Board of Directors

Ian Davis NG
Chairman

Appointed to the Board in March 2013 and as Chairman in May 2013

Career, skills and experience

Ian is senior partner emeritus of McKinsey & Company. He was a partner at McKinsey for 31 years until 2010 and served as chairman and worldwide managing director of McKinsey between 2003 and 2009.

He brings significant financial and strategic experience to the Board.

He has worked with and advised global organisations and companies in a wide variety of sectors as well as in the public sector, enabling him to draw on knowledge of diverse issues and outcomes to assist the Board.

His role in the Cabinet Office, from which he stepped down in March 2016, gives him a unique perspective on government affairs.

Other current principal roles

- BP p.l.c., non-executive director
- Johnson & Johnson Inc., director
- Teach for All Inc., director
- Majid Al Futtaim Holding LLC, director
- McKinsey & Company, senior partner emeritus

Warren East CBE
Chief Executive

Appointed as an independent Non-executive Director in January 2014, Warren became Chief Executive in July 2015

Career, skills and experience

Warren is an engineer by training and had an outstanding record at ARM Holdings plc which he joined in 1994 and where he was CEO from 2001 until 2013. He has a deep understanding of technology and of developing long-term partnerships and has proven strategic and leadership skills in a global business with a strong record of value creation – all of which are relevant to Rolls-Royce particularly as it undergoes a period of transformation.

He is a fellow of the The Institution of Engineering and Technology, a fellow of the Royal Academy of Engineering and a distinguished fellow of BCS, the Chartered Institute for IT. He was awarded a CBE in 2014 for services to the technology industry.

Other current principal roles

- Dyson James Group Limited, director
- The Institution of Engineering and Technology, trustee

David Smith
Chief Financial Officer

Appointed in November 2014

Career, skills and experience

David has extensive industrial experience having worked for over 25 years with Ford and Jaguar Land Rover and latterly with Edwards Group Limited, a major manufacturer of industrial vacuum products. He joined Rolls-Royce as Chief Financial Officer for the Aerospace Division in January 2014 before being appointed as CFO to the Group. David's skills in developing systems have particular benefit to Rolls-Royce where he has introduced a new management information and forecasting system. He is a member of the Chartered Institute of Management Accountants' Advisory Panel. David has resigned from Rolls-Royce and will leave the Group following the appointment of Stephen Daintith, whose biography is shown on page 57.

Other current principal roles

- Motability Operations Group plc, non-executive director

Colin Smith CBE
Group President

Appointed in July 2005

Career, skills and experience

Colin joined Rolls-Royce in 1974. He has held a variety of key positions within the Group including Director – Research & Technology, Director of Engineering & Technology – Civil Aerospace, and Group Director – Engineering & Technology before being appointed as Group President in January 2016. Colin is a fellow of the Royal Society, the Royal Academy of Engineering, the Royal Aeronautical Society and the Institute of Mechanical Engineers. In June 2012, he was awarded a CBE for services to UK engineering.

Colin will step down from the Board at the 2017 AGM.

Other current principal roles

- Council for Science and Technology, member

Composition of Board committees

	NG	R	A	SE	ST
Ian Davis	C				
Lewis Booth	●		C		●
Ruth Cairnie	●	C			●
Sir Frank Chapman	●	●		C	
Irene Dorner	●		●	●	
Lee Hsien Yang	●		●	●	
John McAdam	●	●		●	
Bradley Singer					●
Sir Kevin Smith	●	●			C
Jasmin Staiblin	●				●

C Denotes chairman of committee

Committee membership

NG	Nominations & Governance Committee
R	Remuneration Committee
A	Audit Committee
SE	Safety & Ethics Committee
ST	Science & Technology Committee
■	Denotes chairman of committee

Lewis Booth CBE

Independent
Non-executive Director

A NG ST

Appointed in May 2011

Career, skills and experience

Lewis has considerable financial expertise and experience, having been the former executive vice president and chief financial officer for Ford Motor Company. He brings an international perspective, having worked in Europe, Asia, Africa and the US during his 34-year career in the motor industry. After gaining a bachelor of engineering degree with honours in mechanical engineering, Lewis began his career with British Leyland before joining Ford in 1978. He was awarded a CBE in 2012 for services to the UK automotive and manufacturing industries.

Other current principal roles

- Mondelez International, Inc., director
- Gentherm Inc., director

Ruth Cairnie

Independent
Non-executive Director

R NG ST

Appointed in September 2014

Career, skills and experience

A physicist by background, Ruth has strong strategic and commercial experience gained at Royal Dutch Shell Plc where she held a number of senior international roles, most recently as executive vice president strategy and planning, before her retirement in 2014.

Ruth also has significant remuneration committee experience having chaired the remuneration committee at Keller Group plc since April 2012 and as a member of the remuneration committee at Associated British Foods plc. She chairs the POWERful Women initiative, supporting the progression of women to senior positions in the energy sector, and is a strong supporter of our diversity and inclusion initiatives.

Other current principal roles

- Associated British Foods plc, non-executive director
- Keller Group plc, non-executive director
- POWERful Women, chairman

Sir Frank Chapman

Independent
Non-executive Director

SE NG R

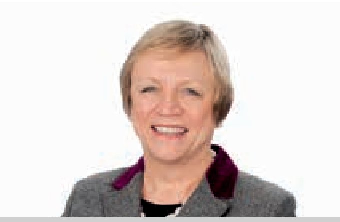
Appointed in November 2011

Career, skills and experience

Sir Frank has significant industrial and safety experience, having worked in the oil & gas industry for 38 years including appointments within Royal Dutch Shell plc and BP p.l.c. He has a life-long passion for engineering and innovation and a deep understanding of technology, together with an outstanding record of business achievement. He was chief executive of BG Group plc for 12 years until 2012 and chairman of Golar LNG Ltd from 2014 to 2015. Sir Frank is a fellow of the Royal Academy of Engineering, the Institute of Mechanical Engineers and the Energy Institute. He was knighted in 2011 for services to the oil & gas industry.

Other current principal roles

- Myeloma UK, vice chairman



Irene Dorner

Independent
Non-executive Director

NG A SE

Appointed in July 2015

Career, skills and experience

Irene has a strong background in risk management and is very familiar with regulatory requirements. She was chief executive officer and president of HSBC, US, until December 2014. Her background in risk management played a key role in strengthening the financial institution's risk processes and she brings this insight as part of her role on our Audit Committee. During a 29-year career at HSBC, she held a number of international roles including leading HSBC in Malaysia and launching its Islamic banking unit. Irene is a passionate advocate of diversity and inclusion and an active supporter of our employee resource groups.

Irene was a consultant at PricewaterhouseCoopers until February 2016. She is also an honorary fellow of St Anne's College, Oxford.

Other current principal roles

- AXA SA, director
- Control Risks International Limited, non-executive director
- OUTLeadership Advisory Board, member

Lee Hsien Yang
Independent
Non-executive Director

NG A SE

Appointed in January 2014

Career, skills and experience

A Singaporean, Hsien Yang was formerly a member of our International Advisory Board and combines a strong background in engineering with extensive international business experience in our most important growth markets. He was chief executive of Singapore Telecommunications Limited for 12 years until 2007. He served as chairman and non-executive director of Fraser and Neave Limited from 2007 to February 2013. He has significant industrial and financial skills.

Other current principal roles

- Civil Aviation Authority of Singapore, chairman
- The Islamic Bank of Asia Private Limited, chairman
- The Australian and New Zealand Banking Group Limited, director
- General Atlantic LLC and associated funds, special adviser
- Lee Kuan Yew School of Public Policy, member of the board of governors
- INSEAD SE Asia Council, president

John McAdam
Independent
Non-executive Director

NG R SE

Appointed in February 2008

Career, skills and experience

John has extensive international and industrial experience. He was appointed to the board of ICI plc in 1999 and became chief executive in 2003, a position he held until 2008. He held a number of senior positions at Unilever, within its Birds Eye Walls, Quest International and Unichema International businesses. He is a former non-executive director of Severn Trent plc and Sara Lee Corporation and stepped down as senior independent director of J Sainsbury plc in 2016.

Other current principal roles

- Rentokil Initial plc, chairman
- United Utilities Group PLC, chairman
- Electra Private Equity PLC, director

Bradley Singer
Non-independent
Non-executive Director

ST

Appointed in March 2016

Career, skills and experience

Brad has an outstanding record as a business leader in the US. He brings with him experience of public companies during periods of change, growth and significant financial outperformance, particularly in the US where Rolls-Royce has important business interests and a significant shareholder base. He has been senior executive vice president and chief financial officer of Discovery Communications, Inc. and chief financial officer and treasurer of American Tower Corp. Before these appointments, he worked as an investment banker at Goldman Sachs. He is a former director of Martha Stewart Living, Omnimedia, Inc., Citizens Communications Corp and Motorola Solutions Inc.

Other current principal roles

- ValueAct Capital Master Fund P.L., partner and chief operating officer
- Posse Foundation, director
- McIntire School Foundation, University of Virginia, trustee

Sir Kevin Smith CBE
Senior Independent
Non-executive Director

ST NG R

Appointed in November 2015

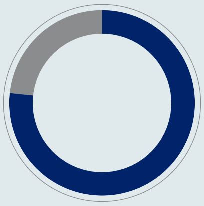
Career, skills and experience

Sir Kevin has extensive industrial leadership experience and a deep knowledge of global engineering and manufacturing businesses, as well as the aerospace industry. He was chief executive officer of GKN plc for nine years until 31 December 2011. Before joining GKN, he spent nearly 20 years with BAE Systems where he held a number of senior executive positions. He joined Unitas Capital in 2012 and served as partner and chairman of its operating advisor group until October 2015, based in Hong Kong. His private equity experience in operation- intensive businesses with Unitas is extremely valuable to Rolls-Royce. He served as a non-executive director of SSE plc between June 2004 and July 2008. He has an honorary fellowship doctorate from Cranfield University, is an honorary fellow of the University of Central Lancashire and a fellow of the Royal Aeronautical Society. He was awarded a CBE in 1997 and was knighted in 2006 for services to industry.

