

# Corporate governance

## Statement on corporate governance compliance

Rolls-Royce attaches the highest priority to corporate governance, the system by which the Company is directed, managed and controlled in the interests of all its stakeholders. The strength of the Company's corporate values, its reputation and its ability to achieve its objectives are influenced by the effectiveness of the Company's approach towards corporate governance.

The Board confirms that throughout 2006, the Company complied with the Combined Code on Corporate Governance (the Combined Code). This corporate governance report and, where appropriate, the Directors' remuneration report, explain how the Company discharges its corporate governance responsibilities.

## The Board's composition and directors' independence

Simon Robertson chairs the Board of the Company and Sir John Rose is the Chief Executive. The division of responsibilities between them is set down in writing and agreed by the Board. Peter Byrom is the Company's Senior Independent Director.

There are currently 11 directors on the Board comprising the non-executive Chairman, the Chief Executive, four other executive directors and five non-executive directors.

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 prevents any individual or small group dominating the Board's decision making.

Each executive director receives a service contract on appointment (see the Directors' remuneration report for further information) and each non-executive director receives a letter setting out the conditions of their appointment.

Non-executive directors are appointed for an initial term of three years, which may be extended subsequently with the agreement of the Board. Executive directors are employees who have executive responsibilities 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, they are selected with the assistance of recruitment consultants.

The Board applies a rigorous process in order to satisfy itself that its non-executive directors remain independent. On his appointment as Chairman on January 1, 2005, Simon Robertson met the criteria for independence contained in the Combined Code. His other significant commitments are described on page 41. The Board reviews the independence of the non-executive directors every year, using its own judgement when applying the criteria in the Combined Code. Having undertaken this review in 2006, the Board confirms that all the non-executive directors are considered to be independent in character and judgement.

On January 1, 2007, Peter Byrom completed ten years service on the Board and therefore does not meet one of the criteria for independence contained in the Combined Code. Having conducted a thorough review in 2006, the Board continues to hold the view that Peter Byrom remains independent in character and judgement, that there are no relationships or circumstances which are likely to affect his independent judgement and that he is in no way dependent on the remuneration he receives from the Company. The Board believes strongly that in a long-term, complex and technologically advanced business, it is essential that non-executive directors have the opportunity to acquire, over a number of years, the experience and knowledge of the business and the sectors within which the Group operates.

In line with previous plans, the Company intends to appoint a new Senior Independent Director later this year. It also expects to appoint to the Board a suitably qualified, non-executive director, with the objective of that person succeeding Peter Byrom as Chairman of the audit committee later this year.

## Role of the Board

The Board is responsible to all its stakeholders for the conduct and performance of the Company.

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

The Board retains responsibility for the approval of certain matters which affect the shape and risk profile of the Company, as well as such items as the annual budget and performance targets, the published accounts, payments to shareholders, major capital investments and any substantial change to balance sheet management policy. This division of responsibilities between the Board and the executive team is

set out in detail in a schedule approved annually by the Board, which defines those decisions which can only be taken by the Board itself.

The Board has approved the following statement summarising its core responsibilities:

### Primary goal

The primary goal of the Board is to ensure that the Company's strategy creates value for the long-term investor within an acceptable risk profile.

### The Board's tasks

In line with its primary goal, the Board's principal tasks are to:

- ensure the development of the Company's strategy and keep it under rigorous review;
- monitor the implementation of the strategy, ensuring that the necessary financial and human resources are in place to deliver it and that effective controls exist to manage risk;
- safeguard the values of the Company, including its brand and corporate reputation and the safety of its products;
- oversee the quality and performance of management and ensure through effective succession planning and remuneration policies that it is maintained at world-class standards; and
- maintain an effective corporate governance framework that delivers long-term value to shareholders.

## Directors' induction, training and information

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. As part of their briefing, non-executive directors visit key sites and meet a cross-section of managers and employees to gain a better understanding of the Group and its operations. Ongoing training is available for all the directors, including presentations by the executive team on particular aspects of the business.

There is an agreed 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 Company Secretary and the General Counsel.

## Board effectiveness

The Chairman meets at least once a year with the non-executive directors without the executive directors present, in order to review the operation of the Board.

The Chairman has an annual meeting with each non-executive director to review their contribution to the Board. The Senior Independent Director chairs an annual meeting with the non-executive directors to review the performance of the Chairman, the outcome of which is reported back to him.

Each year, the Chairman reviews the performance of the Chief Executive as part of the annual salary review process overseen by the remuneration committee. The Chief Executive reviews the performance of the other executive directors in the same way.

In 2006, the nominations committee led the annual process to enable the Board to evaluate the effectiveness of its performance. Following a review in 2005 undertaken by Consilium Associates, the Board decided that in 2006 the review should involve the completion of a written questionnaire by the directors and a series of meetings between the Chairman and each individual director. The results of this exercise were reviewed by the Board in December 2006.

The review covered all aspects of corporate governance, including board and committee structure, board dynamics, the conduct and frequency of board meetings, the consideration of strategic issues by the Board and the information provided to directors. The outcome of this exercise is being used by the directors to implement a number of improvements in the way the Board operates, including the way it reviews strategy and Board composition and processes.

