

UK Corporate Governance Code

The Code

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

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

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

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

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

Board membership

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

Roles and responsibilities

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

Role of the Board

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

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

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

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

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

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

Directors' induction and training

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

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

Shareholder relations

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

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

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

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

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

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

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

Board and committee attendance 2011

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

Figures in brackets denote the maximum number of meetings that could have been attended (seven Board meetings were scheduled and five called at short notice).

The figures include meetings of the former holding company, Rolls-Royce Group plc to May 23, 2011.

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

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

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

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

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

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

The Annual General Meeting (AGM)

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

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

The Board

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

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

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

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

The work of the Board in 2011

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

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

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

Independence of the non-executive directors

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

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

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

Conflicts of interest

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

Indemnity

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

Board committees

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

Executive committees

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

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

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

The GLT's responsibilities are:

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

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

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