Other current principal roles

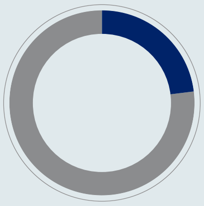
- Unitas Capital, senior adviser
- LEK Consulting, European advisory board member
- University of Central Lancashire, industry steering group member

BOARD MEMBERS BY GENDER



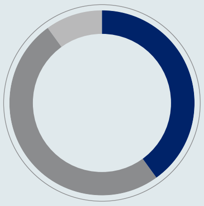
■ Female	3
■ Male	10

BALANCE OF THE BOARD



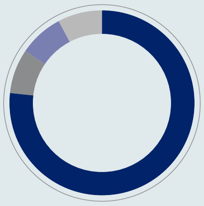
■ Executive Directors	3
■ Non-executive Directors	10

NON-EXECUTIVE DIRECTORS' TENURE



■ 0–3 years	4
■ 3–6 years	5
■ 6–9 years	1

NATIONALITIES OF DIRECTORS*



■ British	10
■ German	1
■ Singaporean	1
■ US	1

* According to the Company's Articles of Association, at least 50% of its Directors must be British citizens.

Jasmin Staiblin

Independent Non-executive Director

NG ST

Appointed in May 2012

Career, skills and experience

A German national, Jasmin combines a strong background in advanced engineering and deep technology knowledge with extensive international business experience, having worked in Switzerland, Sweden and Australia. She has been the chief executive officer of Alpiq Holding AG since 2013. She held a number of senior positions in the ABB Group becoming chief executive officer of ABB Switzerland from 2006 to December 2012.

Other current principal roles

- Alpiq Holding AG, chief executive officer
- Georg Fischer AG, board member

Pamela Coles

Company Secretary

Appointed in October 2014

Career, skills and experience

Pamela is an expert in corporate governance and company law. She has been a fellow of the ICSA: The Governance Institute since 1997. She has held a variety of company secretary roles throughout her career. She joined Rolls-Royce from Centrica plc, where she was head of secretariat. Pamela's previous roles also include group company secretary and a member of the executive committee at The Rank Group plc and company secretary & head of legal at RAC plc.

Other current principal roles

- None

Stephen Daintith

Expected to be appointed as Chief Financial Officer in Spring 2017

Career, skills and experience

Stephen will join Rolls-Royce from Daily Mail and General Trust plc where he has served on its board of directors since 2011. He was a member of the Euromoney Institutional Investor plc audit committee, and a non-executive director of Zoopla Property Group plc, both of which are associated companies of Daily Mail and General Trust plc. Stephen is a chartered accountant and has held a number of senior positions at News Corporation, British American Tobacco, Forte, the Civil Aviation Authority and PricewaterhouseCoopers. He is currently a non-executive director of 3i Group plc.

Stephen has extensive experience of strategic financial management and he has a deep understanding of international business. His record of achievement in change management is particularly relevant to Rolls-Royce.

International Advisory Board (IAB)

The IAB meets annually with the Board in order to provide perspective and to guide strategy development through discussions on the geo-political and global economic landscape. The members of the IAB during the year were as follows:

Lord Powell of Bayswater (Chairman of the IAB)
Former Foreign Affairs and Defence Adviser to Prime Ministers Baroness Thatcher and Sir John Major.

Vladimír Dlouhý
International advisor to Goldman Sachs for Central and Eastern Europe, European deputy chairman of the Trilateral Commission, president, Czech Chamber of Commerce and a former member of the Czech Government.

Sir Rod Eddington
Chairman of JP Morgan (Australia & New Zealand) and former chief executive of British Airways Plc.

Dr Fan Gang
Professor at China's Academy of Social Sciences and director of National Economic Research Institute, China.

Dr Pedro Sampaio Malan
Chairman of Itaú Unibanco's international advisory board and a member of the boards of EDP – Energias do Brasil, Souza Cruz, Brazil, Mills Engenharia, a director of Thomson Reuters Founders Share Company and a member of the Temasek international panel.

Akio Mimura
Senior advisor, honorary chairman Nippon Steel & Sumitomo Metal Corporation, Japan, and chairman of The Japan Chamber of Commerce and Industry.

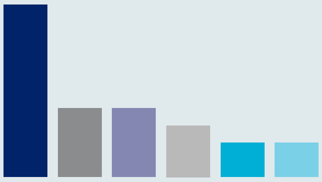
Lubna Olayan
CEO and deputy chairperson of the Olayan Financing Company, Saudi Arabia.

Ratan Tata
Interim chairman of Tata Sons Limited, India.

Ambassador Robert B Zoellick
Chairman of Goldman Sachs International Advisors, senior fellow at the Belfer Center at Harvard University, former president of World Bank Group, US Trade Representative and US Deputy Secretary of State.

Murad Bayar
Board member and CEO of CCN Investment Holdings.

BOARD SKILLS AND EXPERIENCE



■ Chairman, CEO or CFO experience	10
■ Engineering/technology	4
■ Related industry/operational	4
■ Safety/regulatory/risk	3
■ Financial	2
■ Remuneration/HR	2

Chairman's introduction

Ian Davis
Chairman

2016 was a year of significant organisational transformation, market headwinds and operational challenges for the Group, including managing a number of new product introduction programmes. In January 2017, after lengthy regulatory investigations with which we co-operated fully, we concluded deferred prosecution and leniency agreements with the UK Serious Fraud Office, US Department of Justice and the Brazilian authority, MPF.

It is times such as these when the importance of corporate governance comes sharply into focus. It serves to ensure valuable oversight, guidance and experienced support to management as it balances risks and opportunities and navigate difficult and complex issues at a time of significant change. The Board's oversight and engagement on the critical issues ensured that decisions were taken in the Group's best interests and in pursuit of its strategic, financial and operational objectives and transformation milestones.

To facilitate more regular oversight, reporting and interaction with management we added Board calls to our annual schedule, in April and October. We held a number of other ad-hoc Board and committee meetings outside of our annual cycle to deal with matters that required attention between our regular scheduled meetings. Some of the Non-executive Directors also spent time during the year with the business and finance leadership teams outside of formal meetings to gain deeper insight into the operational challenges at a programme and business level. This combination allowed us to understand better, and more closely track, the progress being made by the Group on its transformation agenda and priorities throughout the year, so that we could focus on the right areas.

In 2016, as part of the simpler governance workstream of the transformation programme, we continued to strengthen aspects of our governance arrangements, building on the work undertaken in 2015. We complemented this by increasing focus on talent and succession planning, including supporting Warren East as he reshaped his Executive Leadership Team (ELT).

The 2015 Board effectiveness review conducted by Independent Audit highlighted a need to improve the quality of information presented to the Board. During the year, the Company Secretary led a major piece of governance improvement work to provide tools, templates and training to help management write more effective and relevant papers. This has resulted in significant improvements in the content, length and insightfulness of our Board and committee packs, which in turn prompts more informed discussion and better decision making. In parallel, new management information dashboards developed during 2016 have enabled 'at a glance' views of the status of key programmes and business performance.

One of the most important responsibilities I have as Chairman is to ensure the right balance of skills, experience, independence and knowledge on the Board to provide effective support and challenge to management. There were a number of Board and ELT changes announced during the year, which you can read about in more detail in the Nominations & Governance Committee report on pages 67 to 71.

In March, we welcomed Brad Singer as a new member of the Board and the Science & Technology Committee. Brad is chief operating officer of ValueAct, a major shareholder.

Our relationship with ValueAct has been, and remains, thoughtful and productive. We have a relationship agreement in place which, although less usual in the UK, is fairly standard practice in the US.

In May, Sir Kevin Smith was appointed as Senior Independent Director.

In September, we announced the appointment to the Board of Stephen Daintith as Chief Financial Officer to succeed David Smith. Stephen will take up his new post in Spring 2017.

Colin Smith will also be stepping down from the Board at the 2017 AGM after a distinguished career with the Group spanning over 40 years. We are indebted to Colin for his exemplary contribution to engineering.

In May, Dame Helen Alexander stepped down from the Board having completed her nine-year term. Dame Helen has shown dedication and valued insight throughout her tenure, including in her leadership of the Remuneration Committee. On behalf of the Board, I would like to thank Dame Helen for her contribution and commitment.

In November 2016, I accepted Alan Davies' resignation from the Board. Alan was appointed as a Non-executive Director one year previously and his contribution, expertise and perspectives were highly valued by his colleagues during his period in office.

The Board resolved in December to propose to shareholders the appointment of PwC as auditor with effect from the 2018 AGM. Details of the tender process are contained in the Audit Committee report on page 102.

We consulted with major shareholders during the year on the proposed changes to our remuneration policy. Further details of the consultation and the new policy are in the Directors' remuneration report on pages 72 to 82. We also held our first governance event in the UK and a governance roadshow for major investors in the US. Further details of these events can be found in the Corporate governance report on page 66.

We note with interest the government's green paper on UK corporate governance. The Board is considering the level of interaction with stakeholders, particularly employees. We are planning to hold an 'AGM for employees' in 2017, and Irene Dorner will take the lead at looking at how we can strengthen our links between the boardroom and our employees.

I look forward to reporting our progress on corporate governance in our Annual Report next year.

Ian Davis
Chairman
13 February 2017

Corporate governance

The Board

The role of the Board	→ Providing leadership, knowledge and experience to support and guide the ELT. → Setting Group strategy and objectives after considering recommendations from the ELT.	→ Overseeing and monitoring business performance, internal controls, governance and risk management. → Shareholder engagement. → Oversight of principal risks – competitive position, political risk, programme delivery.
Chairman Ian Davis	→ Effective running of the Board and its committees in accordance with the highest standards of corporate governance. → Setting the Board agenda.	→ Managing the Board to ensure adequate time for discussion of all agenda items. → Ensuring the Board receives accurate, timely and clear information.
Senior Independent Director Sir Kevin Smith	→ Being available to major shareholders if they have concerns which have not been resolved through the normal channels of the Chairman, Chief Executive or other Executive Directors.	→ Conducting an annual review of the performance of the Chairman. → Providing a sounding board for the Chairman.
Other Non-executive Directors	→ Providing skills and external experience to support the Chairman and management.	
Chief Executive Warren East	→ Overseeing the day-to-day operation of the Group's business. → Developing and implementing the Group's strategy as approved by the Board.	→ Establishing and maintaining formal and appropriate delegations of authority. → Maintaining a close working relationship with the Chairman.
Other Executive Directors	→ Providing management perspective to support the Board's decision making.	
Company Secretary Pamela Coles	→ Overseeing the design and effectiveness of the Group's governance arrangements. → Acting as Secretary to the Board and its committees, ensuring compliance with Board procedures and corporate governance requirements.	→ Providing governance, advisory and administrative support to all Directors. → Assisting the Nominations & Governance Committee with plans for Directors' induction and ongoing training.

