

Report of the directors

The directors present their report and the audited financial statements of Rolls-Royce Group plc (the Company) and its subsidiaries (together referred to as the Group) for the year ended December 31, 2007.

Business review

A review of the business can be found on pages 4 to 45.

Corporate governance

The directors' report on corporate governance and the Directors' remuneration report are on pages 51 to 54 and 55 to 64 respectively.

B Shares

At the Annual General Meeting (AGM) on May 7, 2008, the directors will recommend an issue of 89.6 B Shares with a total nominal value of 8.96p for each ordinary share. Together with the interim issue on January 2, 2008 of 40.4 B Shares for each ordinary share with a total nominal value of 4.04p, this is the equivalent of a total annual payment to ordinary shareholders of 13p for each ordinary share.

As a result of the strategic financial review referred to on page 42 the directors have concluded that the dilution caused by the conversion of B Shares to ordinary shares is inconsistent with the Group's strategy. Consequently, it is intended to create a new class of share to be titled 'C Shares'. The directors propose that the 2007 final payment to shareholders be made by a further issue of B Shares using the current B Share process. Subsequently the directors intend that future shareholder payments, commencing with the 2008 interim payment to shareholders, will be by the issue of C Shares.

The principal difference between the existing B Shares and the proposed C Shares is that the C Shares will not carry an option to convert into ordinary shares. The Company plans to make arrangements with its Registrar to enable shareholders to reinvest their payments in a market purchase of ordinary shares. For those shareholders who retain their C Shares, a C Share dividend at a rate of 75 per cent of the London Inter-Bank Offered Rate (LIBOR) will be payable half yearly in arrears.

Further details of this proposal and a resolution seeking shareholder approval will be included in the Notice for the forthcoming AGM.

Subject to shareholder approval, following the 2007 final shareholder payment and prior to the issue of C Shares in respect of the interim shareholder payment, the directors expect that the Company will exercise its rights to redeem for cash any B Shares that remain in issue.

Going concern

After making enquiries, the directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Political donations

In line with its established policy, the Group made no political donations during 2007.

While it remains the Group's policy not to make donations to political parties it is possible that certain routine activities undertaken by the Group might unintentionally fall within the broad scope of the provisions controlling political donations and expenditure contained in the Companies Act 2006.

A resolution will therefore be proposed at the 2008 AGM seeking shareholder approval for the directors to be given authority to make donations and incur expenditure up to a maximum amount of £25,000 per Group company and a maximum amount of £50,000 for the entire Group, which might otherwise be caught by the terms of the Companies Act 2006.

Authority to purchase own shares

At the AGM in 2007, the Company was authorised by shareholders to purchase up to 180,448,489 of its own ordinary shares representing ten per cent of its issued ordinary share capital as at February 7, 2007. The Company did not make use of this authority during 2007.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2008 and a resolution to renew it will be proposed at that meeting.

Adoption of new Articles of Association

Changes to the Articles of Association must be approved by the shareholders, including where applicable with written consent of the Special Shareholder, in accordance with the legislation from time to time. A special resolution will be proposed at the AGM, to adopt new Articles of Association in order to incorporate a number of changes introduced by the Companies Act 2006.

Auditors

A resolution to reappoint the auditors, KPMG Audit Plc, and to authorise the directors to determine their remuneration, will also be proposed at the AGM.

Directors

The directors' biographical details, including their other significant commitments, are set out on page 46. During the year there were a number of Board changes: Professor Peter Gregson and John Rishton were appointed non-executive directors on March 1, 2007; Sir John Taylor retired as a non-executive director on May 1, 2007. On September 1, 2007 Helen Alexander was appointed as a non-executive director and Mike Terrett was appointed as an executive director. On September 13, 2007 Iain Conn succeeded Peter Byrom as the Company's Senior Independent Director and John Rishton succeeded Peter Byrom as chairman of the audit committee. John Cheffins retired as an executive director on September 30, 2007. Carl Symon will retire as a non-executive director at the conclusion of the AGM. He will be succeeded as chairman of the remuneration committee by Helen Alexander.

Under the Company's Articles of Association, one third of the directors are subject to re-election every year, with each director also being subject to re-election at intervals of not more than three years. Any director appointed during the year is separately required to retire and seek election by the shareholders at the next AGM. The Board also requires any non-executive director who has served on the Board for more than nine years to be subject to annual re-election at the AGM.

The directors appointed during the year seeking election by shareholders at the AGM are Helen Alexander and Mike Terrett. Peter Byrom, having served 11 years on the Board, is subject to annual re-election by shareholders. The directors retiring under the annual re-election provisions contained in the Articles of Association are Sir John Rose, Andrew Shilston, Colin Smith, Ian Strachan and Carl Symon. With the exception of Carl Symon they all offer themselves for re-election.

The Articles of Association also provide that no person may be appointed to the office of chairman (in an executive capacity) or to the office of chief executive, managing director or joint managing director of the Company, unless he is a British citizen. No person may be appointed to the office of director of the Company if, immediately following such appointment, the number of directors of the Company who are not British citizens would exceed one half of the total number of directors of the Company for the time being.

Subject to the provisions of relevant statutes, the Company's Memorandum and Articles of Association and any directions given by special resolution, the directors may exercise all the powers of the Company.

