directors of Rolls-Royce Holdings plc, the ultimate parent company. As directors of the ultimate parent company, there is no requirement to disclose their remuneration or their interests in the shares of Rolls-Royce group companies in this Directors' report, as they are included in the annual report of Rolls-Royce Holdings plc.

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.

The risk management process is a key element of the Group's internal control system and 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. The businesses regularly review the effectiveness and consistency of risk management via their assurance framework and the application of the risk management process is subject to review by internal audit.

Responsibility for internal control procedures in joint ventures where we do not have a control agreement lies with the managers of those operations. We seek to exert influence over such ventures by board representation and regularly review the activities of these ventures.

Rolls-Royce Holdings plc has established a risk committee. Every six months the risk committee reviews the key operational risks that the businesses and functions report in accordance with our enterprise-wide risk management policy. The risk committee also determines material external and strategic risks that exist at Group level. The principal risks are reported annually to the Board and are included on pages 14 and 15. In addition, reports and presentations are made to the Board on certain types of specialist risks eg treasury, insurable risks, pensions, health and safety as the risks evolve.

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 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's Finance Manual.

The audit committee

The Rolls-Royce Holdings plc audit 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 (previously termed 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.

Each year, the committee reviews the effectiveness and performance of the external auditors with feedback from committee members, senior finance personnel and internal audit. KPMG were appointed as auditors in 1990 and this appointment has not been subject to a tender process since that date. 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 completed his term in 2012. His replacement as lead audit partner has had no previous involvement with Rolls-Royce in any capacity. No contractual obligations restrict the committee's choice of external auditors. The committee concluded that KPMG provides an effective audit and the committee and the Board have recommended their reappointment.

A resolution to reappoint the external auditor, KPMG Audit Plc, and to authorise the directors to determine the auditor's remuneration, will be proposed at the AGM.

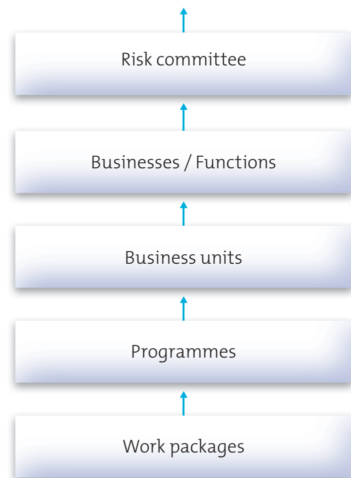
The risk committee

The Rolls-Royce Holdings plc risk committee is responsible for developing and, following Board review and approval, implementing the Group's risk management strategy and mitigation policy.

During the course of its meetings this year, the committee has spent time discussing and agreeing the most significant risks that the Group faces. The 17 risks listed in the last directors' report have been condensed to the eight that can be found on pages 14 to 15. Each of these risks is owned by specific members of the executive team, which reviewed and challenged itself as to how these risks were managed.

Development of principal risks

At the June 2012 committee meeting, the committee performed its usual task of considering any potential changes to the full corporate risk register. The risk register comprises those risks that are escalated to the committee following reviews carried out by the underlying business units, programmes and functions.



These reviews take place at least twice a year. Following discussion, the committee decided that this bottom up process could be sense checked by a top down process; asking each member of the committee to identify the risks they considered would have a significant impact on the Group. The resulting list did overlap with the bottom up approach but helped stimulate debate which led us to redefine some of the risks and produce a new list of principal risks.

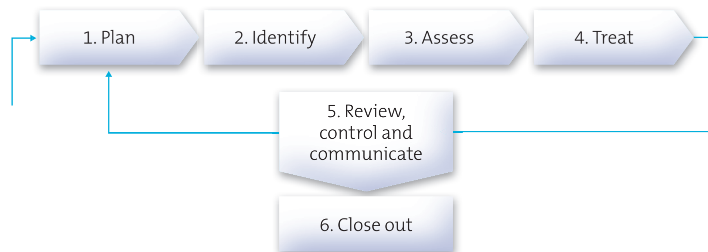
At the November meeting, this new list of principal risks was refined further, making changes to remove duplication and to define the risks more clearly. The committee discussed how the risks had changed and also reviewed how each risk was managed, identifying where further action was required.

In January 2013, the committee concluded this major review of the number and the nature of our risks and believes that the list reported on pages 14 to 15 represents the most significant risks that would have an acute and traumatic impact on the Group were they to occur.

The committee also resolved to develop key risk indicators to measure each of the principal risks and use them to inform us where future action may be required. These will complement the key performance indicators shown on pages 12 to 13.

Group risk process

The risk process is part of our quality management system that all parts of the business must follow and it is shown below.



The General Counsel & Head of Risk now leads our enterprise wide risk team which is responsible for the risk policy and processes. Line ownership for risk management is devolved into our business units and functions, supported by a network of risk champions and risk managers.

Ethics committee and the referral to the Serious Fraud Office

During the last year, much of the discussion at the Rolls-Royce Holdings plc ethics committee centred on specific concerns about bribery and corruption involving intermediaries in overseas markets. This followed a request for information from the SFO about allegations of malpractice in Indonesia and China. The review by our compliance team identified matters of sufficient concern to cause the committee to recommend to the Board that the law firm Debevoise & Plimpton LLP be instructed to conduct an independent investigation.

As a result of that investigation, on 6 December 2012 the Group announced that it was passing information to the SFO addressing their concerns in Indonesia and China and identifying further matters of concern in other overseas markets. The consequence of these disclosures will be decided by the regulatory authorities. It is too early to predict the outcomes but these could include the prosecution of individuals and of the Company. The Group is co-operating fully. John Rishton has stated unequivocally that neither he nor the Board will tolerate improper conduct of any sort and all necessary action will be taken to ensure compliance. The Board is committed to anti-bribery and corruption (ABC) compliance. The Board Charter includes a commitment to ensure the Group meets "the highest legal and ethical standards".

Shareholders and share capital

Share capital
Throughout 2012, the Company's authorised share capital was £400 million, comprising 2,000,000,000 ordinary shares of 20p. On 31 December 2012, there were 1,630,996,508 ordinary shares in issue.

The ordinary shares are not listed.

Dividends
No dividend was paid during the year. An interim dividend of £900 million is proposed to be paid in February 2013.

Other statutory information

Political donations
In line with its established policy, the Group made no political donations pursuant to the authority granted at the Rolls-Royce Holdings plc 2012 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 Rolls-Royce Holdings plc 2013 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 US was US$44,161 (2011: US$44,436). 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 Group 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 Rolls-Royce Holdings plc AGM.

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

The Company had the equivalent of 57 days' purchases outstanding at 31 December 2012, based on the average daily amount invoiced by suppliers during the year.

Indemnity
Rolls-Royce Holdings plc has entered into separate Deeds of Indemnity in favour of the Company's directors which were in force during the financial year and remained in force at the date of this report. The deeds provide substantially the same protection as that already provided to directors under the indemnity in Article 216 of the Articles of Association of Rolls-Royce Holdings plc. Rolls-Royce Holdings has also reviewed, arranged and maintains appropriate insurance cover for any legal action taken against the Company's directors and officers.

Annual report and financial statements

Statement of directors' responsibilities in respect of the directors' report and the financial statements
The directors are responsible for preparing the directors' 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 and 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 32 of the directors' report and a summary of the principal risks affecting the business are shown on pages 14 to 15.

The financial position of the Group, its cash flows, liquidity position, borrowing facilities and financial risks are described on pages 9 to 11 and pages 31 to 32 of the directors' report.

In addition, notes 1, 12, 14 and 16 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 31, 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 £1.3 billion was drawn at the year end. US$230 million of these facilities mature in 2013.

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 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 auditor is 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 auditor is 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 statements
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 39 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

Nigel Goldsworthy
Company Secretary

13 February 2013

Independent Auditor's report
to the Members of Rolls-Royce plc

We have audited the financial statements of Rolls-Royce plc for the year ended 31 December 2012, set out on pages 42 to 111. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRS) 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 auditor
As explained more fully in the directors' responsibilities statement set out on pages 38 and 39, 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 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 Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

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 31 December 2012 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRS 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 information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following:

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

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

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

13 February 2013

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Consolidated income statement

For the year ended 31 December 2012

	Notes	2012 Excluding IAE restructuring £m	2012 IAE restructuring £m	2012 Total £m	2011 £m
Revenue	2	12,161	–	12,161	11,124
Cost of sales		(9,416)	–	(9,416)	(8,676)
Gross profit		2,745	–	2,745	2,448
Other operating income		33	–	33	69
Commercial and administrative costs		(989)	–	(989)	(984)
Research and development costs		(589)	–	(589)	(463)
Share of results of joint ventures and associates	9	173	–	173	116
Operating profit		1,373	–	1,373	1,186
Profit on disposal of businesses	24	–	699	699	3
Profit before financing and taxation	2	1,373	699	2,072	1,189
Financing income	3	1,112	–	1,112	456
Financing costs	3	(479)	–	(479)	(539)
Net financing		633	–	633	(83)
Profit before taxation		2,006	699	2,705	1,106
Taxation	4	(447)	37	(410)	(257)
Profit for the year		1,559	736	2,295	849
Attributable to:					
Ordinary shareholders		1,545	736	2,281	851
Non-controlling interests		14	–	14	(2)
Profit for the year		1,559	736	2,295	849

Consolidated statement of comprehensive income

For the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Profit for the year		2,295	849
Other comprehensive income (OCI)			
Items that will not be reclassified to profit or loss			
Movements in post-retirement schemes	18	(259)	123
Share of other comprehensive income of joint ventures and associates	9	(46)	(3)
Related tax movements	4	91	(53)
		(214)	67
Items that may be reclassified to profit or loss			
Foreign exchange translation differences on foreign operations		(118)	(102)
Share of other comprehensive income of joint ventures and associates	9	(12)	(7)
Related tax movements	4	(1)	(1)
		(131)	(110)
Total comprehensive income for the year		1,950	806
Attributable to:			
Ordinary shareholders		1,936	809
Non-controlling interests		14	(3)
Total comprehensive income for the year		1,950	806

Consolidated balance sheet

At 31 December 2012

	Notes	2012 £m	2011 £m
ASSETS			
Non-current assets			
Intangible assets	7	**2,901**	2,882
Property, plant and equipment	8	**2,564**	2,338
Investments – joint ventures and associates	9	**1,800**	1,680
Investments – other	9	**6**	10
Other financial assets	16	**592**	327
Deferred tax assets	4	**330**	368
Post-retirement scheme surpluses	18	**329**	503
		8,522	8,108
Current assets			
Inventories	10	**2,726**	2,561
Trade and other receivables	11	**4,665**	4,205
Taxation recoverable		**33**	20
Other financial assets	16	**115**	91
Short-term investments		**11**	11
Cash and cash equivalents	12	**2,584**	1,309
Assets held for sale	13	**4**	313
		10,138	8,510
Total assets		**18,660**	16,618
LIABILITIES			
Current liabilities			
Borrowings	14	**(149)**	(20)
Other financial liabilities	16	**(135)**	(107)
Trade and other payables	15	**(6,389)**	(6,276)
Current tax liabilities		**(126)**	(138)
Provisions for liabilities and charges	17	**(220)**	(276)
Liabilities associated with assets held for sale	13	**–**	(135)
		(7,019)	(6,952)
Non-current liabilities			
Borrowings	14	**(1,234)**	(1,184)
Other financial liabilities	16	**(418)**	(919)
Trade and other payables	15	**(1,465)**	(1,314)
Deferred tax liabilities	4	**(584)**	(445)
Provisions for liabilities and charges	17	**(241)**	(226)
Post-retirement scheme deficits	18	**(874)**	(900)
		(4,816)	(4,988)
Total liabilities		**(11,835)**	(11,940)
Net assets		**6,825**	4,678
EQUITY			
Equity attributable to ordinary shareholders			
Called-up share capital	19	**326**	326
Share premium account		**631**	631
Cash flow hedging reserve		**(63)**	(52)
Other reserves		**310**	430
Retained earnings		**5,558**	3,342
		6,762	4,677
Non-controlling interests		**63**	1
Total equity		**6,825**	4,678

The financial statements on pages 42 to 90 were approved by the Board on 13 February 2013 and signed on its behalf by:

Sir Simon Robertson Chairman **Mark Morris** Chief Financial Officer

Consolidated cash flow statement

For the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Reconciliation of cash flows from operating activities			
Operating profit		**1,373**	1,186
Profit on disposal of property, plant and equipment		**(9)**	(8)
Share of results of joint ventures and associates	9	**(173)**	(116)
Dividends received from joint ventures and associates	9	**129**	76
Amortisation and impairment of intangible assets		**231**	169
Depreciation and impairment of property, plant and equipment		**256**	241
Impairment of investments	9	**2**	–
Decrease in provisions		**(40)**	(28)
Increase in inventories		**(158)**	(140)
Increase in trade and other receivables		**(634)**	(258)
Increase in trade and other payables		**205**	172
Movement in other financial assets and liabilities		**(29)**	68
Net defined benefit post-retirement cost/(credit) recognised in profit before financing		**151**	(43)
Cash funding of defined benefit post-retirement schemes		**(297)**	(304)
Share-based payments	20	**55**	59
Net cash inflow from operating activities before taxation		**1,062**	1,074
Taxation paid		**(219)**	(208)
Net cash inflow from operating activities		**843**	866
Cash flows from investing activities			
Disposals of unlisted investments		**4**	1
Additions of intangible assets		**(250)**	(363)
Disposals of intangible assets		**1**	6
Purchases of property, plant and equipment		**(435)**	(412)
Government grants received		**10**	38
Disposals of property, plant and equipment		**30**	31
Acquisitions of businesses (net of cash acquired)	24	**(20)**	(19)
Restructuring of IAE		**942**	–
Disposals of businesses		**–**	7
Investments in joint ventures and associates		**(24)**	(1,329)
Cash flows from loan to Engine Holding GmbH		**167**	(167)
Transfer of subsidiary to associate	24	**(1)**	–
Net cash inflow/(outflow) from investing activities		**424**	(2,207)
Cash flows from financing activities			
Repayment of loans		**(78)**	(501)
Proceeds from increase in loans		**200**	–
Net cash flow from increase/(decrease) in borrowings		**122**	(501)
Interest received		**11**	19
Interest paid		**(52)**	(49)
Decrease in short-term investments		**–**	316
Net cash outflow from financing activities		**81**	(215)
Net increase/(decrease) in cash and cash equivalents		**1,348**	(1,556)
Cash and cash equivalents at 1 January		**1,290**	2,850
Exchange losses on cash and cash equivalents		**(54)**	(4)
Cash and cash equivalents at 31 December		**2,584**	1,290