The Board committees

Nominations & Governance Committee	Remuneration Committee	Audit Committee	Safety & Ethics Committee	Science & Technology Committee
Board composition	Remuneration policy	Financial reporting	S&E governance framework	R&T/R&D strategy
Succession planning	Incentive design and setting of targets	Internal controls	S&E policies and practices	E&T processes
Board nominations	Executive remuneration review	Risk management	S&E training	Technology capabilities and skills
Board evaluation		Internal audit	S&E risk management	R&D investments
Corporate governance		External auditor	S&E investigations	Technology trends and risks
Oversight of principal risk – talent & capability		Oversight of principal risks – IT vulnerability, business continuity, market & financial shock	Sustainability	Oversight of principal risk – disruptive technologies & business models
			Oversight of principal risks – compliance, product failure	

The Board and its committees

The Board is ultimately responsible to shareholders for the direction, management and performance of the Company.

Details of the Board are set out on pages 54 to 57. Details of the Executive Directors' service contracts and the Non-executive Directors' letters of appointment are on pages 91 and 92. Details of their remuneration and share interests are set out in the Directors' remuneration report on pages 83 to 95.

The Board has a schedule of matters reserved for its approval, generally being those items which affect the shape, risk profile or strategic direction of the Group, as well as the key financial items. The Board reviewed the schedule of matters during the year.

The Board has established certain principal committees to provide dedicated focus on particular areas, as set out on the previous page. The chairman of each committee reports to the Board on the committee's activities after each committee meeting.

In addition to the Board's principal committees, it has established a sub-committee of Directors who each hold an appropriate level of UK national security clearance for the purpose of receiving and considering, on behalf of the Board, any UK classified information relating to the Group's programmes and activities.

Matters that are not reserved to shareholders, the Board or one of its committees are the responsibility of the Chief Executive who has established and maintains a schedule of delegations of authority to members of the ELT and other management.

Key matters reserved to the Board:

- The Group's long-term objectives, strategy and risk appetite.
- Shareholder engagement and general meetings.
- Overall corporate governance arrangements including Board and committee composition, committee terms of reference, and Directors' independence and conflicts of interest.
- Internal controls, governance and risk management frameworks.
- Changes to the corporate or capital structure of the Company.
- Annual report and accounts, and financial and regulatory announcements.
- Significant changes in accounting policies or practices.
- Policy on, and declarations of, payments to shareholders.
- Annual budgets and financial expenditure and commitments above levels set by the Board.
- Remuneration policy and remuneration of Directors and senior executives.
- New share incentive or pension plans or major changes to existing plans.

The way in which principles of the UK Corporate Governance Code (the Code) are applied, including the role of the Board and the Chairman, Chief Executive, Senior Independent Director and Company Secretary, the matters reserved to the Board, the terms of reference of each of the Board committees, and details of Directors' induction and training have been agreed by the Board and are set out in our Board governance document available on the corporate governance pages of the Group's website www.rolls-royce.com.

Appointments and re-appointments

The Board was advised by the Nominations & Governance Committee regarding all Board changes. Details of the appointment process, and the changes made during the course of the year, are set out in the Nominations & Governance Committee report on pages 67 to 71.

Independence of the Non-executive Directors

The Board conducts a review of the independence of the Non-executive Directors every year, based on the criteria in the Code and following consideration by the Nominations & Governance Committee as detailed on pages 70 and 71. This review was undertaken in November 2016 and the Board concluded that all the Non-executive Directors, with the exception of Brad Singer, remained independent in character and judgement.

Brad Singer is a partner and the chief operating officer of ValueAct, a major shareholder, and therefore not considered to be an independent Non-executive Director under the provisions set out in the Code. The Company has in place a relationship agreement to manage any conflicts of interest that arise from his connection to ValueAct. A summary of the relationship agreement is on the corporate governance pages of the Group's website.

The Code does not consider the test of independence to be appropriate to the chairman of a company. However, Ian Davis did meet the Code's independence criteria upon his appointment as Chairman in May 2013. His other external commitments are described on page 54.

Directors' indemnities and insurance

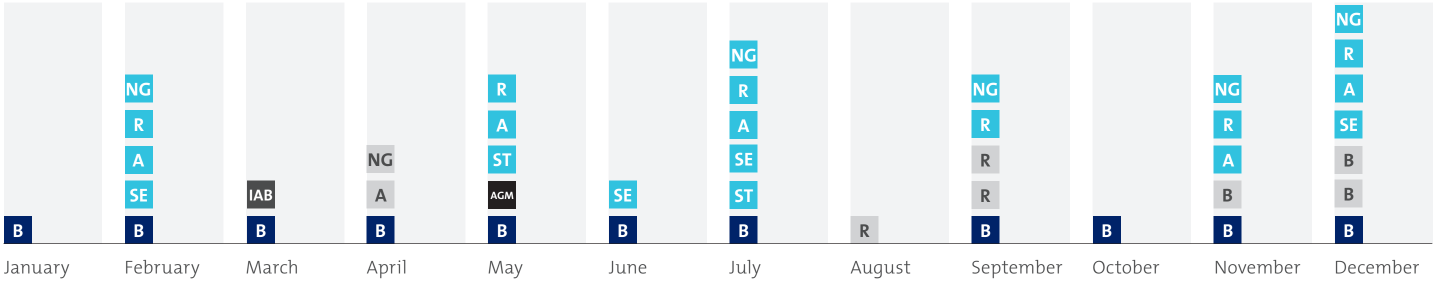
In accordance with the Articles, and to the extent permitted by law, the Company has entered into separate deeds of indemnity with its Directors, which were in force during the financial year and remain in force at the date of this report. The Company also maintains directors' and officers' liability insurance cover which also extends to directors of subsidiary companies.

Compliance with the UK Corporate Governance Code

The Company is subject to the principles and provisions of the Code, a copy of which can be found on the Financial Reporting Council's (FRC) website, www.frc.org.uk.

The Board considers that the Company complied in all material respects with the Code for the whole of the year to 31 December 2016. The Board has agreed that arrangements by which staff may raise concerns in confidence are considered and reviewed by the Safety & Ethics Committee. Any matters relating to financial reporting, the integrity of financial management or fraud are also reported to the Audit Committee.

Board and committee meetings held in 2016



Committee meetings

- NG Nominations & Governance Committee
- R Remuneration Committee
- A Audit Committee
- SE Safety & Ethics Committee
- ST Science & Technology Committee
- ▨ Denotes unscheduled meeting

Other meetings

- B Board
- IAB International Advisory Board
- AGM Annual General Meeting

The unscheduled meetings of the Board in November and December were held to consider progress towards reaching agreements with investigating authorities in UK, US and Brazil.

The unscheduled meeting of the Nominations & Governance Committee held in April was to consider the appointment of Sir Kevin Smith as Senior Independent Director.

The unscheduled meeting of the Audit Committee in April was to consider the audit tender process and the potential consequences of IFRS 15 for the Group's accounting.

The unscheduled meetings of the Remuneration Committee held in August and September were to consider:

- Remuneration packages for the new Chief Financial Officer and Chief Operating Officer.
- Feedback from the initial shareholder consultation on remuneration policy proposals.

Some of the Directors were unable to participate in the unscheduled meetings of the Nominations & Governance Committee held in April and of the Remuneration Committee held in September as these meetings were called on short notice.

BOARD AND COMMITTEE ATTENDANCE AT SCHEDULED MEETINGS

Directors as at 31 December 2016	Board (11 meetings)	Nominations & Governance (5 meetings)	Remuneration (6 meetings)	Audit (5 meetings)	Safety & Ethics (4 meetings)	Science & Technology (2 meetings)
Ian Davis	11/11	5/5	–	–	–	–
Warren East	11/11	–	–	–	–	–
Lewis Booth	11/11	5/5	–	5/5	–	2/2
Ruth Cairnie	11/11	5/5	6/6	–	–	2/2
Sir Frank Chapman[1]	10/11	4/5	5/6	–	4/4	–
Irene Dorner	11/11	5/5	–	5/5	4/4	–
Lee Hsien Yang	11/11	5/5	–	5/5	4/4	–
John McAdam[2]	11/11	5/5	6/6	–	3/4	–
Bradley Singer (appointed 2 March 2016)	8/8	–	–	–	–	2/2
Colin Smith	11/11	–	–	–	–	–
David Smith	11/11	–	–	–	–	–
Sir Kevin Smith	11/11	5/5	6/6	–	–	2/2
Jasmin Staiblin[3]	10/11	4/5	–	–	–	1/2
Former Directors						
Dame Helen Alexander (left 5 May 2016)	5/5	1/1	2/2	–	1/1	–
Alan Davies (left 18 November 2016)	8/10	3/4	–	3/4	–	–

[1] Sir Frank Chapman missed the meetings of the Board, Nominations & Governance Committee and Remuneration Committee in November for medical reasons.

[2] John McAdam missed the meeting of the Safety & Ethics Committee in December due to an unavoidable diary clash with a Board meeting of Rentokil Initial plc where he is Chairman.

[3] Jasmin Staiblin missed the meeting of the Nominations & Governance Committee in July and the Board meeting in December due to needing to attend to urgent business at Alpiq Holding AG, where she is CEO. She also missed the meeting of the Science & Technology Committee in May due to unavoidable last-minute travel disruptions.