The audit, remuneration and nominations committees have separately undertaken reviews of their terms of reference and effectiveness during 2006.



## Organisation

The Group has a clearly defined organisation structure within which operational management has detailed responsibilities and levels of authorisation, supported by written job descriptions and operating manuals.

## The risk management system

The risk management system is an integral part of management's approach to delivering business objectives and is a systematic process designed to identify, assess, treat, manage and communicate risks. It also provides a method of escalation and delegation to the appropriate level within the organisation and ensures actions are owned, defined, resourced and effective.

Management is responsible for the ongoing identification and evaluation of significant risks within its areas of responsibility and, using a common process, for the operation of suitable controls or mitigation actions. Risks are recorded in regularly updated risk registers operating at all levels of the organisation and are continuously reviewed and monitored. During the review process, significant emphasis is placed on learning from and sharing prior experience. Risks may arise from a variety of internal and external sources. They may be associated with regulations, customer requirements and competitor actions or could result from the capability of the processes used to execute the business or from external and largely unpredictable events, such as terrorist activity or war. The principal risks and uncertainties for the Group are shown on pages 18 and 19.

Risks, irrespective of source, are managed through processes operated by project and functional teams. Management reports regularly to the risk committee on its view of risks and how they are managed so that the Board can then consider and review these risks in terms of their potential impact.

Management has continued to perform comprehensive risk reviews for all key projects, programmes and business change plans. In addition, all the processes operated by the Group are subject to continuous improvement, including the risk management process itself.

## Systems of internal control

The general managers of individual businesses are aware of their responsibility to operate systems of internal control which provide reasonable assurance of effective and efficient operations, reliable financial information and compliance with laws and regulations. Financial managers are required to acknowledge in writing that their routine financial reporting is based on reliable data and that their results are properly stated in accordance with Group requirements.

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 are reported monthly against budget and variances reviewed.

The activities of the Group are subject to review by the Department of Risk, including Business Assurance and Project Risk Assessment, and the assurance functions of Health, Safety and Environment, Quality and Engineering. These functions operate to work programmes agreed by the appropriate Board member.

The Business Assurance function, which works closely with the external auditors, undertakes a programme of financial and operational audits and reviews agreed by the audit committee and covering all Group activities. The programme includes independent reviews of the systems of internal control and risk management. The findings and the status of corrective actions taken to address these are reported in writing to both the audit and risk committees twice a year.

## Export controls

The Group attaches the highest priority to complying fully with export controls in all the jurisdictions in which it operates. Detailed processes have been put in place to ensure that the Group follows all applicable legal and regulatory requirements. The Board has established an exports committee, chaired by the Chief Operating Officer, which has responsibility for the application of appropriate controls to the Group's export activity.

In the UK, the Group fully complies with the provisions of the UK Export Control Act on both tangible and intangible exports and with the regulations relating to trade, between third parties outside the UK. Additionally, the Group complies with the relevant EU regulations regarding the export of dual use goods and technology. In relation to other jurisdictions, most notably that of the USA, the Group vigorously enforces a policy of compliance with both the relevant national legislation and its underlying regulatory intent.

## Ethics

The Board believes strongly that the Group's business should be conducted in a way that reflects the highest ethical standards.

Rolls-Royce has a Global Code of Business Ethics which lays down the principles to be followed by employees when conducting business. The code also gives guidance to support achievement of the required standards. Additionally, confidential reporting lines enable UK and US employees to report, outside the normal management chain, any concerns they may have with regard to business conduct.

## Communication with shareholders

The Company attaches importance to the effectiveness of its communications with shareholders. It publishes an Annual review and summary financial statement as well as a full Annual report. There are also separate reports covering the environment and community relations.

The Company maintains a regular dialogue with institutional shareholders and the financial community. This includes presentations of the preliminary and interim results, regular meetings with major shareholders, participation in stockbrokers' seminars and site visits.

Each year the Group holds an investors' seminar, in order to improve the financial community's understanding of the Group and to introduce investors to a broader range of management. All shareholders can gain access to these and other presentations, as well as to the Annual report and other information about the Group, on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com)

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, remuneration and nominations committees are available to answer any questions from shareholders on the work of their committees.

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 elected to receive communications electronically, notice is given by email of the availability of documents on the Group's website.

Responsibility for maintaining regular communications with shareholders rests with the executive management team led by the Chief Executive. However, the Board is informed on a regular basis of key shareholder issues, including share price performance, the composition of the shareholder register and City expectations. Independent research is commissioned annually into institutional shareholder perceptions of the Group. The Chairman, the Senior Independent Director and the non-executive directors make themselves available to meet with shareholders as required.

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

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

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

The Group financial statements are required by law and IFRS as adopted by the EU to present fairly the financial position and performance of the Group; the Companies Act 1985 (the 'Act') provides in relation to such financial statements that references in the relevant part of the Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

The parent company financial statements are required by law to give a true and fair view of the state of affairs of the parent company.

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 IFRS 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 proper accounting records that 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 Act. 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 Report of the directors, Directors' remuneration report and Corporate governance statement that comply 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.

#### **Disclosure of information to auditors**

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

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

This confirmation is given and should be interpreted in accordance with the provisions of Section 234ZA of the Act.