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 170 of the Company's Articles of Association. The Company has also arranged appropriate insurance cover for any legal action taken against its directors.

Share capital

At December 31, 2007, the Company's authorised share capital comprised: 2,500,000,000 ordinary shares of 20p; 1,000,000,000 B Shares of 0.1p; one Special Share of £1; 50,000 preference shares of £1. On December 31, 2007, the following shares were in issue (proportion of total by nominal value): ordinary shares 1,819,812,347 (96 per cent) and B Shares, 15,858,712,652 (4 per cent). Both ordinary shares and B Shares are listed on the London Stock Exchange.

Rights of each class of share

Ordinary Shares – The rights and obligations attaching to ordinary shares are set out in the Company's Articles of Association. Holders of ordinary shares are entitled to attend and speak at general meetings of the Company, to appoint one or more proxies or, if they are corporations, corporate representatives, and to exercise voting rights. Holders of ordinary shares may receive a bonus issue of B Shares or a dividend and on liquidation may share in the assets of the Company. Holders of ordinary shares are entitled to receive the Company's Annual report. Subject to meeting certain thresholds, holders of ordinary shares may requisition a general meeting of the Company and the proposal of resolutions at general meetings.

B Shares – Since July 2004, the Company has issued non-cumulative redeemable convertible preference shares (B Shares) as an alternative to paying a cash dividend. Shareholders are able to redeem any number of their B Shares for cash or convert them into ordinary shares. Any B Shares retained attract a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. In certain circumstances the Company has the option to compulsorily redeem the B Shares, at any time, if the aggregate number of B Shares in issue is less than ten per cent of the aggregate number of B Shares issued, or on the acquisition or capital restructuring of the Company.

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

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

Special Share – Certain rights, set out in the Company's Articles of Association, attach to the special rights non-voting share (Special Share) issued to HM Government (Special Shareholder). Subject to the provisions of the Companies Act 1985, the Special Share may be redeemed by the Treasury Solicitor at par at any time. The Special Share confers no rights to dividends but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

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

Preference Shares – The 50,000 preference shares were issued pursuant to the Company's incorporation and were subsequently redeemed. They cannot be reissued.

Restrictions on transfer of shares and limitations on holdings

There are no restrictions on transfer or limitations on the holding of the ordinary shares or B Shares other than under the Articles of Association (as described below), under restrictions imposed by law or regulation (for example, insider trading laws) or pursuant to the Company's share dealing code.

The Articles of Association provide that the Company should be and remain under United Kingdom control. As such, an individual foreign shareholding limit is set at 15 per cent of the aggregate votes attaching to the share capital of all classes (taken as a whole) and capable of being cast on a poll and to all other shares that the directors determine are to be included in the calculation of such holding.

Shareholder agreements and consent requirements

There are no known arrangements under which financial rights carried by any of the shares in the Company are held by a person other than the holder of the shares and no known agreements between the holders of shares with restrictions on the transfer of shares or exercise of voting rights.

No disposal may be made to a non Group member which, alone or when aggregated with, the same or a connected transaction, constitutes a disposal of the whole or a material part of either the nuclear business or the assets of the Group as a whole, without consent of the Special Shareholder.

Deadlines for exercising voting rights

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

Authority to issue shares

At the AGM in 2007, authority was given to the directors to allot new ordinary shares up to a nominal value of £124,149,953, equivalent to one third of the issued share capital of the Company at February 7, 2007. Such authority is valid until the AGM in 2008 or 18 months from May 2, 2007, whichever is the earlier. A further special resolution was passed to effect a disapplication of pre-emption rights for a maximum of five per cent of the issued share capital of the Company at February 7, 2007. The directors propose to renew these authorities at the AGM in 2008.

At the AGM in 2007, authority was given to the directors to allot new B Shares up to a nominal value of £200 million as an alternative to a cash dividend. Such authority is valid until the AGM in 2008 or 18 months from May 2, 2007, whichever is the earlier. The directors propose to renew this authority at the AGM in 2008.

Voting rights for employee share plan shares

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

Interests in voting rights

At February 6, 2008, the following companies had disclosed an interest in the issued ordinary share capital of the Company in accordance with the requirements of the Financial Services Authority's Disclosure and Transparency Rules:

	% of issued ordinary share capital
Invesco Limited	6.91
Legal and General Group Plc	5.61

Report of the directors continued

Change of control

Major contracts

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

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various lenders. These facilities generally include provisions which, upon the occurrence of a change of control of the Company, may require any outstanding borrowings to be repaid or the alteration or termination of the facility. At December 31, 2007 these facilities were substantially undrawn.

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

Employee share plans

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

- *Executive Share Option Plan* – All options granted have vested and are exercisable. Consequently, no early vesting is currently possible. It is not proposed to make any further grants under this plan, which terminates in 2009.
- *Performance Share Plan* – Awards would vest pro-rata to service in the performance period, subject to remuneration committee judgement of company performance.
- *Annual Performance Related Award deferred shares* – The shares would be released from trust immediately.
- *ShareSave* – Options would become exercisable immediately. The new company might offer an equivalent option in exchange for cancellation of the existing option.
- *Share Incentive Plan* – Consideration received as shares would be held within the Plan, if possible, otherwise the consideration would be treated as a disposal from the Plan.

By order of the Board



Tim Rayner General Counsel and Company Secretary
February 6, 2008