The Board's areas of focus

Matters considered	Outcome	Key areas of focus for 2017
Strategy and risk		
Progress with the transformation programme.	Significant senior management headcount reductions, tracked to underlying cost base.	Continued oversight of execution of transformation plans to deliver targeted benefits.
Board priorities and financial assumptions over the timeframes of three, five and ten years, including key risks, assumptions and sensitivities.	Strategic options clarified. Update of strategic priorities underway to evaluate the best way to deliver enhanced shareholder value in the long term.	The Group's vision, values and culture. Execution of strategic priorities.
Put option exercised by SENER regarding ITP joint venture.	Agreed valuation for acquisition of remaining stake in ITP.	Execution of transaction and integration of ITP into the Group.
Progress with regulatory investigations, with increased oversight as potential deferred prosecution agreements (DPAs) were being discussed with the authorities.	Full co-operation with investigating authorities, leading to agreements with UK, US and Brazilian authorities in January 2017. Lord Gold continued to attend Audit and Safety & Ethics Committee meetings to oversee progress on the ethics and compliance improvement programme.	Monitoring of compliance with the terms of the DPAs and leniency agreement. Considering the conclusions and recommendations in Lord Gold's latest report, and oversight of actions required.
Principal risks including changes to those risks, the underlying principal risk indicators and risks related to the transformation programme.	The Board added a further principal risk: disruptive technologies and business models. With this addition the Board confirmed that the principal risks remained appropriate. More focus on talent and succession risks and increased Board time dedicated to updates on major programmes.	Principal risks will be kept under review, and all will be the subject of 'deep dives' by the Board or a Board committee during 2017.
EU referendum preparations and outcome.	A steering group was set up to monitor developments and report back to the Board.	Further planning and preparations for Britain's exit from the EU.
Coming into force of EU Market Abuse Regulations (MAR).	The Group took appropriate steps, including updating its policies and procedures, to ensure compliance with MAR.	Monitoring of market best practice and any updates or guidance issued.
Succession and leadership		
Board and ELT composition.	Key appointments made including Chief Financial Officer, Chief Operating Officer and Strategy & Marketing Director. Appointments of Sir Kevin Smith as Senior Independent Director and Brad Singer as Non-independent Non-executive Director.	Search for at least one new Non-executive Director to replace Alan Davies who resigned in December 2016 and John McAdam who will step down in 2017.
Diversity and inclusion.	Increasing diversity retained as a key priority for the Group and as a critical part of the transformation programme.	Continued Board oversight and sponsorship of diversity and inclusion within the Group.
Effectiveness of the Board, Chairman and Chief Executive.	The Board and its committees operated effectively in 2016. The Chairman and Chief Executive received constructive feedback on their respective performance and the Board supported their continuation in office.	Implementing recommendations made by Independent Audit as part of Board effectiveness review. See page 65 for more details.
Shareholder engagement and governance		
Terms of a relationship agreement with ValueAct following its acquisition of a significant shareholding and the appointment of Brad Singer to the Board.	Relationship agreement in place.	Continuing constructive engagement with ValueAct and other significant shareholders on appropriate matters.
Investor communications, feedback and governance events and roadshows in the UK and US.	Increased transparency in investor briefings. The governance events were well-received with good input from investors.	Continue shareholder engagement to build investor confidence. A further governance event will be held in 2017.
Private meetings with institutional shareholders to discuss particular areas of interest to them.	Directors met with several institutional shareholders upon request during the year. Topics included sustainability and our ethics and compliance improvement programme.	We will maintain an active shareholder engagement programme in 2017.

Matters considered	Outcome	Key areas of focus for 2017
US governance under Special Security Agreement (SSA)		
Arrangements with the Rolls-Royce North America (RRNA) board, whose members are appointed with the approval of the US Department of Defense to oversee and ensure compliance with laws and regulations concerning security and technology controls.	Following the retirement of James Guyette in 2015, the role of President & CEO of RRNA is no longer a Board position. However, arrangements with the RRNA board continue to be effective. These arrangements permit the Group, under the SSA, to operate US security-cleared facilities and participate in classified technology development and production programs.	Maintaining a good dialogue with, and support to, the RRNA board as required.
Financial performance		
Financial performance and outlook, liquidity and funding including discussions with credit rating agencies.	Regular reports on financial performance and outlook received throughout the year. Group liquidity and funding kept under review considering strategic priorities, the Company's credit ratings and contingencies.	Regular oversight of financial performance against 2017 budget, and of funding plans against strategic priorities and liquidity needs.
IFRS 15 impact.	The Board was briefed on the impact of IFRS 15 on the Group's accounting for revenue and profit, by reference to a notional restatement of 2015 results which was shared with investors at the Group's capital markets' event in November 2016.	Ongoing oversight of preparations for introduction of IFRS 15 in 2018.
The Group's management information (MI) and forecasting project.	A progress update on the project was provided, including a demonstration of the new MI system and KPI dashboard being used by management.	Progress on further improvements will be monitored in 2017.
Financial support for critical supplier.	Reviewed and approved a package of financial support to a key supplier to ensure continuity of materials supply for some of the Group's programmes.	The Group's risk management measures to ensure continuity of supply of critical components and materials will remain an area of Audit Committee review as part of its oversight of the business continuity principal risk.
Audit tender.	The Board resolved to recommend to shareholders the appointment of PwC as the Company's auditor with effect from the 2018 AGM, following recommendations from the Audit Committee.	Not applicable.
Review of the Group's pension arrangements.	A merger of four of the Group's pension schemes and the transfer of one scheme to an insurer.	The level of funding of the remaining schemes will remain under review.
Operational performance		
Civil large engine programmes.	The Board undertook detailed reviews of several of the Group's civil large engine programmes with the Civil Aerospace executive team to understand management's plans to address operational challenges faced.	More detailed Board oversight will continue in 2017 as the business moves through key milestones in its new product introduction programmes and transformation activities.
Product incidents in service and HS&E.	Received reports from the Chairman of the Safety & Ethics Committee and executive management on product-related incidents in service and HS&E matters.	Continued 'tone from the top' emphasising the paramount importance of product and people safety, particularly during a period of transformation.
Sustainability targets.	Overall score in the Dow Jones Sustainability Index improved in 2016.	Progress towards published targets for 2020 will be monitored in 2017.
Payments to shareholders		
The Group's policy on shareholder payments.	Agreed to maintain payments at the level established in early 2016.	Policy to be kept under review in balancing the near-term strategic and operational funding needs with the desire to return in future to a position of year-on-year progressive growth in payments to shareholders.

Information included in the Directors' report

Certain additional information that fulfils the requirements of the Corporate governance statement can be found in the Other statutory information section on pages 186 to 189 and is incorporated into, and forms part of, this Corporate governance report by reference.

Board induction and development

Newly-appointed Directors follow a tailored induction programme, facilitated by the Company Secretary, which includes dedicated time with Group executives and scheduled trips to a variety of business operations. All Directors are encouraged to undertake additional training and to visit the Group's facilities. Details are set out in the Nominations & Governance Committee report on page 70.

Board visit to Indianapolis

The Board meeting in September was held in Indianapolis, US, where the Board visited a number of our key sites in the area and met the local management teams, the RRNA board and US-based employee resource groups. They also reviewed progress with the programme to transform and revitalise our legacy plant and took the opportunity to celebrate the opening of the new Rolls-Royce Development Centre building. The Science & Technology Committee met the teams working on our advanced technology programmes and received detailed briefings and practical demonstrations. You can read more on this in the Science & Technology Committee report on pages 110 to 112.

Internal control and risk management

In developing our internal governance framework (see page 70) we looked at how the Group's risk management and internal control systems work together. You can read about our risk management system on page 48 and details of our internal control system are in the Audit Committee report on pages 100 and 101. As noted on page 48, these systems are designed to manage, rather than eliminate, the risk of failure to achieve objectives and so can only provide reasonable and not absolute assurance against material misstatement or loss. The Board, with the advice of the Audit Committee, has reviewed the effectiveness of the risk management and internal control systems, including controls in relation to the financial reporting process, for the year under review and to the date of this report. The Board confirms that the Group continues to be compliant with the standards in the Code and with the Financial Conduct Authority's Disclosure Guidance and Transparency Rules in this regard.

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 a Group level, are reported monthly against budget and variances are kept under scrutiny.

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 confirm that their business has complied with the Group's finance manual. This contains the Group's key accounting policies.

Executive Leadership Team (ELT)

The ELT is an executive-level forum of the Group's most senior leaders, chaired by the Chief Executive. It comes together to communicate, review and agree on issues and actions of Group-wide significance. It helps to develop, implement and monitor strategic and operational plans, considers the continuing applicability, appropriateness and impact of risks, leads the Group's culture and aids the decision-making of the Chief Executive in managing the business in the performance of his duties.

EXECUTIVE LEADERSHIP TEAM

Chris Barkey
Group Director – Engineering & Technology
Marion Blakey
President & CEO Rolls-Royce North America
Chris Cholerton
President – Defence Aerospace
Warren East CBE
Chief Executive

Mark Gregory
General Counsel
Harry Holt
President – Nuclear
Mary Humiston
Group Human Resources Director
Simon Kirby
Chief Operating Officer
Mikael Makinen
President – Marine

Andreas Schell
CEO – Power Systems
Eric Schulz
President – Civil Aerospace
Colin Smith CBE
Group President (until 4 May 2017)
David Smith
Chief Financial Officer (until 28 February 2017)
Ben Story
Strategy & Marketing Director

Stephen Daintith
Chief Financial Officer (from Spring 2017)

Board evaluation

The Board and its committees undertake an annual evaluation of their effectiveness. In 2016, Independent Audit was again asked to conduct an external evaluation, following up from its reviews in 2014, when first appointed, and 2015. Independent Audit also supported the Audit Committee in the assessment of KPMG as external auditor for 2015. It does not have any other connection to the Company.

The evaluation included a review of Board and committee papers and interviews with the Directors and the Company Secretary. Interviews were also held with other senior managers who interact regularly with the Board and its committees including the General Counsel, Director of Internal Audit and the Director of Compliance and Risk.

The 2015 review specifically focused on strategically important questions and challenges for the Board. The 2016 review noted that improvements had been made on the provision of information, although more could be done to ensure greater clarity on the medium- to long-term development plans. The review recommended that more time be spent on culture and behaviours, while noting that the Board was better informed on talent and succession.

Having gone through the effectiveness review described above, the Directors are satisfied that the Board and each of its committees operated effectively during 2016.

PROGRESS ON KEY AREAS IDENTIFIED

Key areas identified in 2015	Progress in 2016	Focus for 2017
Focusing Board debate and improving Board processes	The Board gave more focus to the transformation agenda and to the near-term strategy with detailed discussions on cash, cost reductions, status of key engine programmes and operational performance.	More focus is needed on the main drivers, levers and challenges faced.
	The Company Secretary's office worked with the ELT and other Board paper authors, providing training, tools and templates which resulted in more effective and relevant papers for the Board and committees. Less time was dedicated to presentations and more to debate and discussion on presented topics.	The work during the year on Board papers has resulted in welcome improvements in their content, length and insightfulness. However, more work is needed to show, with more quantification and detail, progress against well-defined priorities.
Transformation and principal risks	Particular discussion was held around risks to the transformation programme identified in the 2015 evaluation. However, it was agreed that these risks were covered in the principal risks relating to major programme delivery and competitive position.	More time will be spent discussing the culture and behavioural aspects of the transformation programme.
	Disruptive technologies and business models was added as a further principal risk during the year, to reflect the increasing importance of transformative technologies.	Disruptive technologies and business models will be an area of focus for the Science & Technology Committee.
Talent and succession	The Board held a deep dive on succession planning in March 2016 and the Nominations & Governance Committee carried out further reviews and worked with the Chief Executive to support his work refreshing the ELT. The Board also took opportunities to meet with senior managers below ELT level and greater participation by senior managers was encouraged in Board meetings. Further details can be found in the Nominations & Governance Committee report on page 70.	The Board has been better informed on senior personnel issues and changes. Work should continue to strengthen lower management levels.
Management information (MI)	The development of new MI dashboards during the year has helped to provide the Board and management with 'at a glance' indicators of the status of key programmes and business and function performance.	The output from the MI dashboards will help support the further improvements identified for Board paper content.

Shareholder engagement

The Board recognises and values the importance of building strong investor relations through a proactive communication programme. Having strengthened the investor relations department in mid-2015, various initiatives were implemented in 2016 to improve further investors' understanding of the business. This included enhancing disclosure and transparency through improved reporting and engagement, particularly over the forthcoming adoption of IFRS 15 from January 2018.

Our investor relations department plays a key role in building stronger, clearer discussions with current and potential investors and the sell-side analysts that help inform them. During the year, the team has undertaken an extensive investor relations programme involving formal events, site visits, smaller group and one-to-one investor meetings. The purpose of the larger events is to highlight particular issues, themes or announcements that the Group believes develop a better understanding of the business or which warrant further explanation or clarification. One-to-one meetings requested by investors focus on areas of particular interest to them, which in 2016 included our approach to sustainability and our ethics and compliance improvement programme. These events also provide opportunities for shareholders to meet members of the senior management team.

Notable events in 2016 included the capital markets' event held in November with updates from the Chief Executive on transformation progress and strategic priorities and the Chief Financial Officer on the impact of IFRS 15 in particular. The business leaders each presented the market position of their segments, and examples of progress being made were discussed in breakout sessions. The team also hosted a significant number of investors and analysts at the Farnborough air show and undertook a number of site visits to facilities both in the UK and Singapore.

The one-to-one and group meetings provide an opportunity for investors to ask more detailed questions that can improve individual knowledge or clarify areas of misunderstanding. This is a critical process in ensuring market participants make decisions based on a consistent understanding of the information available. In this way, shareholders should be able to appropriately and fairly value the Group's businesses.

We have held over 600 one-to-one and group meetings, led by the Chief Executive, Chief Financial Officer, the Director of Investor Relations or members of the investor relations team. The team has also published five newsletters throughout the year which provide a summary of the core news flow from around the Group, updates on future investor relations events and questions and answers on various topics of current interest to investors.

As a matter of best practice, the Chairman and Senior Independent Director, together with other members of the Board, make themselves available to meet with institutional investors upon request and regularly attend key investor relations events. The Chairman and Senior Independent Director have each met investors in both the UK and the US on scheduled roadshows. In addition, the Chairman hosted a very well-received corporate governance event in April. He was joined by all Board committee chairmen who presented the key areas of focus for their individual committees before questions were taken from major shareholders and corporate governance analysts in smaller workshop sessions.

In early 2016, we consulted with a number of investors on proposed changes to the 2016 annual bonus and performance share plan (PSP). In the autumn, the new chairman of the Remuneration Committee, Ruth Cairnie, undertook an extensive consultation programme to discuss the proposals for the new remuneration policy which will be put to shareholders at the 2017 AGM. Feedback from meetings with over 20 stakeholders helped to determine the shape and quantum of the proposed new policy framework (see Remuneration report on pages 72 to 82).

The Group's website (www.rolls-royce.com) contains up-to-date shareholder information, including an online version of the Annual Report, materials from the capital markets' and corporate governance events, share price information, news releases, presentations to the investment community and information on shareholder services.

Annual general meeting (AGM)

All holders of ordinary shares may attend the Company's AGM at which the Chairman and Chief Executive present a review of the key business developments during the year. This year's AGM will be held at 11.00am BST on Thursday, 4 May 2017 at the Pride Park Stadium, Pride Park, Derby, DE24 8XL. Shareholders can ask questions of the Board on the matters put to the meeting, including the Annual Report and the running of the Company generally. All Directors are invited to attend each AGM. Unless unforeseen circumstances arise, all committee chairmen will be present to take questions at the AGM.

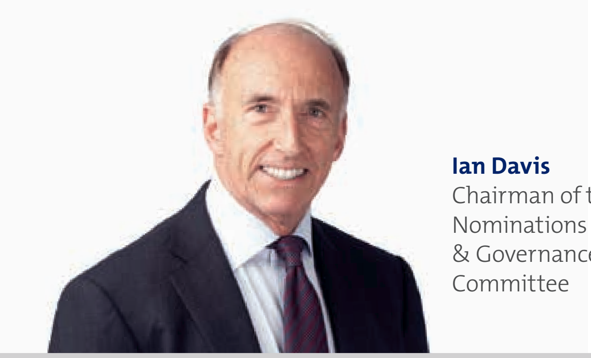
The Company intends to send the AGM notice and any relevant related papers to shareholders at least 20 working days before the meeting. The AGM notice will be available to view on the Group's website.

A poll is conducted on each resolution at all Company general meetings. All shareholders have the opportunity to cast their votes in respect of proposed resolutions by proxy, either electronically or by post. Following the AGM, the voting results for each resolution are published and are made available on our website.

Shareholders unable to attend the AGM can vote on the business of the meeting either by post or online.

The Company will propose at the AGM certain changes to the Articles relating to shareholders who we have been unable to trace for a period of 12 years. In line with many other companies, the Articles currently allow the Company to sell any shares held by an untraced shareholder. The changes to the Articles are intended to clarify when a shareholder is considered to be untraced and to allow the Company to use the net proceeds of the sale of an untraced shareholder's shares to support the Group's community investment and education outreach programmes and to fund other good causes at the Company's discretion. At the same time, the Company intends to continue its use of a professional asset reunification agent to search for shareholders who have not kept their details up-to-date.

Nominations & Governance Committee report



Ian Davis
Chairman of the Nominations & Governance Committee

Highlights

- Considered and recommended to the Board:
  - appointment of Brad Singer as a Non-executive Director
  - appointment of Sir Kevin Smith as Senior Independent Director
  - appointment of Stephen Daintith as Chief Financial Officer
  - re-appointment of Ian Davis as Chairman.
- Global governance framework launched.
- Talent, succession and diversity reviews.

Principal responsibilities

The key areas of responsibility of the Committee are:

- To review the structure, size and composition of the Board and its committees, to ensure that they remain appropriate, and to make recommendations to the Board of any changes.
- To consider succession plans for Directors and senior executives.
- To oversee the induction plans for Directors.
- To review the independence of the Non-executive Directors.
- To conduct an annual evaluation of the Chief Executive.
- To review the Board's diversity policy and its implementation.
- To oversee the principal risk relating to talent and capability.
- To report to the Board on the Group's corporate governance practices and procedures to ensure that they remain appropriate for a group of the size and complexity of Rolls-Royce, taking account of best practice principles.
- To evaluate any conflicts of interest that the Directors may have.

The Chairman and the independent Non-executive Directors are members of this Committee and the Chief Executive attends the Committee meetings.

At a glance

Area of focus	Matters considered	Outcome
Board and committee composition	Re-appointment of one Non-executive Director and of the Chairman. The appointment of a new Senior Independent Director and changes to the chairmanship and composition of Board committees.	The Board made the following appointments after receiving recommendations from the Committee: • Sir Kevin Smith was appointed as Senior Independent Director and chairman of the Science & Technology Committee. • Lee Hsien Yang and Ian Davis were each re-appointed for a second three-year term (subject to annual shareholder approval). • Ruth Cairnie was appointed as chairman of the Remuneration Committee.
Appointments to the Board	Appointment of Brad Singer, partner and the chief operating officer of major shareholder ValueAct Capital. The appointment of a new Chief Financial Officer.	Recommended the appointment of Brad Singer to the Board as a Non-executive Director recognising that he was not considered to be independent. Members of the Committee were involved in the interview process for the Chief Financial Officer and the Committee recommended Stephen Daintith's appointment to the Board.
Succession planning and talent management	Talent and succession, diversity and inclusion reviews. Progress on appointments to the ELT.	This will be a continued area of focus. Further details of the reviews are shown on page 70. Members of the Committee were involved in the interview process for the Chief Operating Officer and the Strategy & Marketing Director.
Board inductions, training and development	A schedule of site visits by all Directors and feedback from inductions from the Directors appointed in 2015.	A number of site visits had been carried out during the year as part of ongoing induction schedules. It was recommended that each Non-executive Director undertake at least one site visit each year, in addition to the Board and committee meetings held outside London.
Governance	Roll out of the global governance framework.	The Group's global governance framework was communicated to all employees during the year.

Board and committee composition

The Committee regularly reviews the balance and composition of the Board, its committees and the executive team. These reviews identify current needs and consider longer-term succession planning in light of the Group's strategy. When reviewing Non-executive Director appointments the Committee considers the current skills, experience and tenure of the Directors and assesses future needs against the longer-term strategy of the Group.

The Committee recommended the appointments of a new Senior Independent Director and new chairmen for the Remuneration and Science & Technology committees. We take care to ensure that the skills and experience of Board members are closely aligned with the needs of the Board committees.

In February 2016, Lewis Booth indicated his intention to relinquish his responsibility as Senior Independent Director once a successor had been appointed. He remains chairman of the Audit Committee. Sir Kevin Smith, first appointed to the Board in November 2015, became Senior Independent Director following the AGM in May 2016. He is well known by the UK investor base and the Committee agreed he would be an excellent successor to Lewis. Sir Kevin was also appointed as chairman of the Science & Technology Committee in February 2016. Sir Kevin has significant aerospace industry knowledge with engineering and manufacturing experience, gained during a long career at GKN and BAE Systems.

Brad Singer joined the Science & Technology Committee on his appointment to the Board on 2 March 2016.

Dame Helen Alexander stepped down from the Board after the AGM in May 2016, having served as a Director for nine years. She was succeeded as chairman of the Remuneration Committee by Ruth Cairnie. Ruth first became a member of the Remuneration Committee when she joined the Board in September 2014. Ruth has been chairman of the remuneration committee at Keller Group plc since April 2012 and also sits on the remuneration committee of Associated British Foods plc. She therefore has both the experience and skills to chair the Rolls-Royce Remuneration Committee.

Alan Davies stepped down from the Board on 18 November 2016. As announced in July 2016, he had been appointed to the Safety & Ethics Committee with effect from 1 September 2016. However, he stepped down from the Board before any subsequent meetings of that committee took place.

Colin Smith will step down from the Board at the 2017 AGM after a distinguished career with the Group spanning over 40 years.

David Smith will leave the Company on 28 February 2017.

The Committee considered and recommended to the Board the terms of appointment for Lee Hsien Yang for a second three-year term subject to annual shareholder re-election. It also recommended my re-appointment, again for a three-year term subject to annual shareholder re-election. A full evaluation of my performance as Chairman was carried out by Lewis Booth, as Senior Independent Director, prior to confirmation of my re-appointment. Board committee membership is set out on page 54.

The Nominations & Governance Committee is satisfied with the composition of the Board committees however, with the resignation of Alan Davies in November 2016 and with the completion of John McAdam's nine-year term in 2017, we have recommended that the Board seeks at least one additional Non-executive Director, in particular someone who can complement the skills and experience on the Audit Committee.

Appointments to the Board

In November 2015, ValueAct notified us that it had increased its shareholding in the Company to above 10%. The Committee discussed the implications of ValueAct increasing its shareholding and encouraged engagement to understand better its management's views, noting that it had requested a seat on the Board. The Committee agreed that any proposed appointee should be credible and have the appropriate skills and experience to bring valued contributions as a Non-executive Director on the Board, particularly as the Group continued to execute its transformation programme. Candidates would be required to follow the rigorous selection process that applies to all Board appointments. The Committee also considered the implications of having a shareholder representative as a Director and referred this matter to the Board for further consideration. The Committee agreed that any shareholder representative would not be considered independent.

During January and February 2016, Brad Singer, a partner and the chief operating officer of ValueAct, met with members of the Committee and with the Executive Directors. I also had several extended meetings with him and took up a number of references both on him as an individual and from other chairmen who have experience of having an active shareholder represented on their boards.

Previously, Brad had been senior executive vice president and the chief financial officer of Discovery Communications Inc, and chief financial officer and treasurer of American Tower Corp. He has also worked as an investment banker at Goldman Sachs in New York and London. The Committee agreed that Brad has an excellent record as a business leader. He has experience of public companies during periods of change, growth and significant financial outperformance, particularly in the US where Rolls-Royce has important business interests and a significant shareholder base.

The Committee considered that Brad was an appropriate candidate and recommended his appointment. The Board took account of the discussion of the Committee and of the terms of the proposed relationship agreement between the Company, ValueAct and Brad Singer and agreed that appointing him to the Board was in the best interests of shareholders.

Both Brad's appointment and the terms of the relationship agreement were finalised and published on 2 March 2016. Details of the relationship agreement are available on the corporate governance page of the Group's website, www.rolls-royce.com.

Stephen Daintith will join the Board as Chief Financial Officer in Spring 2017. Details of his career, skills and experience can be found on page 57.

The Inzito Partnership (Inzito) was engaged as the search consultant for the Chief Financial Officer. A candidate brief, which included technical and personal qualities and skills, was drawn up by the Chief Executive and Group Human Resources Director and shared with members of the Nominations & Governance Committee. Inzito drew up a list of potential candidates and the Chief Executive and Group Human Resources Director interviewed a number of them before presenting a shortlist of candidates for members of the Committee to interview. Formal and informal references were taken on the shortlisted candidates and Stephen Daintith met all members of the Committee, and met with the Chief Executive and Chairman several times, before his appointment was recommended to the Board. The terms of his appointment were also considered and agreed by the Remuneration Committee in principle before the Board formally appointed Stephen.

Each of the Directors continues to be effective and able to devote sufficient time to the business of the Company and the Nominations & Governance Committee will continue to keep the Board's composition under review.

Diversity and inclusion

The Board and Committee actively support the Group's diversity and inclusion vision.

Rolls-Royce is a founder patron of the FTSE 100 Cross-Company Mentoring Programme which aims to widen the pool of eligible female board candidates. Following the departure of Dame Helen Alexander the percentage of women on the Board has fallen to 23% (2015:29%). Appointments will always be made on merit, however, for future Board appointments the Committee will instruct search consultants to identify as a priority female candidates who meet the skills and experience brief. As with previous Board appointments, we will consider candidates from the widest possible pool and will only engage search firms that have signed up to the Voluntary Code of Conduct for Executive Search firms. The Board has noted the Hampton Alexander recommendation for FTSE 100 companies to have at least 33% of the positions in their executive pipeline filled by women by 2020.

Our global diversity and inclusion policy and anti-discrimination policies aim to ensure that all employees are treated with dignity and respect and are empowered to deliver without fear of bullying or harassment (for more information see pages 42 and 43). We are making preparations to report under the Gender Pay Gap Reporting Regulations by April 2018.

The Group acknowledges the challenges of increasing diversity within our industry. We are working closely with the Royal Academy of Engineering's Diversity Leadership Group which has launched working groups to drive change and challenge the status quo for diversity and inclusion in the engineering sector. We have representation on its steering group and support four of its five action groups.

We give full and fair consideration to all employment applications from people with disabilities, and support disabled employees, helping them to make the best use of their skills and potential. Our high performance culture training continues to be rolled out across the globe to help employees increase their personal effectiveness.

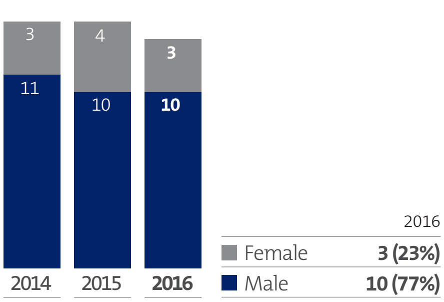
In March 2016, the Group Human Resources Director and Head of Global Talent Management shared with the Committee key diversity and inclusion achievements during 2015 and provided current global demographics and key elements of the diversity and inclusion strategy and priorities.

Non-executive Directors took positive action to meet a number of employee groups throughout the year to support these priorities. This included: an informal lunch with the Women's Group in Dahlewitz, Germany, on International Women's Day; dinner with high potential women in Derby, UK in May; and a meeting with representatives of the six employee resource groups (ERGs) in North America during the Board's visit to Indianapolis in September. In addition, individual members of the Committee took opportunities to support various activities by the ERGs in the UK, Germany and the US.

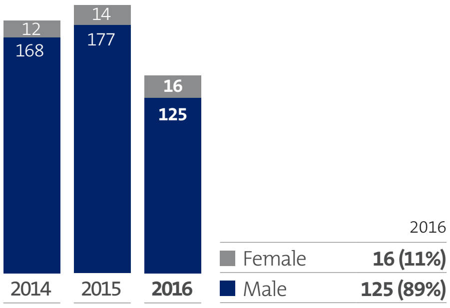
Diversity and inclusion strategy and priorities

- Senior leaders committing to a diverse and inclusive environment.
- Hiring diverse talent at all levels.
- Continual improvement in the way we act and behave to ensure full inclusion of all our talent and enable them to perform at their best.
- Engage and retain our best talent.
- Provide equal opportunity and advance diverse talent on merit.

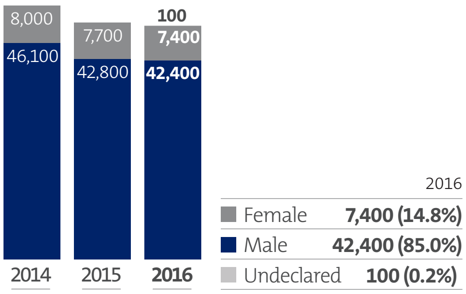
BOARD MEMBERS BY GENDER



SENIOR MANAGERS BY GENDER



EMPLOYEE HEADCOUNT BY GENDER



* Changes to our HR management system has enabled employees to choose whether to declare gender information. This has introduced an undeclared category to our gender reporting in 2016.

Succession planning and talent management

A principal risk to the business is the inability to attract, retain and incentivise talented individuals to deliver our strategy. The Committee is responsible for reviewing talent, capability and succession at the most senior levels of the business.

Following the announcement of the senior management restructuring in December 2015, and as part of our continuing transformation programme, there has been an increase in focus on our succession planning. Both the Committee and the Board held deep dives in these areas during 2016. Our desire to increase diversity, as described above, influences our approach to succession planning, training and development.

The Chief Executive and Group Human Resources Director led discussions on succession planning with the Board and the Committee in March and September 2016 respectively. In March, the Board considered skills and capability gaps at ELT level and succession planning both immediately below ELT level and those that would be ready to take up an ELT position in one or two moves. A new senior management structure was announced in December 2015 including the intention to appoint a new Chief Operating Officer. It was also agreed that a new role, Strategy & Marketing Director, would be added to the ELT. It was agreed that it was appropriate to recruit these roles from outside the business to help bring a fresh perspective. Members of the Committee were involved in the appointments of Simon Kirby as Chief Operating Officer and Ben Story as Strategy & Marketing Director.

We recognise that succession planning includes nurturing our own talent pool and giving opportunities to those who are capable of growing into more senior roles. Therefore, the review by the Committee in September focused on the executive pipeline from which the future leaders of the Company were likely to emerge, both for ELT roles and other key management areas. The Board also had dinner with a number of senior managers below ELT level in November 2016 and certain Non-executive Directors attended the senior leadership conference during the year to meet and exchange views with key managers.

Board inductions, training and continuing development

The Company Secretary is responsible for ensuring that new Directors have a thorough and appropriate induction. Each newly appointed Director has a structured induction programme and receives a comprehensive data pack providing detailed information on the Group. Each induction is based on the individual Director's requirements and includes meetings with all other Directors and members of the ELT as well as other relevant employees, committee attendees and external advisers. All Directors visit the Group's main operating sites as part of their induction and are encouraged to make at least one visit to other sites each year throughout their tenure. Often these visits take place in small groups of two or three Directors together as it is often useful to have a common understanding and insight into an area of the business that may be less well known to one or more of them. It also gives the Directors the chance to spend time with their fellow Board members in a less formal setting which helps them to understand the concerns of their colleagues. We regard these site visits as an important part of continuing education as well as an essential part of the induction process. They help Directors understand the business through direct experience of seeing processes in operation and by having discussions with a range of employees.

A summary of the visits carried out by individual Board members and Board committee in 2016 (as referred to in the Safety & Ethics and Science & Technology Committee reports) is shown on page 71.

Further training is available for all Directors, as appropriate, including presentations by the ELT on particular aspects of the business. The transformation team also presented to Non-executive Directors on progress, and the Board undertook the Group's ethics training.

There is a procedure for Directors to take independent professional advice at the Company's expense and every Director has independent access to the Company Secretary, who reports to the Chairman.

Governance

A core element of our transformation is world-class governance: excellence in how we govern our business, manage risk, and make sure standards are maintained throughout the Group.

The Group's governance framework, which was approved by the Committee in December 2015, was deployed Group wide during the year in five languages. It was supported by an all-employee communications campaign which included a video message from the Chief Executive and a dedicated intranet site. Rolling out the framework has been an important step in clarifying the Group's expectations of its employees and supports the work being undertaken on transformation.

The framework outlines the rules which apply to all Rolls-Royce employees and is intended to guide them in making the right decisions on behalf of the Group, faster and with more confidence. In particular, the framework:

- Describes the Group's organisational structure, accountabilities and responsibilities.
- Clarifies decision-making authorities.
- Gives employees an overview of our mandatory policies, processes and procedures.

The Committee was kept up to date on progress as the framework was rolled out across the Group. The framework is kept under review and further enhancements will be communicated to employees in 2017.

Conflicts of interest and independence

The Committee reviews the Non-executive Directors' external interests every year to determine whether each of them may continue to be considered independent. In undertaking the evaluation the Committee considers, among other things, the criteria set out in the Code.

The Committee also reviews any potential conflicts of interest as they arise and recommends to the Board whether these should be authorised and whether any conditions should be attached to any authorisation. Additionally, an annual review of conflicts of interest is undertaken to ensure that any previously authorised conflicting situations are still dealt with appropriately.

Brad Singer, as a representative of a significant shareholder, is not considered to be independent. As noted on page 68, the conflict of interest is managed by a relationship agreement between the Company, ValueAct and Brad Singer.

Having carried out the review, the Committee advised the Board that it considered that each of the remaining Non-executive Directors, with the exception of the Chairman for whom the test is not appropriate, continued to be independent. The Committee therefore recommended to the Board that each of the Director's potential conflicts of interest be authorised, without imposing any conditions.

Looking forward

We have made good progress on our priorities for 2016 which were to develop succession plans, to ensure that the transformation of the business was adequately supported below Board level, and to oversee the development and roll out of the internal governance framework. These areas will continue to be priorities for the Committee in 2017.

Ian Davis
Chairman of the
Nominations & Governance Committee

NON-EXECUTIVE DIRECTORS' SITE VISITS IN 2016

* Advanced Remanufacturing & Technology Centre

Remuneration Committee report

Ruth Cairnie
Chairman of the Remuneration Committee

Highlights

- New remuneration policy.
- Outturns for 2016.
- Terms of appointment for Chief Financial Officer.

2016 overview

Introduction

I am pleased to present my first report as chairman of the Remuneration Committee describing what we have done in the year and how we have reviewed our remuneration policy.

Policy review

Much of the Committee's activity in 2016 has focused on reviewing our policy.

Business context

The Group is at a critical stage in undergoing a major transition of the business including a ramp-up in delivery of new Trent engines, the associated modernisation of the manufacturing footprint and the far-reaching organisational transformation that is underway.

Whilst the transition has an expected short-term negative impact on profit, performance will improve through successful delivery of our transformation programme driving cost reduction and improving operational execution, and through achieving the increase in rate of engine delivery. This underpins our investment case and remuneration should be strongly linked to delivering this programme over the coming years.

Policy drivers

Four key themes have emerged to underpin our policy design: supporting transformation, talent, stewardship and simplification.

- We focused on the linkage to successful delivery of the transformation agenda which is closely matched to shareholder interests.
- We also needed to address the competitiveness of our current rewards. Through 2016, we have sought to recruit into a number of senior positions to strengthen skills in some areas, or to support an overall raising of our leadership capability to deliver the transformation, bringing in experience from other sectors. In this we have encountered real evidence of our rewards not being sufficiently competitive to secure some key talent that would make a strong contribution to Rolls-Royce.
- We have continued to focus on aligning the interests of Executive Directors and shareholders.
- We have also looked for opportunities to simplify our reward structure, and to ensure a coherent framework that can be cascaded to lower levels in the organisation.

Proposed changes

The overall structure will be unchanged, comprising base salary, benefits, annual bonus and a new long-term incentive plan (LTIP). This reflects our continued focus on pay for performance.

A number of simplifications are proposed in the structure of both annual bonus and LTIP, replacing multiplicative structures, hurdles and kickers with simpler additive components.

The performance measures are proposed to be unchanged for both annual bonus and LTIP, but with careful consideration having being given to the weightings of the LTIP components and a primary focus on growth in free cash flow.

Cash flow targets will be based on cumulative cash flow per share (CPS) as now; earnings per share (EPS) targets will be set on cumulative EPS over the three-year performance period; total shareholder return (TSR) will be measured relative to the constituents of the FTSE 100 as now, as well as the S&P Global Industrials Index. This approach better reflects our status as a FTSE 100 company and a global engineering group.

The maximum level of LTIP award is proposed to be increased to 250% of salary for the Chief Executive and 225% for other Executive Directors, to enhance our ability to attract and retain the talent we need in competitive markets. We also seek headroom up to 300% for the Chief Executive and 250% for other Executive Directors if this should be necessary for future recruitment. We have no other intention to use this headroom. Our current discretion to award a higher level of annual bonus on recruitment will be removed.

Shares received upon the vesting of LTIP awards, following the three-year performance period, will be subject to a two-year holding period. This approach further aligns incentives with long-term interests of shareholders.

The level of LTIP vesting for threshold performance will be reduced from 30% to 20% of the maximum.

Shareholder engagement

We have consulted extensively with major shareholders throughout the policy review. Early in the year several shareholders expressed concerns about retention and motivation given our more limited incentive levels. We continued to discuss our thinking with shareholders as we developed our policy during the year. The majority of shareholders who participated in this process:

- Recognised the level of challenge in delivering the transformation and our need to attract top class talent.
- Supported the simplified remuneration structures.
- Welcomed the inclusion of a holding period and reduced threshold vesting for LTIP awards.
- Strongly supported cash as the most important measure.
- Supported an increase in the LTIP maximum award in the context of delivering our transformation.

Some shareholders favoured a more highly-geared approach to remuneration, with significantly higher incentive opportunities. Other shareholders, while supportive of an increase, were mindful, as are we, of the increasing attention to high levels of executive pay and concerns about inequality. On balance, we have opted for an operational LTIP maximum that, while a significant increase, was not as high as some of our shareholders suggested. A small number of shareholders suggested a fundamentally different approach to remuneration with higher salaries and lower leverage based on performance. However, at this time our strong preference is to link reward firmly with performance and the delivery of our transformation programme.

We also consulted widely with shareholders on LTIP performance measures. We received a very strong message that cash flow was the most important performance measure. Several shareholders asked us to consider a long-term return measure in the mix. On reflection, we were of the view that this would be too opaque as a Group-level incentive metric given the very diverse nature of our businesses, differing sources of R&D funding and their long investment cycles. Some shareholders were ambivalent about inclusion of relative TSR, however we wanted to maintain a portion linked to the in-period value delivered to shareholders. Our shareholders also recognised the significant changes to EPS, as we transition to reporting under IFRS 15, but understood the approach we propose to take.

Agreements with investigating authorities

As announced on 17 January 2017, agreements were entered into between Rolls-Royce and the UK Serious Fraud Office (SFO), US Department of Justice (DoJ) and Brazilian Federal Prosecution Service (MPF). These agreements relate to bribery and corruption involving intermediaries in a number of overseas markets from January 1989 to November 2013 and will result in penalties totalling £671m over the next five years. The agreements that have been reached relate to legacy behaviour, and, Lord Justice Leveson, made clear in his judgment, no current member of the Board was involved. As set out in his judgment, the new executive team demonstrated extraordinary co-operation and has made essential changes, creating new policies, practices and cultures.

As a Committee we have considered remuneration consequences for individuals who were in office at the time. Our clawback provisions were introduced in 2014, which was after the relevant period of these events. In cases where employees have been dismissed or resigned as a result of Rolls-Royce's own internal investigation, shares and incentives have been cancelled in full as a consequence of the termination of their employment.

Because the SFO, DoJ and MPF agreements relate to legacy matters, and given that the legal judgment was very clear that there was no culpability in relation to existing management, the Committee has concluded that the impact of the penalties should be excluded from the 2016 bonus and from future incentive targets.

2016 outturns

We have given careful consideration to both the reported numbers and the external context in determining the bonus outturns for 2016.

Group underlying profit and cash flow, our key financial metrics, were both above the target levels and therefore a bonus will be paid for the first time in three years.

Underlying profit is a key measure of performance and as such does not include the accounting impacts of non-operational factors. In particular it excludes our US dollar hedge book valuation adjustment, which is a non-cash consequence of managing our foreign exchange risk, and is larger this year due to the post-referendum sterling decline.

In assessing the achievement of bonus targets, the Committee made overall downwards adjustments to both profit and cash flow elements. Adjustments were made to remove gains from unbudgeted foreign exchange movements and cash receipts as well as restructuring payments.

Following these adjustments the Committee also reviewed the bonus outturn in the round, taking into account the Company's performance and the shareholder context. 2016 was a solid year in which we exceeded cash and profit expectations and our transformation programme is off to a good start. However, reflecting the overall experience of our shareholders, in a year when underlying profits have fallen, the Committee agreed with the management and Board that it would be appropriate for the business element of the executive team's bonuses to be reduced to target levels.

The 2014 performance share plan (PSP) awards will not vest as the performance conditions were not met over the three-year performance period to 31 December 2016.

Board changes

In September 2016, we announced that David Smith would leave Rolls-Royce after two years as Chief Financial Officer and will be succeeded by Stephen Daintith. Stephen is expected to take up the role in Spring 2017. Colin Smith will also be stepping down from the Board at the 2017 AGM, after 43 years with Rolls-Royce.

The Committee considered appropriate terms for David and Colin on their departure. Their remaining contractual entitlements will be subject to phasing and mitigation. PSP awards will be pro-rated for service and will vest at the normal time, depending on achievement against the relevant performance targets. The 2014 awards have lapsed as the targets were not met and 2015 awards, for all participants, are not expected to vest either. Neither will participate in incentive schemes for 2017.

The Committee also considered the remuneration package for Stephen on his appointment, and believe his package is appropriate for the role and for someone of his experience and capabilities. We will also make some buyout awards in respect of his forfeited awards, retaining performance conditions where relevant and matching or exceeding time horizons.

2017 salary review

The Committee has reviewed the salary levels of the Executive Directors and has concluded that an increase of 2% will be made to Warren East in line with those made to other employees. All salary increases for management are being deferred until 1 September 2017. No increases are being made for other Executive Directors.

Principal responsibilities

The key areas of responsibility of the Committee are:

- To set and monitor the strategy and policy for the remuneration of the Executive Directors, the Chairman and members of the Executive Leadership Team (ELT).
- To determine the design, conditions and coverage of annual and long-term incentive plans for senior executives and approve total and individual payments under the plans.
- To determine targets for any performance-related pay plans.
- To determine the issue and terms of all share-based plans available to all employees.
- To oversee any major changes in remuneration.

Resolutions

At our AGM in 2017 we will be asking shareholders to pass resolutions to approve:

- Our new Directors' remuneration policy.
- Our Directors' remuneration report which sets out how we have applied our existing policy during 2016.
- Our new LTIP to accommodate the new remuneration policy.

I would like to thank the shareholders who contributed to the Committee's discussions during the year, and we hope that all our shareholders will support these resolutions.

Ruth Cairnie
Chairman of the
Remuneration Committee

Remuneration for 2016 – at a glance*

Fixed pay + Annual bonus (APRA) + Performance share plan (PSP)

Fixed pay	
Base salary	No increases for Executive Directors in 2016. Base salaries during the year were: Warren East – £925,000; Colin Smith – £550,000; David Smith – £540,000.
Pension	Pension arrangements during the year were: • Warren East – cash allowance of 25% of salary. • Colin Smith – continued participation in defined benefit scheme with no further accrual. – cash allowance of 32% of salary. • David Smith – cash allowance of 32% of salary.
Other benefits	Benefits include car or car allowance and related costs, financial planning assistance, certain insurances and other benefits.
Annual bonus (APRA)	
Maximum award**	For 2016, the maximum APRA was 180% of salary for the Chief Executive and 150% of salary for other Executive Directors.
Performance measures	Group performance for 2016 was based on: • 75% financial (profit and cash performance). • 25% non-financial (employee and customer metrics). Group performance outcomes can be multiplied by 0% to 120% based on individual performance.
Deferral	40% of awards are deferred into shares for two years.
Award for 2016	GROUP AND INDIVIDUAL PERFORMANCE AND BONUS OUTCOMES (see table below) Discretion was applied to reduce the Group performance outturn to on-target (60% of maximum).
Performance share plan (PSP)	
Maximum award**	The maximum annual PSP award is normally 180% of salary for the Chief Executive and 150% of salary for other Executive Directors. As disclosed last year, for 2016 awards only, the maximum opportunities were reduced to 150% of salary and 130% of salary respectively as a balance to changes to the measurement of the EPS hurdle.
Performance measures	Awards are subject to an aggregate CPS performance condition measured over three years. The number of shares awarded can then be adjusted (up to 125% for 2016 awards) based on relative TSR versus constituents of the FTSE 100. No awards can vest until an EPS hurdle is met. As disclosed last year, for 2016 awards EPS must exceed the Organisation for Economic Co-operation and Development (OECD) index of consumer prices over the two-year period 2017 and 2018.
Vesting of 2014 award	The 2014 PSP awards will lapse in March 2017 based on performance to 31 December 2016 as the performance measures were not met.
Shareholding	
Shareholding requirements	The Chief Executive is required to build up a holding equal to 250% of salary. For other Executive Directors the requirement is 200% of salary.

GROUP AND INDIVIDUAL PERFORMANCE AND BONUS OUTCOMES

	Group performance (percentage of max)	Individual multiplier	Overall percentage of salary	Overall percentage of maximum
Warren East	60%	1.1	99%	55%
Colin Smith	60%	1.0	75%	50%
David Smith	60%	1.0	75%	50%

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* Based on current policy which is available on our website at www.rolls-royce.com.

** APRA and PSP awards are subject to malus and clawback in certain circumstances (see page 79).

Remuneration policy from 2017

Introduction

The policy will take effect from 4 May 2017, subject to shareholder approval at the AGM.

Consideration of shareholder feedback

During the policy review we have had extensive and constructive consultation with our largest shareholders which has been a significant factor in shaping the new policy. Further details are set out on page 73.

The overall consensus that came out of the consultation was:

- Recognition of the level of challenge in delivering transformation and attracting top talent.
- Support for simplified remuneration structures.
- Strong support for cash as the most important measure of performance.
- Welcome for the inclusion of a holding period post the performance period on the LTIP.
- Support for an increase in the LTIP maximum award in the context of delivering the transformation, linked to appropriately stretching targets.
- Recognition of the value of having some objective and quantifiable non-financial measures in addition to financial measures in our short-term incentive plan.

These views have been reflected in the final policy design for 2017.

Key policy themes

As part of the remuneration policy review, the Committee has taken the opportunity to take a broad look at our remuneration approach underpinned by four key themes:

Supporting transformation – our policy should incentivise and reward the delivery of our transformation programme over the next three years. This programme aims to simplify the organisation and processes and embed the right cultural behaviours; these set the foundation for cost reduction and improved productivity, as well as greater pace, simplicity and clearer accountability in the way we work. This programme is essential to achieving both the production ramp-up and cost efficiencies that underpin the cash flow generation that is key to our long-term investment case. Our view is that remuneration should be strongly linked to the successful delivery of this programme and its financial benefits.

Talent – we must be able to attract and retain the individuals necessary for business success across a global and diverse talent pool. Our recent experience has shown that our current level of reward is not sufficiently competitive to secure some key talent that would make a strong contribution to the Group.

Stewardship – the system of remuneration should align interests of executives and shareholders and comprise a significant proportion of share-based long term incentives.

Simplification – our reward structure and performance measures should be aligned to the strategy and be simple to communicate to participants and shareholders. It should reflect the business priorities in terms of both financial and non-financial parameters and be seen to incentivise the right behaviours and the right outcomes for a long term, sustainable and profitable future.

Given the importance of delivering our business transformation over the next three years, we believe that retaining a strong emphasis on performance-related incentives is appropriate. We therefore plan to retain a structure of salary, benefits, annual bonus and long term incentives, underpinned by appropriate performance measures and award levels.

Main changes to policy design

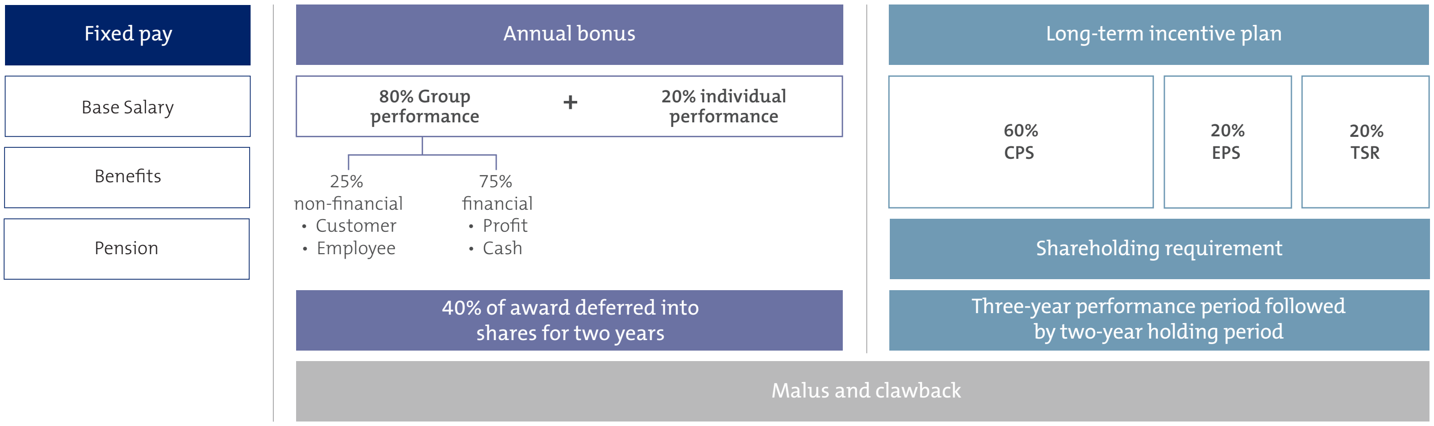
Supporting transformation – we will better align the incentive performance measures and weighting of those measures to our business strategy. For 2017, LTIP awards will be weighted 60% CPS, 20% EPS, and 20% TSR.

Talent – we will increase the level of award so that we can attract and retain the talent that we need. Under the new policy the normal maximum level of long-term incentive award is increased from 180% for the Chief Executive and 150% for the other Executive Directors to 250% of salary for the Chief Executive and 225% for other Executive Directors. The overall maximum under the policy will be 300% for the Chief Executive and 250% for other Executive Directors (for use in recruitment only).

Stewardship – we will introduce a two-year shareholding period following the three-year LTIP performance period. This will support the continued alignment of Executive Directors' reward to the interests of shareholders. We will reduce the amount of the long-term incentive award that vests for threshold performance from 30% of the award (equivalent to 54% of salary for the Chief Executive) to 20% of the award (equivalent to 50% of salary).

Simplification – we are simplifying the structure of our bonus and LTIP replacing multiplicative structures, hurdles and kickers with simpler additive components.

Summary of policy design changes and link to policy themes*



* Weightings and non-financial measures are as applied in 2017.

Element	Commentary	Policy theme
Fixed pay	No changes are proposed to the fixed pay element of the remuneration policy approved by shareholders at the 2014 AGM. The new remuneration policy to be approved at the 2017 AGM will continue to apply until the 2020 AGM.	*Talent*
Annual bonus	Performance measures remain appropriate following the introduction of customer and employee metrics in 2016. Bonuses are determined primarily by Group financial performance but the Committee may apply non-financial metrics that support the underlying strategic priorities for the forthcoming year.	*Transformation*
	From 2017, