Report from Lewis Booth Chairman of the audit committee

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

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

Membership

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

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

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

Responsibilities

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

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

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

Work of the committee in 2011

Financial reporting

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

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

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

Business assurance

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

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

Auditors

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

Non-audit fees

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

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

Other matters

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

Private meetings

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

Non-audit services provided by KPMG

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

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

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

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

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

External auditors' appointment

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

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

Lewis Booth
Chairman of the audit committee