Consolidated cash flow statement

	2012 £m	2011 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Increase/(decrease) in cash and cash equivalents	**1,348**	(1,556)
Cash flow from (increase)/decrease in borrowings	**(122)**	501
Cash flow from decrease in short-term investments	**–**	(316)
Change in net funds resulting from cash flows	**1,226**	(1,371)
Net funds (excluding cash and cash equivalents) of businesses acquired	**(78)**	–
Exchange losses on net funds	**(54)**	(5)
Fair value adjustments	**2**	92
Movement in net funds	**1,096**	(1,284)
Net funds at 1 January excluding the fair value of swaps	**116**	1,400
Net funds at 31 December excluding the fair value of swaps	**1,212**	116
Fair value of swaps hedging fixed rate borrowings	**104**	106
Net funds at 31 December	**1,316**	222

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

	At 1 January 2012 £m	Funds flow £m	Net funds of businesses acquired £m	Exchange differences £m	Fair value adjustments £m	Reclassifications £m	At 31 December 2012 £m
Cash at bank and in hand	**1,284**	(578)		(33)	–	–	**673**
Money market funds	**11**	397		–	–	–	**408**
Short-term deposits	**14**	1,510		(21)	–	–	**1,503**
Overdrafts	**(19)**	19		–	–	–	**–**
Cash and cash equivalents	**1,290**	1,348	–	(54)	–	–	**2,584**
Short-term investments	**11**	–	–	–	–	–	**11**
Other current borrowings	**(1)**	78	(78)	–	–	(148)	**(149)**
Non-current borrowings	**(1,183)**	(200)	–	–	2	148	**(1,233)**
Finance leases	**(1)**	–	–	–	–	–	**(1)**
Net funds excluding fair value of swaps	**116**	1,226	(78)	(54)	2	–	**1,212**
Fair value of swaps hedging fixed rate borrowings	**106**				(2)		**104**
Net funds	**222**	1,226	(78)	(54)	–	–	**1,316**

Consolidated statement of changes in equity

For the year ended 31 December 2012

		Attributable to ordinary shareholders							
	Notes	Share capital £m	Share premium £m	Cash flow hedging reserve[1] £m	Translation reserve £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2011		326	631	(37)	524	2,369	3,813	4	3,817
Profit for the year		–	–	–	–	851	851	(2)	849
Foreign exchange translation differences on foreign operations		–	–	–	(101)	–	(101)	(1)	(102)
Movement on post-retirement schemes	18	–	–	–	–	123	123	–	123
Share of OCI of joint ventures and associates	9	–	–	(15)	8	(3)	(10)	–	(10)
Related tax movements	4	–	–	–	(1)	(53)	(54)	–	(54)
Total comprehensive income for the year		–	–	(15)	(94)	918	809	(3)	806
Share-based payments – direct to equity[2]		–	–	–	–	43	43	–	43
Related tax movements	4	–	–	–	–	12	12	–	12
Other changes in equity in the year		–	–	–	–	55	55	–	55
At 1 January 2012		**326**	**631**	**(52)**	**430**	**3,342**	**4,677**	**1**	**4,678**
Profit for the year		–	–	–	–	2,281	2,281	14	2,295
Foreign exchange translation differences on foreign operations		–	–	–	(118)	–	(118)	–	(118)
Movement on post-retirement schemes	18	–	–	–	–	(259)	(259)	–	(259)
Share of OCI of joint ventures and associates	9	–	–	(11)	(1)	(46)	(58)	–	(58)
Related tax movements	4	–	–	–	(1)	91	90	–	90
Total comprehensive income for the year		–	–	**(11)**	**(120)**	**2,067**	**1,936**	**14**	**1,950**
Share-based payments – direct to equity[2]		–	–	–	–	24	24	–	24
Transactions with NCI[3]		–	–	–	–	116	116	48	164
Related tax movements	4	–	–	–	–	9	9	–	9
Other changes in equity in the year		–	–	–	–	**149**	**149**	**48**	**197**
At 31 December 2012		**326**	**631**	**(63)**	**310**	**5,558**	**6,762**	**63**	**6,825**

[1] See accounting policies note 1.
[2] 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 to the group.
[3] On 2 January 2012, the Group transferred its interest in Bergen Engines AS (Bergen) to Engine Holding GmbH, its joint vehicle with Daimler AG. As it retained rights to control Bergen, the transaction has been treated as a disposal of 50 per cent of Bergen to a non-controlling interest for €200m.

Notes to the consolidated financial statements

1 Accounting policies

The Company

Rolls-Royce plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended 31 December 2012 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 13 February 2013.

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 31 December 2012 (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 38.

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 7, the Group has significant intangible assets. The decision as to when to commence capitalisation of development costs and whether sales of original equipment give rise to recognisable recoverable engine costs is a key judgement.
- As noted in the risk and revenue sharing partnerships accounting policy on page 49, the Group enters into arrangements with partners who make non-refundable payments, which the directors consider represent a reimbursement to the Group for its past expenditure, including that in establishing the market to which the partners gain access, on the basis that the Group has satisfied the relevant performance obligations and the payments are not linked to the future supply arrangements between the partners and the Group. Under the arrangements, the partners share the programme costs and receive a share in future programme revenues or profits.
- As set out in note 22, 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 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 31 December 2012 **£1,388m,** 31 December 2011 £1,442m).
- 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 31 December 2012 **£193m**, 31 December 2011 £230m). 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 31 December 2012 **£330m**, 31 December 2011 £368m) 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 **£545m** before deferred taxation being recognised on the balance sheet at 31 December 2012 (31 December 2011 £397m). 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 18.

Provisions

As described in the accounting policy on page 52, the Group measures provisions (carrying value at 31 December 2012 **£461m**, 31 December 2011 £502m) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates take 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 together with the Group's share of the results of joint ventures and associates made up to 31 December.

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.

The Group has an indirect interest of 50 per cent in Bergen Engines AS. Under the terms of the shareholders' agreement with Daimler AG, the Group controls this company.

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. Transactions with non-controlling interests are recorded directly in equity.

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 22. 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 make cash payments that are not refundable. Cash sums received, which reimburse the Group for past expenditure, including that in establishing the market to which the partners gain access, 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, partners receive a share of the programme revenues or profits, which 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.

Taxation

The tax charge/credit 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.

1 Accounting policies (continued)

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 generally 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:

- 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.
- 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.
- 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.

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 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.

1 Accounting policies (continued)

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 recognised represents the excess of the fair value of the purchase consideration over the fair value to the Group of the net of the identifiable assets acquired and the liabilities assumed. On transition to IFRS on 1 January 2004, goodwill was recognised based the carrying value under the previous accounting policies. Goodwill in respect of the acquisition of a subsidiary is recognised as an intangible asset. Goodwill arising on the acquisition of joint ventures and associates is included in the carrying value of the investment.

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.

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, where relevant, 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.

1 Accounting policies (continued)

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 directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

Post-retirement benefits
Pensions and similar benefits (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. 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.

1 Accounting policies (continued)

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;
- past service costs are recognised immediately to the extent the benefits are already vested, or otherwise recognised on a straight-line basis over the average period until the benefits become vested; 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.

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

Share-based payments

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

The cost of shares of Rolls-Royce Holdings plc held by the Group for the purpose of fulfilling obligations in respect of employee share plans is deducted from equity in the consolidated balance sheet.

See note 20 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 on page 86.

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 2012

The Group has adopted revisions to IAS 1 *Presentation of Financial Statements* that require items of other comprehensive income to be classified depending on whether they may be potentially reclassified to the income statement. There is no net impact.

There were no other revisions to Adopted IFRS that became applicable in 2012 which had a significant impact on the Group's financial statements.

1 Accounting policies (continued)

Revisions to IFRS not applicable in 2012

Standards and interpretations issued by the IASB are only applicable if endorsed by the EU. The following will or may be applicable in the future:

- Amendments to IAS 19 *Employee Benefits*: the principal change is that the financing on post-retirement benefits is calculated on the net surplus or deficit using an 'AA' corporate bond rate. This will be effective for 2013. If it had been effective in 2012, it would have increased the current service cost of defined benefit post-retirement schemes by £9 million, the past service cost by £5 million and reduced the net post-retirement scheme financing cost by £55 million. The net deficit at 31 December 2012 would have reduced by £100 million.
- IFRS 11 *Joint Arrangements*: the principal potential effect is certain entities currently classified as joint ventures would be 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. This would not affect the Group's net assets or profit after tax for the period. This will be effective for 2013. The Group has reviewed its joint ventures and has concluded that none of its material joint ventures fall to be classified as joint operations under the requirements of IFRS 11.
- 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.

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 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.

Engine Holding – development, manufacture, marketing, and sales of diesel engines, and aftermarket services and the equity accounted share of Tognum AG.

Technology and Operations discussed in the business review operate on a Group-wide basis across all the above segments. Following the transfer of Bergen Engines AS to Engine Holding on 2 January 2012, the comparative figures for 2011 have been restated to put them on a consistent basis.

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

Underlying revenues – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these reflect the achieved exchange rates arising on settled derivative contracts.

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 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.

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

2 Segmental analysis (continued)

Year ended 31 December 2012	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Engine Holding £m	Intra-segment £m	Total reportable segments £m
Underlying revenue from sale of original equipment	2,934	1,231	1,288	344	118	(22)	5,893
Underlying revenue from aftermarket services	3,503	1,186	961	618	169	(121)	6,316
Total underlying revenue	6,437	2,417	2,249	962	287	(143)	12,209
Underlying operating profit excluding share of results of joint ventures and associates	597	391	295	9	32	(11)	1,313
Share of results of joint ventures and associates	130	13	(1)	12	77	–	231
Underlying profit before financing and taxation	727	404	294	21	109	(11)	1,544
Segment assets	8,963	1,543	2,163	1,328	155	(683)	13,469
Investments in joint ventures and associates	440	(22)	4	50	1,328	–	1,800
Segment liabilities	(5,508)	(1,762)	(1,434)	(554)	(282)	672	(8,868)
Net assets	3,895	(241)	733	824	1,201	(11)	6,401
Investment in intangible assets, property, plant and equipment and joint ventures and associates	581	126	101	94	11	–	913
Depreciation and amortisation	322	46	55	42	4	–	469
Year ended 31 December 2011							
Underlying revenue from sale of original equipment	2,232	1,102	1,322	527	185	(110)	5,258
Underlying revenue from aftermarket services	3,340	1,133	949	556	146	(105)	6,019
Total underlying revenue	5,572	2,235	2,271	1,083	331	(215)	11,277
Underlying operating profit excluding share of results of joint ventures and associates	384	367	282	6	44	–	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	287	16	80	–	1,258
Segment assets	8,312	1,373	2,064	1,213	405	(746)	12,621
Investments in joint ventures and associates	403	(22)	8	42	1,249	–	1,680
Segment liabilities	(6,000)	(1,838)	(1,448)	(550)	(164)	746	(9,254)
Net assets	2,715	(487)	624	705	1,490	–	5,047
Investment in intangible assets, property, plant and equipment and joint ventures and associates	620	70	75	83	1,318	–	2,166
Depreciation and amortisation	267	48	56	38	1	–	410

2 Segmental analysis (continued)

Reconciliation to reported results

Year ended 31 December 2012	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Revenue from sale of original equipment	5,893	–	5,893	41	5,934
Revenue from aftermarket services	6,316	–	6,316	(89)	6,227
Total revenue	12,209	–	12,209	(48)	12,161
Operating profit excluding share of results of joint ventures and associates	1,313	(54)[1]	1,259	(59)	1,200
Share of results of joint ventures and associates	231	–	231	(58)	173
Profit on disposal of businesses	–	–	–	699	699
Profit before financing and taxation	1,544	(54)	1,490	582	2,072
Net financing		(61)	(61)	694	633
Profit before taxation		(115)	1,429	1,276	2,705
Taxation		(318)	(318)	(92)	(410)
Profit for the year		(433)	1,111	1,184	2,295
Year ended 31 December 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		(48)	(48)	(35)	(83)
Profit before taxation		(100)	1,158	(52)	1,106
Taxation		(261)	(261)	4	(257)
Profit for the year		(361)	897	(48)	849

[1] Central corporate costs

Underlying adjustments

	2012				2011			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	12,209	1,490	(61)	(318)	11,277	1,206	(48)	(261)
Revenue recognised at exchange rate on date of transaction	(48)	–	–	–	(153)	–	–	–
Realised (gains)/losses on settled derivative contracts[1]	–	(25)	–	–	–	(116)	24	–
Net unrealised fair value changes to derivative contracts[2]	–	–	747	–	–	(5)	(49)	–
Effect of currency on contract accounting	–	(23)	–	–	–	4	–	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	–	–	11	–	–	–	2	–
Effect of acquisition accounting[3]	–	(69)	–	–	–	(64)	–	–
Post-retirement scheme past-service credits[4,5]	–	–	–	–	–	164	–	–
Net post-retirement scheme financing	–	–	(64)	–	–	–	(12)	–
Related tax effect	–	–	–	(129)	–	–	–	4
IAE restructuring	–	699	–	37	–	–	–	–
Total underlying adjustments	(48)	582	694	(92)	(153)	(17)	(35)	4
Reported per consolidated income statement	12,161	2,072	633	(410)	11,124	1,189	(83)	(257)

[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: (i) include those included in equity accounted joint ventures; and (ii) 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 in 2011, which was excluded from underlying profit.
[5] In 2011, the Group agreed revised post-retirement healthcare arrangements on certain of its overseas schemes. This resulted in a net gain in the income statement of £34m which was excluded from underlying profit.

2 Segmental analysis (continued)

	2012 £m	2011 £m
Reportable segment assets	**13,469**	12,621
Investments in joint ventures and associates	**1,800**	1,680
Cash and cash equivalents and short-term investments	**2,595**	1,320
Fair value of swaps hedging fixed rate borrowings	**104**	106
Income tax assets	**363**	388
Post-retirement scheme surpluses	**329**	503
Total assets	**18,660**	16,618
Reportable segment liabilities	**(8,868)**	(9,254)
Borrowings	**(1,383)**	(1,204)
Income tax liabilities	**(710)**	(583)
Post-retirement scheme deficits	**(874)**	(900)
Total liabilities	**(11,835)**	(11,941)
Net assets	**6,825**	4,677

Geographical segments

The Group's revenue by destination is shown below:

	2012 £m	2011 £m
United Kingdom	**1,641**	1,361
Norway	**446**	374
Germany	**319**	409
Spain	**177**	189
Italy	**151**	183
France	**182**	143
Russia	**165**	143
Rest of Europe	**676**	547
USA	**3,999**	3,578
Canada	**351**	301
China	**1,117**	934
South Korea	**194**	210
Middle East and South East Asia	**1,729**	1,778
Rest of Asia	**306**	290
Africa	**123**	261
Australasia	**240**	228
Other	**345**	195
	12,161	11,124

In 2012, revenue (included in all reportable segments, other than Engine Holding) of **£1,203m** (2011 £1,143m) 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:

	2012 £m	2011 £m
United Kingdom	**3,139**	2,980
North America	**723**	670
Nordic countries	**883**	902
Germany	**2,023**	1,907
Other	**497**	441
	7,265	6,900

Notes to the consolidated financial statements

3 Net financing

	Notes	2012 Per consolidated income statement £m	2012 *Underlying financing*[1] *£m*	2011 Per consolidated income statement £m	2011 *Underlying financing*[1] *£m*
Financing income					
Interest receivable		**10**	***10***	20	*20*
Fair value gains on foreign currency contracts[2]	16	**750**	**–**	–	–
Financial RRSPs – foreign exchange differences and other changes in unrealised value	16	**11**	**–**	2	–
Expected return on post-retirement scheme assets	18	**341**	**–**	410	–
Net foreign exchange gains		**–**	**–**	24	–
		1,112	***10***	456	*20*
Financing costs					
Interest payable		**(51)**	***(51)***	(50)	*(50)*
Fair value losses on foreign currency contracts[2]	16	**–**	**–**	(21)	–
Financial charge relating to financial RRSPs	16	**(10)**	***(10)***	(11)	*(11)*
Fair value losses on commodity derivatives[2]	16	**(3)**	**–**	(28)	–
Interest on post-retirement scheme liabilities	18	**(405)**	**–**	(422)	–
Other financing charges		**(10)**	***(10)***	(7)	*(7)*
		(479)	***(71)***	(539)	*(68)*
Net financing		**633**	***(61)***	(83)	*(48)*
Analysed as:					
Net interest payable		**(41)**	***(41)***	(30)	*(30)*
Net post-retirement scheme financing		**(64)**	**–**	(12)	–
Net other financing		**738**	***(20)***	(41)	*(18)*
Net financing		**633**	***(61)***	(83)	*(48)*
[1] See note 2					
[2] Net gain/(loss) on items held for trading		**747**	–	(49)	–

4 Taxation

	UK 2012 £m	UK 2011 £m	Overseas 2012 £m	Overseas 2011 £m	Total 2012 £m	Total 2011 £m
Current tax						
Current tax (credit)/charge for the year	**(3)**	(1)	**218**	177	**215**	176
Less double tax relief	**(1)**	(2)	**–**	–	**(1)**	(2)
	(4)	(3)	**218**	177	**214**	174
Adjustments in respect of prior years	**(7)**	1	**(18)**	(8)	**(25)**	(7)
	(11)	(2)	**200**	169	**189**	167
Deferred tax						
Charge for the year	**193**	69	**45**	37	**238**	106
Adjustments in respect of prior years	**1**	2	**6**	(7)	**7**	(5)
Credit resulting from reduction in UK tax rate	**(24)**	(11)	**–**	–	**(24)**	(11)
	170	60	**51**	30	**221**	90
Recognised in the income statement	**159**	58	**251**	199	**410**	257

4 Taxation (continued)

Other tax (charges)/credits

	OCI				Equity	
	Items that will not be reclassified		Items that may be reclassified			
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Current tax:						
Share-based payments – direct to equity					**3**	6
Deferred tax:						
Net investment hedge	**–**	–	**(1)**	(1)		
Movement in post-retirement schemes	**91**	(53)	**–**	–		
Share-based payments – direct to equity					**6**	6
	91	(53)	**(1)**	(1)	**9**	12

Tax reconciliation

	2012 £m	2011 £m
Profit before taxation	**2,705**	1,106
Less share of results of joint ventures and associates (note 9)	**(173)**	(116)
Profit before taxation excluding joint ventures and associates	**2,532**	990
Nominal tax charge at UK corporation tax rate 24.5% (2011 26.5%)	**620**	262
UK R&D credit	**(26)**	(29)
Rate differences	**58**	40
Effect of restructuring of IAE [1]	**(209)**	–
Other permanent differences	**9**	8
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	**–**	(1)
Adjustments in respect of prior years	**(18)**	(12)
Reduction in closing deferred taxes resulting from decrease in UK tax rate	**(24)**	(11)
	410	257
Underlying items (note 2)	**318**	261
Non-underlying items	**92**	(4)
	410	257

[1] Pursuant to the Substantial Shareholding Exemption, the majority of the upfront proceeds received on the IAE restructuring (see note 24) are not subject to tax.

Deferred taxation assets and liabilities

	2012 £m	2011 £m
At 1 January	**(77)**	13
Amount charged to income statement	**(221)**	(90)
Amount credited/(charged) to other comprehensive income	**90**	(54)
Amount credited to equity	**6**	6
Acquisition of businesses	**(1)**	(3)
Transferred (from)/to assets held for sale	**(46)**	46
Exchange differences	**(5)**	5
At 31 December	**(254)**	(77)
Deferred tax assets	**330**	368
Deferred tax liabilities	**(584)**	(445)
	(254)	(77)

4 Taxation (continued)

The analysis of the deferred tax position is as follows:

	At 1 January 2012 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Transferred from assets held for sale £m	Exchange differences £m	At 31 December 2012 £m
Intangible assets	**(243)**	58	–	–	–	(46)	(1)	**(232)**
Property, plant and equipment	**(135)**	(25)	–	–	1	–	1	**(158)**
Other temporary differences	**(61)**	21	(1)	–	–	–	2	**(39)**
Amounts recoverable on contracts	**(250)**	(101)	–	–	–	–	–	**(351)**
Pensions and other post-retirement scheme benefits	**99**	(31)	91	–	(2)	–	(8)	**149**
Foreign exchange and commodity financial assets and liabilities	**121**	(177)	–	–	–	–	–	**(56)**
Losses	**328**	34	–	6	–	–	1	**369**
Advance corporation tax	**64**	–	–	–	–	–	–	**64**
	(77)	(221)	90	6	(1)	(46)	(5)	**(254)**

	At 1 January 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 31 December 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)

	2012 £m	2011 £m
Advance corporation tax	**118**	118
Losses and other unrecognised deferred tax assets	**39**	41
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	**157**	159

The Autumn Statement 2012 announced that the UK corporation tax rate will reduce to 21 per cent by 2014. The reductions to 24 per cent effective from 1 April 2012 and 23 per cent effective from 1 April 2013 were substantively enacted on 26 March 2012 and 3 July 2012 respectively. As the rate change to 23 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 2012, **£24m** has been credited to the income statement, **£3m** 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 **£15m** and reducing the deferred tax liability by **£33m**.

The temporary differences associated with investments in subsidiaries, joint ventures and associates, for which a deferred tax liability has not been recognised, aggregate to **£144m** (2011 £178m). No deferred tax liability has been recognised on the potential withholding tax due on the remittance of undistributed profits as the Group is able to control the timing of such remittances and it is probable that consent will not be given in the foreseeable future.

5 Employee information

	2012 Number	2011 Number
Average number of employees		
United Kingdom	**22,800**	21,600
Rest of world	**20,000**	18,800
	42,800	40,400
Civil aerospace	**21,500**	19,800
Defence aerospace	**7,800**	7,600
Marine	**8,800**	8,600
Energy	**3,700**	3,500
Engine Holding	**1,000**	900
	42,800	40,400

	£m	£m
Group employment costs[1]		
Wages and salaries	**2,163**	2,037
Social security costs	**265**	245
Share-based payments (note 20)	**55**	59
Pensions and other post-retirement scheme benefits (note 18)	**279**	23
	2,762	2,364

[1] Remuneration of key management personnel is shown in note 23.

6 Auditors' remuneration

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

	2012 £m	2011 £m
Fees payable to the Company's auditor for the audit of the Company's annual financial statements	**1.7**	1.6
Fees payable to the Company's auditor and its associates for the audit of the Company's subsidiaries pursuant to legislation	**2.8**	2.7
Total fees payable for audit services	**4.5**	4.3
Fees payable to the Company's auditor and its associates for other services:		
Audit related assurance services	**0.3**	0.2
Taxation compliance services	**0.3**	0.3
Taxation advisory services	**0.2**	0.2
Internal audit services	**0.6**	–
Information technology	**0.4**	–
All other services	**0.1**	0.2
	6.4	5.2
Fees payable in respect of the Group's pension schemes:		
Audit	**0.2**	0.2
Taxation compliance services	**0.1**	–

7 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
Cost:						
At 1 January 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 1 January 2012	**1,106**	**720**	**954**	**464**	**490**	**3,734**
Exchange differences	(4)	(2)	(4)	–	(1)	(11)
Additions	–	28	38	35	124	225
Acquisitions of businesses	10	–	–	–	9	19
Transferred from subsidiary to associate	–	–	(1)	–	–	(1)
Disposals	(1)	(6)	(6)	–	(3)	(16)
At 31 December 2012	**1,111**	**740**	**981**	**499**	**619**	**3,950**
Accumulated amortisation:						
At 1 January 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 1 January 2012	**7**	**197**	**268**	**231**	**149**	**852**
Charge for the year [1]	–	34	50	64	61	209
Impairment	3	–	–	–	–	3
Disposals	(1)	(6)	(6)	–	(2)	(15)
At 31 December 2012	**9**	**225**	**312**	**295**	**208**	**1,049**
Net book value:						
At 31 December 2012	**1,102**	**515**	**669**	**204**	**411**	**2,901**
At 31 December 2011	1,099	523	686	233	341	2,882
At 1 January 2011	1,108	496	630	346	304	2,884

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

Goodwill

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

Cash-generating unit (CGU) or groups of CGUs

	Primary reporting segment	2012 £m	2011 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**223**	230
Offshore marine – arising from the acquisitions of Vinters Limited and Scandinavian Electric Holdings AS	Marine	**649**	645
Offshore marine – arising from the acquisition of ODIM ASA	Marine	**115**	112
Other	Various	**115**	112
		1,102	1,099

7 Intangible assets (continued)

Goodwill has been tested for impairment during 2012 on the following basis:

- The carrying values of goodwill 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. 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 (2011 13 per cent), based on the Group's weighted average cost of capital, adjusted for specific risks.

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 (2011 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 Limited – 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 (2011 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 **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 (2011 11 per cent), based on the Group's weighted average cost of capital, adjusted for specific risks.
- 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.

8 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At 1 January 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 to assets held for sale	15	–	(13)	–	2
Disposals	(2)	(84)	(17)	(1)	(104)
At 1 January 2012	**981**	**2,646**	**216**	**454**	**4,297**
Exchange differences	(14)	(25)	(1)	(9)	(49)
Additions	50	124	18	299	491
Acquisitions of businesses	–	45	–	–	45
Disposals of businesses	–	(4)	–	–	(4)
Reclassifications	60	168	4	(232)	–
Disposals	(5)	(65)	(14)	(1)	(85)
At 31 December 2012	**1,072**	**2,889**	**223**	**511**	**4,695**
Accumulated depreciation:					
At 1 January 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 to assets held for sale	6	–	(7)	–	(1)
Disposals	(2)	(74)	(6)	–	(82)
At 1 January 2012	**315**	**1,598**	**44**	**2**	**1,959**
Exchange differences	(3)	(13)	–	–	(16)
Charge for the year [1]	39	196	20	–	255
Reclassifications	7	(7)	–	–	–
Disposals of businesses	–	(2)	–	–	(2)
Disposals	(3)	(58)	(2)	(2)	(65)
At 31 December 2012	**355**	**1,714**	**62**	**–**	**2,131**
Net book value:					
At 31 December 2012	**717**	**1,175**	**161**	**511**	**2,564**
At 31 December 2011	666	1,048	172	452	2,338
At 1 January 2011	606	1,041	147	342	2,136

[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:

	2012 £m	2011 £m
Net book value of finance leased assets:		
Land and buildings	**7**	7
Plant and equipment	**4**	5
Assets held for use in operating leases:		
Cost	**242**	235
Depreciation	**(65)**	(60)
Net book value	**177**	175
Capital expenditure commitments	**258**	196
Cost of fully depreciated assets	**721**	655

The Group's share of equity accounted entities' capital commitments is **£31m** (2011 £25m).

9 Investments

	Equity accounted			Other
	Joint ventures £m	Associates £m	Total £m	Unlisted £m
At 1 January 2011	393	–	393	11
Exchange differences	(62)	–	(62)	–
Additions	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 – will not be reclassified to profit or loss	(3)	–	(3)	–
Share of OCI of joint ventures and associates – may be reclassified to profit or loss	(7)	–	(7)	–
At 1 January 2012	**1,680**	**–**	**1,680**	**10**
Exchange differences	(58)	–	(58)	–
Additions	191	–	191	–
Taxation paid by the Group	6	–	6	–
Transfer to subsidiary	(5)	–	(5)	–
Impairment	(2)	–	(2)	–
Share of retained profit	44	–	44	–
Transferred from subsidiary to associate	–	2	2	–
Disposals	–	–	–	(4)
Share of OCI of joint ventures and associates – will not be reclassified to profit or loss	(46)	–	(46)	–
Share of OCI of joint ventures and associates – may be reclassified to profit or loss	(12)	–	(12)	–
At 31 December 2012	**1,798**	**2**	**1,800**	**6**

	Joint ventures						Associates		Total	
	Engine Holding £m	Other £m	2012 £m	Engine Holding £m	Other £m	2011 £m	2012 £m	2011 £m	2012 £m	2011 £m
Assets:										
Non-current assets	**1,590**	**1,717**	**3,307**	1,687	1,529	3,216	**1**	–	**3,308**	3,216
Current assets	**718**	**818**	**1,536**	818	891	1,709	**2**	–	**1,538**	1,709
Liabilities: [2]										
Current liabilities	**(421)**	**(655)**	**(1,076)**	(477)	(793)	(1,270)	**(1)**	–	**(1,077)**	(1,270)
Non-current liabilities	**(559)**	**(1,410)**	**(1,969)**	(779)	(1,196)	(1,975)	**–**	–	**(1,969)**	(1,975)
	1,328	**470**	**1,798**	1,249	431	1,680	**2**	–	**1,800**	1,680
[2] Liabilities include borrowings of:	**(103)**	**(1,271)**	**(1,374)**	(176)	(1,176)	(1,352)	**–**	–	**(1,374)**	(1,352)
Revenue	**1,223**	**2,827**	**4,050**	491	3,055	3,546	**3**	–	**4,053**	3,546
Profit before financing and taxation	**33**	**189**	**222**	(13)	165	152	**–**	–	**222**	152
Net financing	**(10)**	**(22)**	**(32)**	(12)	(19)	(31)	**–**	–	**(32)**	(31)
Taxation	**(1)**	**(16)**	**(17)**	10	(15)	(5)	**–**	–	**(17)**	(5)
Results recognised in the consolidated income statement	**22**	**151**	**173**	(15)	131	116	**–**	–	**173**	116
Dividends received	**(28)**	**(101)**	**(129)**	–	(76)	(76)	**–**	–	**(129)**	(76)
Retained profit	**(6)**	**50**	**44**	(15)	55	40	**–**	–	**44**	40

The principal joint ventures at 31 December 2012 are listed on pages 113 and 114.

10 Inventories

	2012 £m	2011 £m
Raw materials	336	319
Work in progress	1,056	921
Long-term contracts work in progress	10	12
Finished goods	1,282	1,267
Payments on account	42	42
	2,726	2,561
Inventories stated at net realisable value	136	169
Amount of inventory write-down	64	114
Reversal of inventory write-down	1	3

11 Trade and other receivables

	2012 £m	2011 £m
Trade receivables	1,182	1,123
Amounts recoverable on contracts [1]	1,902	1,665
Amounts owed by joint ventures and associates	351	421
Loan to Engine Holding GmbH	–	169
Amounts owed by parent undertaking	546	196
Other receivables	479	475
Prepayments and accrued income	205	156
	4,665	4,205
Analysed as:		
Financial instruments (note 16):		
Trade receivables and similar items	1,662	1,655
Other non-derivative financial assets	364	550
Non-financial instruments	2,639	2,000
	4,665	4,205
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	40	4
Amounts recoverable on contracts	1,473	1,314
Amounts owed by joint ventures and associates	3	20
Other receivables	63	60
Prepayments and accrued income	32	28
	1,611	1,426

[1] The balance at 31 December 2012 includes an allowance of **£80m** (2011 £63m), being the directors' best estimate of the loss that will occur from the Group's contract with EPI Europrop International GmbH to participate in the development of the TP400 engine for the A400M military transport aircraft.

12 Cash and cash equivalents

	2012 £m	2011 £m
Cash at bank and in hand	673	1,284
Money-market funds	408	11
Short-term deposits	1,503	14
	2,584	1,309
Overdrafts (note 14)	–	(19)
Cash and cash equivalents per cash flow statement (page 44)	2,584	1,290
Cash held as collateral against third party obligations (note 22)	64	67

13 Assets held for sale

	2012 £m	2011 £m
Intangible assets – recoverable engine costs	–	186
Property, plant and equipment	4	6
Investment in joint venture	–	13
Amounts recoverable on contracts	–	59
Amounts owed by joint ventures	–	49
Assets held for sale	4	313
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 12 October 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, on 29 June 2012, the Group and Pratt & Whitney restructured their participation in IAE, which produces the V2500 engine for the Airbus A320 family of aircraft. Rolls-Royce sold its equity, programme share and related goodwill in IAE to Pratt & Whitney for US$1.5 billion.

As Rolls-Royce continues 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 was not considered to give rise to a discontinued operation.

14 Borrowings

	Current		Non-current		Total	
	2012 £m	2011 £m	2012 £m	2011 £m	2012 £m	2011 £m
Unsecured						
Overdrafts	–	19	–	–	–	19
Bank loans	2	1	404	204	406	205
7 3/8% Notes 2016 £200m	–	–	200	200	200	200
6.38% Notes 2013 US$230m [1]	147	–	–	160	147	160
6.55% Notes 2015 US$83m [1]	–	–	58	62	58	62
6.75% Notes 2019 £500m [2]	–	–	571	557	571	557
Secured						
Obligations under finance leases [3]:	–	–	1	1	1	1
	149	20	1,234	1,184	1,383	1,204

[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 interest rate swap agreements under which the Group has undertaken to pay floating rates of interest which form a fair value hedge.
[3] Obligations under finance leases are secured by related leased assets.

15 Trade and other payables

	Current		Non-current		Total	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Payments received on account [1]	**1,361**	1,396	**609**	487	**1,970**	1,883
Trade payables	**1,109**	1,028	**–**	–	**1,109**	1,028
Amounts owed to parent undertaking	**2**	40	**–**	–	**2**	40
Amounts owed to joint ventures and associates	**202**	215	**1**	1	**203**	216
Other taxation and social security	**107**	88	**–**	–	**107**	88
Other payables	**1,574**	1,623	**95**	58	**1,669**	1,681
Accruals and deferred income	**2,034**	1,886	**760**	768	**2,794**	2,654
	6,389	6,276	**1,465**	1,314	**7,854**	7,590
[1] Includes payments received on account from joint ventures and associates	**262**	358	**162**	147	**424**	505

Included within accruals and deferred income are government grants of **£89m** (2011 £104m). During the year, **£16m** (2011 £2m) of government grants were released to the income statement.

Trade and other payables are analysed as follows:

	2012 £m	2011 £m
Financial instruments (note 16):		
Trade payables and similar items	**2,571**	2,356
Other non-derivative financial liabilities	**704**	718
Non-financial instruments	**4,579**	4,516
	7,854	7,590

16 Financial instruments

Carrying values and fair values of financial instruments

	Notes	Basis for determining fair value	Assets				Liabilities		Total
			Held for trading £m	Loans and receivables £m	Available for sale £m	Cash £m	Held for trading £m	Other £m	£m
At 31 December 2012									
Unlisted non-current asset investments	9	A	**–**	**6**	**–**	**–**	**–**	**–**	**6**
Trade receivables and similar items	11	B	**–**	**1,662**	**–**	**–**	**–**	**–**	**1,662**
Other non-derivative financial assets	11	B	**–**	**364**	**–**	**–**	**–**	**–**	**364**
Derivative financial assets		C	**707**	**–**	**–**	**–**	**–**	**–**	**707**
Short-term investments		B	**–**	**11**	**–**	**–**	**–**	**–**	**11**
Cash and cash equivalents	12	B	**–**	**1,503**	**408**	**673**	**–**	**–**	**2,584**
Borrowings	14	D	**–**	**–**	**–**	**–**	**–**	**(1,383)**	**(1,383)**
Derivative financial liabilities		C	**–**	**–**	**–**	**–**	**(360)**	**–**	**(360)**
Financial RRSPs		D	**–**	**–**	**–**	**–**	**–**	**(193)**	**(193)**
Trade payables and similar items	15	B	**–**	**–**	**–**	**–**	**–**	**(2,571)**	**(2,571)**
Other non-derivative financial liabilities	15	B	**–**	**–**	**–**	**–**	**–**	**(704)**	**(704)**
			707	**3,546**	**408**	**673**	**(360)**	**(4,851)**	**123**
At 31 December 2011									
Unlisted non-current asset investments	9	A	–	10	–	–	–	–	10
Trade receivables and similar items	11	B	–	1,655	–	–	–	–	1,655
Other non-derivative financial assets	11	B	–	550	–	–	–	–	550
Derivative financial assets		C	418	–	–	–	–	–	418
Short-term investments		B	–	11	–	–	–	–	11
Cash and cash equivalents	12	B	–	14	11	1,284	–	–	1,309
Borrowings	14	D	–	–	–	–	–	(1,204)	(1,204)
Derivative financial liabilities		C	–	–	–	–	(796)	–	(796)
Financial RRSPs		D	–	–	–	–	–	(230)	(230)
Trade payables and similar items	15	B	–	–	–	–	–	(2,356)	(2,356)
Other non-derivative financial liabilities	15	B	–	–	–	–	–	(718)	(718)
			418	2,240	11	1,284	(796)	(4,508)	(1,351)

Fair values equate to book values for both 2012 and 2011, with the following exceptions:

	2012		2011	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	**(1,383)**	**(1,542)**	(1,204)	(1,371)
Financial RRSPs	**(193)**	**(215)**	(230)	(254)

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 bank deposits where the 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.

16 Financial instruments (continued)

Carrying values of other financial assets and liabilities

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Financial RRSPS £m	Total £m
At 31 December 2012						
Non-current assets	**498**	**4**	**90**	**592**	**–**	**592**
Current assets	**104**	**6**	**5**	**115**	**–**	**115**
	602	**10**	**95**	**707**	**–**	**707**
Current liabilities	**(97)**	**(8)**	**–**	**(105)**	**(30)**	**(135)**
Non-current liabilities	**(233)**	**(15)**	**(7)**	**(255)**	**(163)**	**(418)**
	(330)	**(23)**	**(7)**	**(360)**	**(193)**	**(553)**
	272	**(13)**	**88**	**347**	**(193)**	**154**
At 31 December 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)	(107)
Non-current liabilities	(683)	(19)	(2)	(704)	(215)	(919)
	(768)	(26)	(2)	(796)	(230)	(1,026)
	(447)	(12)	81	(378)	(230)	(608)

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 1 January 2011	(336)	21	175	(140)
Movements in fair value hedges [1]	2	–	83	85
Movements in cash flow hedges	(1)	–	–	(1)
Movements in other derivative contracts [2]	(21)	(28)	1	(48)
Contracts settled[3]	(91)	(5)	(178)	(274)
At 1 January 2012	**(447)**	**(12)**	**81**	**(378)**
Movements in fair value hedges [1]	(8)	–	6	(2)
Movements in cash flow hedges	(4)	–	–	(4)
Movements in other derivative contracts [2]	750	(3)	1	748
Contracts settled [3]	(19)	2	–	(17)
At 31 December 2012	**272**	**(13)**	**88**	**347**

[1] Net gain on related hedged items **£2m** (2011 £85m net loss).
[2] Included in financing.
[3] Includes contracts settled in fair value hedges **£nil** (2011 £177m gain) and cash flow hedges **£4m** loss (2011: £1m loss).

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.

16 Financial instruments (continued)

Movements in the carrying values were as follows:

	Financial RRSPs	
	2012 £m	2011 £m
At 1 January	(230)	(266)
Cash paid to partners	35	46
Additions	–	–
Exchange adjustments included in OCI	1	(1)
Financing charge[1]	(10)	(11)
Excluded from underlying profit:		
Exchange adjustments[1]	9	1
Changes in forecast payments[1]	2	1
At 31 December	(193)	(230)

[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 on page 31.

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.

16 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 31 December 2012							
Foreign exchange contracts:							
Fair value hedges	**175**	**129**	**–**	**46**	**–**	**15**	**–**
Non-hedge accounted	**17,701**	**4,585**	**3,542**	**9,029**	**545**	**587**	**(330)**
Interest rate contracts:							
Fair value hedges	**692**	**141**	**51**	**–**	**500**	**89**	**–**
Non-hedge accounted	**7**	**–**	**–**	**7**	**–**	**6**	**(7)**
Commodity contracts:							
Non-hedge accounted	**286**	**76**	**68**	**99**	**43**	**10**	**(23)**
	18,861	**4,931**	**3,661**	**9,181**	**1,088**	**707**	**(360)**
At 31 December 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)

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 31 December 2012					
Currencies sold forward:					
Sterling	**–**	**495**	**–**	**23**	**518**
US dollar	**14,407**	**–**	**1,817**	**840**	**17,064**
Euro	**–**	**–**	**–**	**177**	**177**
Other	**21**	**11**	**70**	**15**	**117**
At 31 December 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

Other derivative financial instruments are denominated in the following currencies:

	2012 £m	2011 £m
Sterling	**506**	510
US dollar	**479**	421
Other	**–**	33

16 Financial instruments (continued)

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

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2012					
Assets					
Unlisted non-current investments	**1**	**–**	**4**	**1**	**6**
Trade receivables and similar items	**234**	**1,176**	**169**	**83**	**1,662**
Other non-derivative financial assets	**121**	**75**	**40**	**128**	**364**
Short-term investments	**5**	**–**	**–**	**6**	**11**
Cash and cash equivalents	**495**	**1,037**	**606**	**446**	**2,584**
	856	**2,288**	**819**	**664**	**4,627**
Liabilities					
Borrowings	**(1,173)**	**(205)**	**(5)**	**–**	**(1,383)**
Financial RRSPs	**–**	**(139)**	**(54)**	**–**	**(193)**
Trade payables and similar items	**(1,254)**	**(825)**	**(289)**	**(203)**	**(2,571)**
Other non-derivative financial liabilities	**(250)**	**(320)**	**(17)**	**(117)**	**(704)**
	(2,677)	**(1,489)**	**(365)**	**(320)**	**(4,851)**
	(1,821)	**799**	**454**	**344**	**(224)**
At 31 December 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	656	367	236	1,309
	372	1,944	721	498	3,535
Liabilities					
Borrowings	(977)	(222)	(5)	–	(1,204)
Financial RRSPs	–	(173)	(57)	–	(230)
Trade payables and similar items	(1,095)	(812)	(275)	(174)	(2,356)
Other non-derivative financial liabilities	(252)	(308)	(18)	(140)	(718)
	(2,324)	(1,515)	(355)	(314)	(4,508)
	(1,952)	429	366	184	(973)

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 31 December 2012					
Sterling	**–**	**22**	**1**	**4**	**27**
US dollar	**4**	**–**	**(6)**	**5**	**3**
Euro	**(1)**	**(2)**	**–**	**–**	**(3)**
Other	**6**	**1**	**(5)**	**1**	**3**
At 31 December 2011					
Sterling	–	1	–	3	4
US dollar	3	–	(2)	10	11
Euro	(1)	(1)	–	–	(2)
Other	1	4	1	3	9

16 Financial instruments (continued)

Ageing beyond contractual due date of financial assets

	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 31 December 2012					
Unlisted non-current asset investments	**6**	**–**	**–**	**–**	**6**
Trade receivables and similar items	**1,470**	**132**	**43**	**17**	**1,662**
Other non-derivative financial assets	**343**	**18**	**1**	**2**	**364**
Derivative financial assets	**707**	**–**	**–**	**–**	**707**
Short-term investments	**11**	**–**	**–**	**–**	**11**
Cash and cash equivalents	**2,584**	**–**	**–**	**–**	**2,584**
	5,121	**150**	**44**	**19**	**5,334**
At 31 December 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	1,309	–	–	–	1,309
	3,657	199	68	29	3,953

Contractual maturity analysis of financial liabilities

	Gross values					
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
At 31 December 2012						
Borrowings	**(210)**	**(257)**	**(403)**	**(778)**	**265**	**(1,383)**
Derivative financial liabilities	**(108)**	**(103)**	**(138)**	**(14)**	**3**	**(360)**
Financial RRSPs	**(35)**	**(32)**	**(75)**	**(100)**	**49**	**(193)**
Trade payables and similar items	**(2,568)**	**(1)**	**(1)**	**(1)**	**–**	**(2,571)**
Other non-derivative financial liabilities	**(694)**	**(10)**	**–**	**–**	**–**	**(704)**
	(3,615)	**(403)**	**(617)**	**(893)**	**317**	**(5,211)**
At 31 December 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)
Trade payables and similar items	(2,353)	(1)	(1)	(1)	–	(2,356)
Other non-derivative financial liabilities	(715)	(2)	–	(1)	–	(718)
	(3,282)	(452)	(1,119)	(780)	329	(5,304)

16 Financial instruments (continued)

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.

		2012 Period in which interest rate reprices					
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments [1]	4.1927%	11	9	2	–	–	–
Cash and cash equivalents [2]		2,584	2,584	–	–	–	–
Unsecured bank loans							
€2m floating rate loan	0.5000%	(2)	–	–	–	–	(2)
€5m floating rate loan	EURIBOR + 0.75	(4)	(4)	–	–	–	–
Overdrafts [3]		–	–	–	–	–	–
Interest rate swaps	5.3225%	–	7	–	–	(7)	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–	–	–	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–	–	–	–
Unsecured bond issues							
7³/₈% Notes 2016 £200m	7.3750%	(200)	–	–	–	(200)	–
6.38% Notes 2013 US$230m	6.3800%	(147)	–	(147)	–	–	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(147)	147	–	–	–
6.55% Notes 2015 US$83m	6.5500%	(58)	–	–	–	(58)	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(58)	–	–	58	–
6.75% Notes 2019 £500m	6.7500%	(571)	–	–	–	–	(571)
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(571)	–	–	–	571
Other secured							
Obligations under finance leases	5.0000%	(1)	–	–	–	–	(1)
		1,212	1,420	2	–	(207)	(3)

		2011 Period in which interest rate reprices					
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments [1]	4.3782%	11	9	2	–	–	–
Cash and cash equivalents [2]		1,309	1,309	–	–	–	–
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							
7³/₈% Notes 2016 £200m	7.3750%	(200)	–	–	–	(200)	–
6.38% Notes 2013 US$230m	6.3800%	(160)	–	–	(160)	–	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(160)	–	160	–	–
6.55% Notes 2015 US$83m	6.5500%	(62)	–	–	–	(62)	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(62)	–	–	62	–
6.75% Notes 2019 £500m	6.7500%	(557)	–	–	–	–	(557)
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(557)	–	–	–	557
Other secured							
Obligations under finance leases	5.0000%	(1)	–	–	–	–	(1)
		116	327	2	–	(210)	(3)

[1] Interest on the short-term investments is at fixed rates.
[2] Cash and cash equivalents comprise 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.

16 Financial instruments (continued)

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

	2012 £m	2011 £m
Expiring after two years	**1,000**	1,200

Sensitivity analysis

Sensitivities at 31 December (all other variables held constant) – impact on profit after tax and equity	2012 £m	2011 £m
Sterling 10% weaker against the US dollar	**(1,073)**	(1,083)
Sterling 10% stronger against the US dollar	**878**	886
Euro 10% weaker against the US dollar	**(146)**	(93)
Euro 10% stronger against the US dollar	**115**	78
Commodity prices 10% lower	**(20)**	(15)
Commodity prices 10% higher	**20**	15

At 31 December 2012 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 funds and this is mitigated as described under the interest rate risk management policies on page 72.

17 Provisions for liabilities and charges

	At 1 January 2012 £m	Exchange differences £m	Acquisitions of businesses £m	Disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At 31 December 2012 £m
Warranty and guarantees	**285**	(3)	7	–	(18)	42	(66)	**247**
Contract loss	**52**	(1)	–	–	(8)	29	(18)	**54**
Restructuring	**6**	–	–	–	(1)	–	(1)	**4**
Customer financing	**81**	(1)	–	–	–	2	–	**82**
Insurance	**51**	–	–	–	(21)	31	(14)	**47**
Other	**27**	–	–	(3)	(4)	10	(3)	**27**
	502	(5)	7	(3)	(52)	114	(102)	**461**
Current liabilities	**276**							**220**
Non-current liabilities	**226**							**241**

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 Chief Financial Officer's review on page 11. The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 22. It is estimated that the provision will be utilised as follows:

	2012 £m	2011 £m
Potential claims with specific claim dates:		
In one year or less	**30**	12
In more than one year but less than five years	**43**	62
In more than five years	**8**	6
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	**–**	–
Up to five years	**1**	1
Thereafter	**–**	–
	82	81

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.

18 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.

18 Post-retirement benefits (continued)

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to 31 December 2012. The most recent funding valuations of the main UK schemes were:

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

Amounts recognised in the income statement

	2012			2011		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost	**123**	**38**	**161**	119	34	153
Past-service cost/(credit)	**2**	**(12)**	**(10)**	(126)	(68)	(194)
Curtailment	**–**	**–**	**–**	–	(2)	(2)
	125	**26**	**151**	(7)	(36)	(43)
Defined contribution schemes	**23**	**41**	**64**	16	38	54
Operating cost	**148**	**67**	**215**	9	2	11
Financing in respect of defined benefit schemes:						
Expected return on assets	**(315)**	**(26)**	**(341)**	(381)	(29)	(410)
Interest on liabilities	**356**	**49**	**405**	372	50	422
	41	**23**	**64**	(9)	21	12
Total income statement charge	**189**	**90**	**279**	–	23	23

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2012 £m	2011 £m	2012 £m	2011 £m	2012 £m	2011 £m
Cost of sales – included in underlying profit	**108**	114	**46**	38	**154**	152
Cost of sales – excluded from underlying profit	**–**	(204)	**–**	–	**–**	(204)
Commercial and administrative costs	**33**	36	**14**	12	**47**	48
Research and development	**10**	11	**4**	4	**14**	15
	151	(43)	**64**	54	**215**	11

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 **£36m** (2011 £35m) in the year.

Amounts recognised in the other comprehensive income

	2012 £m	2011 £m
Actuarial (loss)/gain on scheme assets	**(10)**	1,426
Experience losses on scheme liabilities	**(777)**	(720)
Movement in unrecognised surplus	**465**	(683)
Movement in minimum funding liability	**63**	100
	(259)	123

18 Post-retirement benefits (continued)

Defined benefit schemes

Assumptions

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

	2012		2011	
	UK schemes %	Overseas schemes %	UK schemes %	Overseas schemes %
Rate of increase in salaries	**4.1**	**3.9**	4.2	4.0
Rate of increase of pensions in payment	**2.5**	**2.6**	1.7	1.7
Discount rate	**4.4**	**3.9**	4.7	4.5
Expected rate of return on scheme assets	**3.1**	**5.6**	3.4	5.6
Inflation assumption *	**3.0**	**2.4**	3.1	2.5

* For the UK schemes, this is the assumption for the Retail Price Index. The Consumer Price Index is assumed to be 0.6 per cent lower.

The discount rates are determined by reference to the market yields on AA rated corporate bonds. For the main schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. For other 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 future improvements in line with the CMI 2011 core projections and long-term improvements of 1.25 per cent. Where appropriate, these are 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	**20.8 years**
Future pensioner currently aged 45	**22.4 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 **7.9** per cent grading down to **5.0** per cent over **6.7** years.

Amounts recognised in the balance sheet

	2012			2011		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	**(8,588)**	**(609)**	**(9,197)**	(7,713)	(557)	(8,270)
Fair value of scheme assets	**9,794**	**534**	**10,328**	9,519	497	10,016
	1,206	**(75)**	**1,131**	1,806	(60)	1,746
Present value of unfunded obligations	**–**	**(568)**	**(568)**	–	(495)	(495)
Unrecognised past-service credit [1]	**–**	**(82)**	**(82)**	–	(94)	(94)
Unrecognised surplus [2]	**(853)**	**–**	**(853)**	(1,318)	–	(1,318)
Minimum funding liability [3]	**(173)**	**–**	**(173)**	(236)	–	(236)
Net asset/(liability) recognised in the balance sheet	**180**	**(725)**	**(545)**	252	(649)	(397)
Post-retirement scheme surpluses	**317**	**12**	**329**	495	8	503
Post-retirement scheme deficits	**(137)**	**(737)**	**(874)**	(243)	(657)	(900)

[1] The unrecognised past-service credit arose as a result of revisions to post-retirement healthcare schemes in 2011. It will be amortised over the remaining service lives of the participants (11.3 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.

18 Post-retirement benefits (continued)

Changes in present value of defined benefit obligations

	2012			2011		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	**(7,713)**	**(1,052)**	**(8,765)**	(7,039)	(1,063)	(8,102)
Exchange differences	–	42	42	–	–	–
Current service cost	(123)	(38)	(161)	(119)	(34)	(153)
Past-service (cost)/credit	(2)	–	(2)	126	162	288
Finance cost	(356)	(49)	(405)	(372)	(50)	(422)
Contributions by employees	(4)	(2)	(6)	(4)	(3)	(7)
Benefits paid out	323	38	361	312	37	349
Acquisition of businesses	(54)	–	(54)	–	–	–
Actuarial losses	(659)	(118)	(777)	(617)	(103)	(720)
Settlement	–	2	2	–	2	2
At 31 December	**(8,588)**	**(1,177)**	**(9,765)**	(7,713)	(1,052)	(8,765)
Funded schemes	**(8,588)**	**(609)**	**(9,197)**	(7,713)	(557)	(8,270)
Unfunded schemes	**–**	**(568)**	**(568)**	–	(495)	(495)

Changes in fair value of scheme assets

	2012			2011		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	**9,519**	**497**	**10,016**	7,783	434	8,217
Exchange differences	–	(18)	(18)	–	1	1
Expected return on assets	315	26	341	381	29	410
Contributions by employer	250	47	297	256	48	304
Contributions by employees	4	2	6	4	3	7
Benefits paid out	(323)	(38)	(361)	(312)	(37)	(349)
Acquisition of businesses	59	–	59	–	–	–
Actuarial (losses)/gains	(30)	20	(10)	1,407	19	1,426
Settlement	–	(2)	(2)	–	–	–
At 31 December	**9,794**	**534**	**10,328**	9,519	497	10,016
Actual return on scheme assets	**285**	**46**	**331**	1,788	48	1,836

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

	2012				2011			
	UK		Overseas		UK		Overseas	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
UK schemes:								
Liability driven investment (LDI) portfolios[1]	**2.8**	**7,925**	**5.4**	**313**	3.1	8,330	5.3	291
Longevity swap[2]	**4.4**	**(126)**	**–**	**–**	4.7	(79)	–	–
Equities	**5.9**	**1,095**	**7.5**	**119**	6.0	1,004	7.9	118
Sovereign debt	**2.3**	**245**	**–**	**–**	2.8	159	–	–
Corporate bonds	**3.5**	**334**	**3.6**	**74**	4.0	13	4.0	83
Other	**2.7**	**321**	**4.3**	**28**	2.8	92	2.5	5
	3.1	**9,794**	**5.6**	**534**	3.4	9,519	5.6	497

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 rates of return for LDI portfolios are determined by the implicit yields on the portfolios at the balance sheet date and that for the longevity swap by the discount rate.

18 Post-retirement benefits (continued)

The expected rates of return on other individual categories of scheme assets are determined by reference to gilt yields. In the UK, equities and corporate bonds are assumed to generate returns that exceed the return from gilts by **3.25** per cent and **0.9** 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 2013.

Sensitivities

For the most significant schemes, the investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. The impacts of principal sensitivities are:

	2012 £m	2011 £m
UK defined benefit obligations – 0.25% reduction in the discount rate [1]	(319)	(298)
UK defined benefit assets – 0.25% reduction in interest rates [1]	458	463
UK defined benefit obligations – Age ratings increase by one year	(199)	(163)
UK defined benefit longevity swap – Age ratings increase by one year	68	62
UK defined benefit obligations – 0.5% increase in rate of increase in salaries	(197)	(127)
Post-retirement medical benefit obligations – 1% increase in healthcare trend rates	(49)	(45)
Post-retirement medical benefit obligations – 1% decrease in healthcare trend rates	41	56
Post-retirement medical benefit expense – 1% increase in healthcare trend rates	4	4
Post-retirement medical benefit expense – 1% decrease in healthcare trend rates	(3)	(5)

[1] 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 97 per cent.

History of defined benefit schemes

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

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Balance sheet					
Present value of defined benefit obligations	(9,765)	(8,765)	(8,102)	(7,537)	(6,546)
Fair value of scheme assets	10,328	10,016	8,217	7,402	7,446
Unrecognised past-service credit	(82)	(94)	–	–	–
Unrecognised surpluses	(853)	(1,318)	(635)	(335)	(1,042)
Minimum funding liabilities	(173)	(236)	(336)	(385)	(425)
Deficit	(545)	(397)	(856)	(855)	(567)
Experience (losses)/gains					
Actuarial (losses)/gains on scheme assets	(10)	1,426	460	(270)	178
Experience (losses)/gains on scheme liabilities	(777)	(720)	(303)	(878)	766
Movement in unrecognised surpluses	465	(683)	(300)	707	(928)
Recognition of minimum funding liability on 1 January 2008	–	–	–	–	(491)
Movement in minimum funding liabilities	63	100	49	40	66
Total amount recognised in OCI	(259)	123	(94)	(401)	(409)
Cumulative amounts recognised in OCI since 1 January 2004	(328)	(69)	(192)	(98)	303

19 Share capital

	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid		
At January 1, 2011 and December 31, 2012	1,631	326

20 Share-based payments

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

	2012 £m	2011 £m
Total expense recognised for equity-settled share-based payments transactions	**49**	52
Total expense recognised for cash-settled share-based payments transactions	**6**	7
Share-based payments recognised in the consolidated income statement	**55**	59
Liability for cash-settled share-based payment transactions	**18**	9

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.

20 Share-based payments (continued)

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

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2012	**27.5**	**447**	**0.5**	**100**	**19.5**	**3.3**
Granted	–	–	–	–	4.3	2.0
Additional entitlements arising from TSR performance	–	–	–	–	2.8	–
Forfeited	(0.6)	446	–	–	(0.8)	(0.1)
Exercised	(0.1)	409	(0.4)	103	(11.8)	(1.2)
Outstanding at 31 December 2012	**26.8**	**447**	**0.1**	**77**	**14.0**	**4.0**
Exercisable at 31 December 2012	–	–	0.1	77	–	–
Outstanding at 1 January 2011	26.5	384	0.7	125	19.5	3.1
Granted	10.6	525	–	–	5.3	2.6
Additional entitlements arising from TSR performance	–	–	–	–	1.1	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(0.9)	387	–	–	(0.7)	(0.1)
Exercised	(8.7)	357	(0.2)	207	(5.7)	(2.4)
Outstanding at 31 December 2011	27.5	447	0.5	100	19.5	3.3
Exercisable at 31 December 2011	–	–	0.5	100	–	–

As share options are exercised throughout the year, the weighted average share price during the year of **836 pence** (2011 642 pence) is representative of the weighted average share price at the date of exercise. The closing price at 31 December 2012 was **873.5 pence** (2011 746.5 pence).

The average remaining contractual life of exercisable options is **0.2** years (2011 1.0 years).

Share options outstanding

	ShareSave		ESOP		Total	
Exercise prices (pence)	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years
At 31 December 2012						
0 – 99	**–**	**–**	**0.1**	**0.2**	**0.1**	**0.2**
300 – 399	**10.5**	**1.3**	**–**	**–**	**10.5**	**1.3**
400 – 499	**5.9**	**0.1**	**–**	**–**	**5.9**	**0.1**
500 – 599	**10.4**	**3.2**	**–**	**–**	**10.4**	**3.2**
	26.8	**1.8**	**0.1**	**0.2**	**26.9**	**1.8**
At 31 December 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

The range of exercise prices of options outstanding at 31 December 2012 was: for ShareSave between **387 pence** and **525 pence** (2011 387 pence and 525 pence); and for ESOP it was **77 pence** (2011 77 pence and 188 pence).

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to **three** senior executives were outstanding at 31 December 2012.

20 Share-based payments (continued)

Fair values of share-based payments

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:

	2012	2011
PSP – 25% TSR uplift	885p	662p
PSP – 50% TSR uplift	985p	737p
ShareSave – 3 year grant	n/a	210p
ShareSave – 5 year grant	n/a	238p
APRA	809p	612p

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

	PSP		ShareSave
	2012	2011	2011
Weighted average share price	809p	612p	691p
Exercise price	n/a	n/a	525p
Expected dividends	16.5p	15.4p	16.0p
Expected volatility	31%	32%	30%
Correlation	39%	36%	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	0.6%	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.

21 Operating leases

Leases as lessee

		2012 £m	2011 £m
Rentals paid	– hire of plant and machinery	**94**	104
	– hire of other assets	**34**	29
Non-cancellable operating lease rentals are payable as follows:			
Within one year		**147**	117
Between one and five years		**490**	401
After five years		**526**	479
		1,163	997

Leases as lessor

	2012 £m	2011 £m
Rentals received – credited within revenue from aftermarket services	**30**	36
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	**2**	3
Between one and five years	**7**	8
After five years	**1**	2
	10	13

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 **£4m** (2011 £3m) and sublease receipts of **£17m** (2011 £23m) 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 eight 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 29 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 **£10m** (2011 £5m) and sublease receipts expected to be received is **£9m** (2011 £4m).

22 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:

	2012		2011	
	£m	$m	£m	$m
Gross contingent liabilities	**569**	***925***	612	*951*
Contingent liabilities net of relevant security [1]	**70**	***114***	124	*192*
Contingent liabilities net of relevant security reduced by 20% [2]	**133**	***216***	201	*312*
[1] Security includes unrestricted cash collateral of:	**64**	***104***	67	*104*

[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.

22 Contingent liabilities (continued)

Following a request for information from the Serious Fraud Office (SFO) about allegations of malpractice in Indonesia and China, investigations by Rolls-Royce have identified matters of concern in these, and in other overseas markets. The Group has passed information to the SFO relating to these concerns and is cooperating fully.

The consequence of these disclosures will be decided by the regulatory authorities. It is too early to predict the outcomes, but these could include the prosecution of individuals and of the Company. Accordingly, the potential for fines or other penalties cannot currently be assessed. As the investigation is ongoing it is not possible to identify the timescale in which these issues might be resolved.

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 **£48m** (2011 £68m).

23 Related party transactions

	2012 £m	2011 £m
Sales of goods and services to joint ventures and associates	**2,937**	2,864
Purchases of goods and services from joint ventures and associates	**(3,082)**	(2,380)
Operating lease payments to joint ventures and associates	**(57)**	(77)
Guarantees of joint ventures' and associates' borrowings	**12**	124
Dividends received from joint ventures and associates	**129**	76
RRSP receipts from joint ventures and associates	**13**	13
Other income received from joint ventures and associates	**2**	56

The aggregated balances with joint ventures are shown in notes 11 and 15. Transactions with Group pension schemes are shown in note 18.

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 in the Annual Report of Rolls-Royce Holdings plc. Remuneration for key management personnel is shown below:

	2012 £m	2011 £m
Salaries and short-term benefits	**15**	18
Post-retirement schemes	**1**	1
Share-based payments	**8**	14
	24	33

24 Acquisitions and disposals

During the year, the Group made a number of acquisitions:

- on 19 June 2012, Superstructure Capital Limited, a business engaged in marketing and sale of safety and risk management software to the aerospace industry;
- on 13 July 2012, PFW Aerospace UK, a business engaged in the manufacture of precision components for the aerospace industry;
- on 13 December 2012, Rolls-Royce Goodrich Engine Controls Limited (AEC, acquisition of 50 per cent not already held), a business engaged in the development and manufacture of aero-engine controls; and
- on 27 December 2012, PKMJ Technical Services, Inc., a nuclear engineering services business in the US.

Recognised amounts of identifiable assets acquired and liabilities assumed

	£m
Intangible assets	9
Property, plant and equipment	45
Post-retirement scheme surpluses	5
Inventory	37
Trade and other receivables	61
Cash and cash equivalents	7
Trade and other payables	(52)
Borrowings	(78)
Deferred tax liabilities	(1)
Provisions	(7)
Total identifiable assets and liabilities	26
Goodwill arising	10
Bargain purchase[1]	(4)
Total consideration	32
Satisfied by:	
Cash consideration	27
Existing shareholding	5
	32
Net cash outflow arising on acquisition:	
Cash consideration	27
Less: cash and cash equivalents acquired	(7)
Cash outflow per cash flow statement	20
Identifiable intangible assets comprise:	
Technology, patents and licenses	2
Customer relationships	5
Other	2
	9

[1] Bargain purchase of £4m arising on the acquisition of AEC has been recognised as a gain within commercial and administrative costs, offset by a charge of £2m on revaluing the previous joint venture investment.

These acquisitions did not have a significant impact on the results for the year, and would not have done had they been acquired on 1 January 2012.

24 Acquisitions and disposals (continued)

During the year, the Group disposed of:

- on 27 June 2012, Rolls-Royce Fuel Cell Systems Inc. (dilution of existing shareholding to 49 per cent); and
- on 29 June 2012 for US$1.5 billion, the equity, programme share and related goodwill of IAE International Aero Engines AG, which produces the V2500 engine for the Airbus A320 family of aircraft.

Assets and liabilities disposed

	IAE[1] £m	Other £m	Total £m
Intangible assets	193	1	194
Property, plant and equipment	–	2	2
Investment in joint venture	13	–	13
Trade and other receivables	76	1	77
Cash and cash equivalents	–	1	1
Trade and other payables	(31)	–	(31)
Provisions for liabilities and charges	(8)	(3)	(11)
Net assets	**243**	**2**	**245**
Profit on disposal of businesses	699	–	699
Transfer of subsidiary to associate	–	(2)	(2)
Disposal proceeds	**942**	**–**	**942**
Cash and cash equivalents disposed	–	(1)	(1)
Cash inflow/(outflow) per cash flow statement	**942**	**(1)**	**941**

[1] At 31 December 2011, the assets and liabilities associated with the IAE business were classified as 'Assets held for sale', as described in note 13.

25 Events after the reporting period – Consolidation of Tognum AG

On 1 January 2013, conditions were fulfilled which gave the Group certain rights that result in Tognum AG being classified as a subsidiary and consolidated. Rolls-Royce and Daimler AG each hold 50 per cent of the shares of Engine Holding GmbH, which itself holds approximately 99 per cent of the shares of Tognum AG. From 25 August 2011 to 31 December 2012 the Group's interest in Tognum was classified as a joint venture and equity accounted. Tognum is a premium supplier of engines, propulsion systems and components for marine, energy, defence, and other industrial applications (often described as 'off-highway' applications).

The table below sets out the illustrative effects of this business combination. These are based on: (i) a price of €26 per share (the offer price of the acquisition of Tognum by Engine Holding in 2011) and (ii) adjustments to reflect the fair values of Tognum's assets and liabilities on the acquisition of Tognum by Engine Holding on 25 August 2011, updated where appropriate. Both these bases will be updated during 2013.

Provisional identifiable assets acquired and liabilities assumed

	£m
Intangible assets	1,134
Property, plant and equipment	572
Investments in joint ventures and associates	30
Inventory	764
Trade and other receivables	479
Taxation recoverable	46
Financial assets	29
Cash and cash equivalents	240
Trade and other payables	(520)
Current tax liabilities	(26)
Borrowings and other financial liabilities	(306)
Deferred tax	(263)
Provisions	(435)
Post-retirement schemes	(397)
Total identifiable assets and liabilities	1,347
Goodwill arising	735
Total consideration	2,082
Consideration satisfied by:	
Existing shareholding	1,409
NCI	673
	2,082

The carrying value of the Group's interest in Tognum before the change in classification was **£1,328m**. On the basis of the illustrative valuation, the Group will recognise a gain of £81m in 2013 as a result of re-measuring this interest.

Company balance sheet

At 31 December 2012

		Notes	2012 £m	2011 £m
Fixed assets				
Intangible assets		3	**717**	667
Tangible assets		4	**1,152**	1,089
Investments	– subsidiary undertakings	5	**1,773**	1,769
	– joint ventures	5	**45**	40
			3,687	3,565
Current assets				
Stocks		6	**1,371**	1,261
Debtors	– amounts falling due within one year	7	**3,216**	3,235
	– amounts falling due after one year	7	**517**	856
Other financial assets	– amounts falling due within one year	8	**124**	131
	– amounts falling due after one year	8	**594**	333
Short-term deposits			**1,487**	–
Cash at bank and in hand			**384**	647
			7,693	6,463
Creditors – amounts falling due within one year				
Borrowings		9	**(696)**	(404)
Other financial liabilities		8	**(174)**	(147)
Other creditors		10	**(5,815)**	(5,733)
			(6,685)	(6,284)
Net current assets			**1,008**	179
Total assets less current liabilities			**4,695**	3,744
Creditors – amounts falling due after one year				
Borrowings		9	**(1,229)**	(1,179)
Other financial liabilities		8	**(447)**	(950)
Other creditors		10	**(795)**	(710)
			(2,471)	(2,839)
Provisions for liabilities and charges		11	**(122)**	(124)
Net assets excluding post-retirement schemes			**2,102**	781
Post retirement schemes – surpluses		13	**796**	838
– deficits		13	**(15)**	(5)
Net assets			**2,883**	1,614
Capital and reserves				
Called-up share capital		14	**326**	326
Share premium account		15	**631**	631
Revaluation reserve		15	**29**	35
Other reserves		15	**167**	167
Profit and loss account		15	**1,730**	455
Total shareholders' funds			**2,883**	1,614

The financial statements on pages 91 to 111 were approved by the Board on 13 February 2013 and signed on its behalf by:

Sir Simon Robertson Chairman

Mark Morris Chief Financial Officer

Company's registered number 1003142

Statement of total recognised gains and lossess

For the year ended 31 December 2012

	2012 £m	2011 £m
Profit attributable to the shareholders of Rolls-Royce plc	**1,367**	(44)
Net movement on post-retirement schemes	**(182)**	258
Related tax movements	**67**	(43)
Total recognised gains relating to the year	**1,252**	171

Reconciliation of movements in shareholders' funds

For the year ended 31 December 2012

	2012 £m	2011 £m
At 1 January	**1,614**	1,418
Total recognised gains for the year	**1,252**	171
Share-based payments – direct to equity	**17**	25
At 31 December	**2,883**	1,614

1 Accounting policies

Basis of accounting

The financial statements have been prepared in accordance with applicable accounting standards on the historical cost basis, modified to include the revaluation of land and buildings, and on a going concern basis as described on page 38.

As permitted by the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements.

As permitted by FRS 1 *Cash flow statements*, no cash flow statement has been prepared, as a consolidated cash flow statement has been prepared by the ultimate parent company.

Some small adjustments have been made to comparative figures to put them on a consistent basis with the current year.

Revenue recognition

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

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured.

Sales of services and long-term contracts are recognised when the outcome of the transaction can be reliably estimated. Revenue is recognised by reference to the stage of completion based on services performed to date as a percentage of the total contractual obligation. The assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on: costs incurred to the extent these relate to services performed up to the reporting date; achievement of contractual milestones where appropriate; or flying hours or equivalent for long-term aftermarket arrangements.

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

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

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

Government investment

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

Risk and revenue sharing partnerships (RRSPs)

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

The Company has arrangements with partners who do not undertake development work or supply parts. Such arrangements are considered to be financial instruments as defined by FRS 25 *Financial instruments: Presentation* and are accounted for using the amortised cost method.

Notes to the Company financial statements

Research and development
The charge to the profit and loss account consists of research and development expenditure incurred in the year, excluding known recoverable costs on contracts, contributions to shared engineering programmes and application engineering. Application engineering expenditure, incurred in the adaptation of existing technology to new products, is capitalised and amortised over the programme life, up to a maximum of 15 years, where both the technical and commercial risks are considered to be sufficiently low.

Interest
Interest receivable/payable is credited/charged to the profit and loss account using the effective interest method.

Taxation
Provision for taxation is made at the current rate and for deferred taxation at the projected rate on all timing differences that have originated, but not reversed at the balance sheet date. Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled.

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

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

Financial instruments
FRS 26 *Financial instruments: recognition and measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different. Rolls-Royce has classified its financial instruments as follows:

- Short-term investments are generally 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 creditors and financial RRSPs are classified as other liabilities.
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading.

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

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

Notes to the Company financial statements

Hedge accounting

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

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

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

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

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

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

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

Certification costs and participation fees

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

Software

The cost of acquiring software that is not specific to an item of tangible fixed assets is classified as an intangible asset.

Tangible fixed assets and depreciation

Tangible fixed assets are stated at cost or valuation less accumulated depreciation and any provision for impairments in value.

Depreciation is provided on a straight-line basis to write-off the cost or valuation, less the estimated residual value, over the estimated useful life. Estimated useful lives are as follows:

i) Land and buildings, as advised by the Group's professional valuers:
   a) Freehold buildings – five to 45 years (average 23 years).
   b) Leasehold land and buildings – lower of valuers' estimates or period of lease.
   c) No depreciation is provided in respect of freehold land.
ii) Plant and equipment – five to 25 years (average 13 years).
iii) Aircraft and engines – five to 20 years (average 15 years).
iv) No depreciation is provided on assets in the course of construction.

Notes to the Company financial statements

Impairment of fixed assets
Impairment of fixed assets is considered in accordance with FRS 11 *Impairment of fixed assets and goodwill*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the income-generating unit to which the asset belongs.

Intangible assets not yet available for use are tested for impairment annually. Other fixed assets are assessed for any indications of impairment annually. If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

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

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

Operating leases
Payments made and rentals received under operating lease arrangements are charged/credited to the income statement on a straight-line basis.

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

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

Post-retirement benefits
Pensions and similar benefits are accounted for under FRS 17 *Retirement benefits*. For defined benefit plans, obligations are measured at discounted present value whilst plan assets are recorded at fair value. The service and financing costs of such plans are recognised separately in the profit and loss account; service costs are spread systematically over the lives of employees and financing costs are recognised in the periods in which they arise. Actuarial gains and losses are recognised immediately in the statement of total recognised gains and losses. Surplus in schemes are recognised as assets only if they represent economic benefits that are available to the Company in the future.

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

Share-based payments
The Company participates in Rolls-Royce Holdings plc employee share-based payment arrangements. These are equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant. The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of shares or options that will eventually vest. The costs of these share-based payments are treated as a capital contribution from the parent company. Any payments made by the Company to its parent company, in respect of these arrangements, are treated as a return of this capital contribution.

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

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

See note 17 for further description of the share-based payment plans.

Notes to the Company financial statements

2 Emoluments of directors

	2012		2011	
	Highest paid director £000	Other directors £000	Highest paid director £000	Other directors £000
Aggregate emoluments excluding deferred share plans	**1,960**	**4,902**	1,551	4,976
Aggregate amounts relating to deferred share plans	**496**	**7,993**	359	5,057
Aggregate value of Company contributions to Company defined contribution pensions schemes	**123**	**383**	115	552
Gains realised on exercise of share options [1]	**–**	**–**	–	5

	2012 Number	2011 Number
Number of directors with accruing retirement benefits:		
Defined contribution schemes	**2**	3
Defined benefit schemes [2]	**2**	2
Number of directors with enhanced protection rights within defined benefit schemes	**2**	2
Number of directors exercising share options	**–**	2
Number of directors receiving shares as part of long-term incentives schemes	**5**	6

[1] Includes gains under the ShareSave plan.
[2] Two directors were contributing members of both defined contribution and defined benefit schemes (2011 two directors).

3 Intangible assets

	Certification costs and participation fees £m	Software and other £m	Total £m
Cost:			
At 1 January 2012	**646**	**319**	**965**
Additions	14	112	126
Disposals	(6)	–	(6)
At 31 December 2012	**654**	**431**	**1,085**
Accumulated amortisation:			
At 1 January 2012	**197**	**101**	**298**
Charge for the year	33	43	76
Disposals	(6)	–	(6)
At 31 December 2012	**224**	**144**	**368**
Net book value:			
At 31 December 2012	**430**	**287**	**717**
At 1 January 2012	449	218	667

Notes to the Company financial statements

4 Tangible assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost or valuation:					
At 1 January 2012	**448**	**1,449**	**37**	**179**	**2,113**
Additions	8	66	–	126	200
Reclassifications	14	69	–	(83)	–
Disposals	(4)	(25)	–	–	(29)
At 31 December 2012	**466**	**1,559**	**37**	**222**	**2,284**
Accumulated depreciation:					
At 1 January 2012	**153**	**859**	**11**	**1**	**1,024**
Charge for the year	16	112	7	–	135
Disposals	(5)	(20)	–	(2)	(27)
At 31 December 2012	**164**	**951**	**18**	**(1)**	**1,132**
Net book value:					
At 31 December 2012	**302**	**608**	**19**	**223**	**1,152**
At 1 January 2012	295	590	26	178	1,089

	2012 £m	2011 £m
Tangible fixed assets include:		
Net book value of finance leased assets	**11**	12
Non-depreciable land	**68**	60
Land and buildings at cost or valuation comprise:		
Cost	**320**	286
Valuation at 31 December 1996	**146**	162
	466	448
On an historical cost basis the net book value of land and buildings would have been as follows:		
Cost	**436**	413
Depreciation	**(162)**	(153)
	274	260
Capital expenditure commitments	**152**	121

Notes to the Company financial statements

5 Investments

	Subsidiary undertakings[1]	Joint ventures[2]		
	Shares at cost[3] £m	Shares at cost £m	Loans £m	Total £m
At 1 January 2012	**1,769**	**35**	**5**	**40**
Additions	50	3	2	5
Impairment	(14)	–	–	–
Disposals/write-offs	(32)	–	–	–
At 31 December 2012	**1,773**	**38**	**7**	**45**

[1] The principal subsidiary undertakings are listed on page 112.
[2] The principal joint ventures are listed on pages 113 and 114.
[3] The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited, one of its subsidiaries. At 31 December 2012, this guarantee was £25m (2011 £25m).

6 Stocks

	2012 £m	2011 £m
Raw materials	**78**	76
Work in progress	**438**	391
Long-term contracts work in progress	**(4)**	(1)
Finished goods	**837**	773
Payments on account	**22**	22
	1,371	1,261

7 Debtors

	Falling due within one year		Falling due after one year	
	2012 £m	2011 £m	2012 £m	2011 £m
Trade debtors	**361**	307	**39**	–
Amounts recoverable on contracts	**10**	127	**165**	406
Amounts owed by – subsidiary undertakings	**1,699**	1,823	**–**	–
– joint ventures	**319**	517	**3**	19
– parent and its subsidiaries	**544**	196	**–**	–
Deferred tax assets (note 12)	**–**	–	**281**	403
Other debtors	**210**	172	**–**	–
Prepayments and accrued income	**73**	93	**29**	28
	3,216	3,235	**517**	856

Notes to the Company financial statements

8 Other financial assets and liabilities

Details of the Company's policies on the use of financial instruments are given in the accounting policies on pages 93 to 96.

The fair values of other financial instruments held by the Company are as follows:

		Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Financial RRSPs £m	Total £m
At 31 December 2012							
Assets	– amounts falling due within one year	**113**	**6**	**5**	**124**	**–**	**124**
	– amounts falling due after one year	**500**	**4**	**90**	**594**	**–**	**594**
Liabilities	– amounts falling due within one year	**(124)**	**(8)**	**–**	**(132)**	**(42)**	**(174)**
	– amounts falling due after one year	**(241)**	**(15)**	**(7)**	**(263)**	**(184)**	**(447)**
		248	**(13)**	**88**	**323**	**(226)**	**97**
At 31 December 2011							
Assets	– amounts falling due within one year	124	7	–	131	–	131
	– amounts falling due after one year	243	7	83	333	–	333
Liabilities	– amounts falling due within one year	(106)	(7)	–	(113)	(34)	(147)
	– amounts falling due after one year	(698)	(19)	(2)	(719)	(231)	(950)
		(437)	(12)	81	(368)	(265)	(633)

Derivative financial instruments

The Company uses various financial instruments to manage its exposure to movements in foreign exchange rates. The Company uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals). To hedge the currency risk associated with a borrowing denominated in US dollars, the Company has currency derivatives designated as part of a fair value hedge. The Company uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates. Where the effectiveness of the hedge relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the hedging reserve and released to match actual payments on the hedged item.

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

	Foreign exchange instruments £m	Commodity instruments £m	Interest rate instruments £m	Total £m
At 1 January 2011	(402)	21	175	(206)
Movements in fair value hedges [1]	2	–	83	85
Movements in cash flow hedges	(1)	–	–	(1)
Movements in other derivative contracts	16	(28)	1	(11)
Contracts settled	(52)	(5)	(178)	(235)
At 1 January 2012	**(437)**	**(12)**	**81**	**(368)**
Movements in fair value hedges [1]	(8)	–	6	(2)
Movements in cash flow hedges	(4)	–	–	(4)
Movements in other derivative contracts	686	(3)	1	684
Contracts settled	11	2	–	13
At 31 December 2012	**248**	**(13)**	**88**	**323**

[1] Gain on related hedged items £2m (2011 £85m net loss).

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

Financial risk and revenue sharing partnerships (RRSPs)

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

8 Other financial assets and liabilities (continued)

The amortised cost values of financial RRSPs were as follows:

	2012 £m	2011 £m
At 1 January	**(265)**	(290)
Cash paid to partners	51	66
Financing charge	(17)	(18)
Exchange adjustments	12	(2)
Changes in forecast payments	(7)	(21)
At 31 December	**(226)**	(265)

9 Borrowings

	Falling due within one year		Falling due after one year	
	2012 £m	2011 £m	2012 £m	2011 £m
Unsecured				
Overdrafts	**549**	404	**–**	–
Bank loans	**–**	–	**400**	200
$7\frac{3}{8}$% Notes 2016 £200m	**–**	–	**200**	200
6.38% Notes 2013 US$230m [1]	**147**	–	**–**	160
6.55% Notes 2015 US$83m [1]	**–**	–	**58**	62
6.75% Notes 2019 £500m [2]	**–**	–	**571**	557
	696	404	**1,229**	1,179
Repayable – otherwise than by installments				
Between one and two years			**–**	160
Between two and five years			**458**	462
After five years			**771**	557
			1,229	1,179

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

10 Other creditors

	Falling due within one year		Falling due after one year	
	2012 £m	2011 £m	2012 £m	2011 £m
Payments received on account [1]	**331**	401	**609**	487
Trade creditors	**548**	529	**–**	–
Amounts owed to – subsidiary undertakings	**2,688**	2,285	**–**	–
– joint ventures	**194**	207	**2**	1
– parent and its subsidiaries	**–**	42	**–**	–
Corporate taxation	**89**	98	**–**	–
Other taxation and social security	**34**	29	**–**	–
Other creditors	**1,000**	1,229	**87**	56
Accruals and deferred income	**931**	913	**97**	166
	5,815	5,733	**795**	710
[1] Includes payments received on account from joint ventures and associates	**151**	250	**162**	147

Notes to the Company financial statements

11 Provisions for liabilities and charges

	At 1 January 2012 £m	Disposal of business £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At 31 December 2012 £m
Warranties and guarantees	**36**	–	(11)	6	(2)	**29**
Contract loss	**7**	–	(2)	12	–	**17**
Customer financing	**76**	(9)	–	5	–	**72**
Restructuring	**5**	–	(1)	–	–	**4**
	124	(9)	(14)	23	(2)	**122**

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

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

Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 18. Timing of utilisation is uncertain.

12 Deferred taxation

	£m
At 1 January 2012	**126**
Amount charged to profit and loss account	(145)
Amount charged to statement of total recognised gains and losses	67
At 31 December 2012	**48**

There are other deferred tax assets totalling £102m (2011: £102m) that have not been recognised on the basis that their future economic benefit is uncertain.

The Autumn Statement 2012 announced that the UK corporation tax rate will reduce to 21 per cent by 2014. The reductions to 24 per cent effective from 1 April 2012 and 23 per cent effective from 1 April 2013 were substantively enacted on 26 March 2012 and 3 July 2012 respectively. As the rate change to 23 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 profit and loss account except to the extent that they relate to items previously charged or credited to reserves. Accordingly, in 2012, £19m has been charged to the profit and loss account and £18m has been credited to the statement of total recognised gains and losses.

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 £1m.

12 Deferred taxation (continued)

The analysis of the deferred tax position is as follows:

	2012 £m	2011 £m
Fixed asset timing differences	**(93)**	(101)
Other timing differences	**20**	15
Pensions and other post-retirement scheme benefits	**(233)**	(277)
Foreign exchange and commodity financial assets and liabilities	**(56)**	121
Losses	**349**	307
Advance corporation tax	**61**	61
	48	126
Included within:		
Debtors – amounts falling due after one year	**281**	403
Post-retirement scheme – surpluses	**(238)**	(278)
– deficits	**5**	1
	48	126

The above figures exclude taxation payable on capital gains which might arise from the sale of fixed assets at the values at which they are stated in the Company's balance sheet.

13 Post-retirement benefits

Defined benefit schemes

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

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to 31 December 2012. The most recent funding valuations of the main schemes were:

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

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

	2012 %	2011 %
Rate of increase in salaries	**4.1**	4.2
Rate of increase of pensions in payment	**2.5**	1.7
Discount rate	**4.4**	4.7
Expected rate of return on scheme assets	**3.1**	3.4
Inflation assumption [1]	**3.0**	3.1

[1] This is the assumption for the Retail Price Index. The Consumer Price Index is assumed to be 0.6 per cent lower.

13 Post-retirement benefits (continued)

The discount rates are determined by reference to the market yields on AA rated corporate bonds. The rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. The discount rates on page 103 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 are derived from the SAP actuarial tables, with future improvements in line with the CMI 2011 core projections and long-term improvements of 1.25%. Where appropriate, these are adjusted to take account ofthe 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	20.9 years
Future pensioner currently aged 45	22.6 years

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

Amounts recognised in the balance sheet

	2012 £m	2011 £m
Present value of funded obligations	**(8,533)**	(7,713)
Fair value of scheme assets	**9,734**	9,519
Unrecognised surplus [1]	**(187)**	(696)
Surplus	**1,014**	1,110
Related deferred tax liability	**(233)**	(277)
Net asset recognised in the balance sheet	**781**	833
Analysed as:		
Post-retirement scheme surpluses	**796**	838
Post-retirement scheme deficits	**(15)**	(5)
	781	833

[1] Where a surplus has arisen on a scheme, in accordance with FRS 17 *Retirement benefits*, the surplus is recognised as an asset only if it represents a future economic benefit available to the Company. Any surplus in excess of this benefit is not recognised in the balance sheet. Surpluses have arisen largely as a result of differences between the actuarial and FRS 17 discount rate assumptions.

13 Post-retirement benefits (continued)

Changes in present value of defined benefit obligations

	2012 £m	2011 £m
At 1 January	**(7,713)**	(7,039)
Current service cost	**(122)**	(119)
Past-service credit	**(1)**	126
Finance cost	**(356)**	(372)
Contributions by employees	**(4)**	(4)
Benefits paid out	**323**	312
Actuarial losses	**(660)**	(617)
At 31 December	**(8,533)**	(7,713)

Changes in fair value of scheme assets

	2012 £m	2011 £m
At 1 January	**9,519**	7,783
Expected return on assets	**315**	381
Contributions by employer	**250**	256
Contributions by employees	**4**	4
Benefits paid out	**(323)**	(312)
Actuarial gains	**(31)**	1,407
At 31 December	**9,734**	9,519
Actual return on plan assets	**284**	1,788

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

	2012		2011	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
LDI portfolio [1]	**2.8**	**7,924**	3.1	8,330
Longevity swap [2]	**4.4**	**(126)**	4.7	(79)
Equities	**5.9**	**1,083**	6.0	1,004
Sovereign debt	**2.7**	**214**	2.8	159
Corporate bonds	**3.6**	**320**	4.0	13
Other	**2.7**	**319**	2.8	92
	3.2	**9,734**	3.4	9,519

[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 scheme has agreed an average life expectancy with a counterparty. If pensioners live longer than expected the counterparty will make payments to the scheme to offset the additional cost of paying pensions. If the reverse applies, the cost of paying pensions will be reduced but the scheme will be required to make payments to the counterparty.

The scheme assets do not include any financial instruments of the Rolls-Royce Holdings plc group, nor any property occupied by, or other assets used by, the group.

The expected rates of return for LDI portfolios are determined by the implicit yields on the portfolios at the balance sheet date.

The expected rates of return on individual categories of scheme assets are determined by reference to gilt yields. Equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25 per cent and 0.9 per cent per annum respectively.

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

Notes to the Company financial statements

13 Post-retirement benefits (continued)

Future contributions

The Company expects to contribute approximately **£250m** to its defined benefit schemes in 2013.

Sensitivities

The investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. The impacts of the principal sensivities are:

	2012 £m	2011 £m
Defined benefit obligations – 0.25% reduction in discount rate	**(315)**	(298)
Defined benefit assets – 0.25% reduction in interest rates	**453**	463
Defined benefit obligations – age ratings increase by one year	**(198)**	(163)
Defined benefit longevity swap – age ratings increase by one year	**68**	62
Defined benefit obligations – 0.5% increase in rate of increase in salaries	**(193)**	(127)

History of defined benefit schemes

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

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Balance sheet					
Present value of defined benefit obligations	**(8,533)**	(7,713)	(7,039)	(6,714)	(5,719)
Fair value of scheme assets	**9,734**	9,519	7,783	7,048	7,163
Unrecognised surplus	**(187)**	(696)	(164)	(75)	(566)
Asset	**1,014**	1,110	580	259	878
Experience gains/(losses)					
Actuarial (losses)/gains on scheme assets	**(31)**	1,407	444	(311)	264
Experience (losses)/gains on scheme liabilities	**(660)**	(617)	(142)	(865)	776
Movement in unrecognised surplus	**509**	(532)	(89)	491	(453)
Total amount recognised in the statement of total recognised gains and losses	**(182)**	258	213	(685)	587
Cumulative amount recognised in the statement of total recognised gains and losses since 1 January 2002	**(204)**	(22)	(280)	(493)	192

Defined contribution schemes

The Company operates a number of defined contribution schemes. The total expense recognised in the profit and loss account was **£18m** (2011 £13m).

Notes to the Company financial statements

14 Share capital

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At 1 January and 31 December 2012	**2,000**	**400**
Issued and fully paid		
At 1 January and 31 December 2012	**1,631**	**326**

15 Movements in capital and reserves

	Non-distributable reserves					
	Share capital £m	Share premium £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m	Total equity £m
At 1 January 2012	**326**	**631**	**35**	**167**	**455**	**1,614**
Total recognised gains relating to the year	–	–	–	–	1,252	1,252
Transfers between reserves	–	–	(6)	–	6	–
Share-based payments – direct to equity	–	–	–	–	17	17
At 31 December 2012	**326**	**631**	**29**	**167**	**1,730**	**2,883**

16 Operating lease annual commitments

	2012 £m	2011 £m
Leases of land and buildings which expire:		
Between one and five years	**1**	2
After five years	**3**	1
Other leases which expire:		
Within one year	**1**	1
Between one and five years	**5**	3

17 Share-based payments

Effect of share-based payment transactions on the Company's results

	2012 £m	2011 £m
Total expense recognised for equity-settled share-based payment transactions	**30**	32

Share-based payment plans in operation during the year

During the year, the Company participated in the following share-based payment plans operated by Rolls-Royce Holdings plc:

Performance Share Plan (PSP)

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

ShareSave share option plan

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

17 Share-based payments (continued)

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

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

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

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2012	**16.9**	**445p**	**0.2**	**106p**	**11.3**	**1.8**
Granted	–	–	–	–	–	–
Additional entitlements arising from TSR performance	–	–	–	–	2.4	1.1
Additional shares accrued from reinvestment of C Shares	–	–	–	–	1.7	–
Forfeited	(0.2)	454p	–	–	(0.5)	–
Exercised	(0.1)	409p	(0.1)	133p	(7.0)	(0.7)
Outstanding at 31 December 2012	**16.6**	**445p**	**0.1**	**77p**	**7.9**	**2.2**
Exercisable at 31 December 2012	**–**	**–**	**0.1**	**77p**	**–**	**–**
Outstanding at 1 January 2011	16.3	380p	0.3	132p	11.2	1.6
Granted	6.3	525p	–	–	3.0	1.5
Additional entitlements arising from TSR performance	–	–	–	–	0.7	–
Forfeited	(0.5)	387p	–	–	(0.3)	–
Exercised	(5.2)	346p	(0.1)	208p	(3.3)	(1.3)
Outstanding at 31 December 2011	16.9	445p	0.2	106p	11.3	1.8
Exercisable at 31 December 2011	–	–	0.2	106p	–	–

As share options are exercised throughout the year, the weighted average share price during the year of **836 pence** (2011 642 pence) is representative of the weighted average share price at the date of exercise. The middle market closing price at 31 December 2012 was **873.5 pence** (2011 747 pence).

The average remaining contractual life of exercisable options is **0.2** years (2011 1.0 years).

17 Share-based payments (continued)

Share options outstanding

	ShareSave		ESOP		Total	
Exercise prices (pence)	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years
At 31 December 2012						
0 – 99	**–**	**–**	**0.1**	**0.2**	**0.1**	**0.2**
300 – 399	**6.6**	**1.4**	**–**	**–**	**6.6**	**1.4**
400 – 499	**3.9**	**0.1**	**–**	**–**	**3.9**	**0.1**
500 – 599	**6.1**	**3.4**	**–**	**–**	**6.1**	**3.4**
	16.6	**2.0**	**0.1**	**0.2**	**16.7**	**2.0**
At 31 December 2011						
0 – 99	–	–	0.1	1.2	0.1	1.2
100 – 199	–	–	0.1	0.2	0.1	0.2
300 – 399	6.7	2.4	–	–	6.7	2.4
400 – 499	3.9	1.1	–	–	3.9	1.1
500 – 599	6.3	4.4	–	–	6.3	4.4
	16.9	2.8	0.2	1.0	17.1	2.8

The range of exercise prices of options outstanding at 31 December 2012: ShareSave between **387 pence** and **525 pence** (2011 387 pence and 525 pence); and for ESOP **77 pence** (2011 between 77 pence and 188 pence).

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to **three** directors and senior executives were outstanding at 31 December 2012.

Fair values of share-based payment plans

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

	2012	2011
PSP – 25% TSR uplift	**885p**	662p
PSP – 50% TSR uplift	**985p**	737p
ShareSave – 3 year grant	**n/a**	210p
ShareSave – 5 year grant	**n/a**	238p
APRA	**809p**	612p

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

	PSP		ShareSave
	2012	2011	2011
Weighted average share price	**809p**	612p	**691p**
Exercise price	**n/a**	n/a	**525p**
Expected dividends	**16.5p**	15.4p	**16.0p**
Expected volatility	**31%**	32%	**30%**
Correlation	**39%**	36%	**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	**0.6%**	1.9%	**1.9%**

Notes to the Company financial statements

17 Share-based payments (continued)

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

PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies 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.

18 Contingent liabilities

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

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

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions were:

	2012		2011	
	£m	$m	£m	$m
Gross contingent liabilities	569	925	612	951
Contingent liabilities net of relevant security [1]	70	114	124	192
Contingent liabilities net of relevant security reduced by 50% [2]	133	216	201	312
[1] Unrestricted cash collateral held as security	64	104	67	104

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

18 Contingent liabilities (continued)

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.

Following a request for information from the Serious Fraud Office (SFO) about allegations of malpractice in Indonesia and China, investigations by Rolls-Royce have identified matters of concern in these, and in other overseas markets. The Company has passed information to the SFO relating to these concerns and is cooperating fully.

The consequence of these disclosures will be decided by the regulatory authorities. It is too early to predict the outcomes, but these could include the prosecution of individuals and of the company. Accordingly, the potential for fines or other penalties cannot currently be assessed. As the investigation is ongoing it is not possible to identify the timescale in which these issues might be resolved.

Contingent liabilities exist in respect of guarantees provided by the Company in the ordinary course of business for product delivery, performance and reliability. The Company has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. The Company is party to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Company is no longer fully insured against known and potential claims from employees who worked for certain of the Company's UK-based businesses for a period prior to the acquisition of those businesses by the Company. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Company.

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee. At 31 December 2012, there were Company guarantees in respect of joint ventures amounting to **£12m** (2011 £124m).

The Company participates in a Cash Pooling Arrangement. Under the Pooling Arrangement the Company benefits from more favourable interest rates than would be available outside of the Pooling Arrangement as well as more streamlined treasury functions. As part of the Pooling Arrangement, the Company cross-guarantees the borrowings of other pooling participants. At 31 December 2012 these guarantees amounted to **£24m** (2011 £14m).

19 Related party transactions

The Company is a wholly owned subsidiary of Rolls-Royce Holdings plc and therefore has taken advantage of the exemption in FRS 8 *Related party disclosures* not to disclose related party transactions with its parent company and other wholly owned group companies.

There are no significant related party transactions with non-wholly owned group companies

The aggregated balances with joint ventures are shown in notes 7 and 10.

20 Ultimate holding company

The ultimate holding company is Rolls-Royce Holdings plc, incorporated in Great Britain. The financial statements for Rolls-Royce Holdings plc may be obtained from the Company Secretary, Rolls-Royce Holdings plc, 65 Buckingham Gate, London SW1E 6AT.

Subsidiaries, jointly controlled entities and associates

At 31 December 2012

Incorporated within the UK – directly held unless marked*

Optimized Systems and Solutions Limited	Equipment health management and advanced data management services
Rolls-Royce Engine Control Systems Limited*	Development and manufacture of aero engine controls
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
Vinters Engineering Limited*	Production, repair and overhaul of power generation, transmission and conversion equipment for military and commercial activities

The above companies operate principally in the UK and the effective Group interest is 100 per cent.

Incorporated overseas – directly held unless marked*

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 Manufacturing (Shanghai) Limited*	Manufacture and supply of marine equipment and marine aftermarket support services
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	Bergen Engines AS*	Design and manufacture of medium-speed diesel engines (50%)
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	PKMJ Technical Services, Inc.*	Nuclear engineering services and software solutions
US	R. Brooks Associates Inc.*	Specialist civil nuclear reactor 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 Marine North America Inc.*	Design and manufacture of marine equipment and marine aftermarket support services

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

Subsidiaries, jointly controlled entities and associates
At 31 December 2012

Incorporated within the UK – directly held unless marked*

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

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.

Subsidiaries, jointly controlled entities and associates

At 31 December 2012

Incorporated overseas – directly held unless marked*

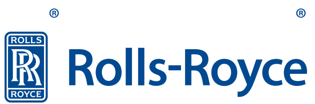
		Class	% of class held	% of equity held
China	Xian XR Aero Components Co Limited Manufacturing facility for aero engine parts	Ordinary	49	49
Germany	EPI Europrop International GmbH (effective interest 35.5%) A400M engine collaboration	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) EJ200 engine collaboration	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) MTR390 engine collaboration	Ordinary	33.3	33.3
Germany	N3 Engine Overhaul Services GmbH & Co KG* Aero engine repair and overhaul	Ordinary	50	50
Germany	Tognum AG* Supplier of engines and power trains for marine propulsion, distributed power generation and industrial 'off highway' sectors	Ordinary	49.5	49.5
Hong Kong	Hong Kong Aero Engine Services Limited* Aero engine repair and overhaul	Ordinary	45	45
India	International Aerospace Manufacturing Private Limited* Manufacture of compressor shrouds, compressor rings, turbine blades and nozzle guide vanes	Ordinary	50	50
Israel	Techjet Aerofoils Limited* Manufacture of compressor aerofoils for gas turbines	A Ordinary B Ordinary	50 50	50
Malaysia	Advanced Gas Turbine Solutions Sdn Bhd* Industrial gas turbine aftermarket services	Ordinary	49	49
Singapore	International Engine Component Overhaul Pte Limited* Aero engine repair and overhaul	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%)* Aero engine repair and overhaul	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA Aero engine component manufacture and maintenance	Ordinary	46.9	46.9
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* Aero engine leasing	Partnerships	50	–
US	Exostar LLC* Business to business internet exchange	Partnership	18.5	–
US	LG Fuel Cell Systems Inc.* Development of fuel cells	Common Stock	49	49
US	Texas Aero Engine Services, LLC* Aero engine repair and overhaul	Partnership	50	–

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 113 to 114 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.



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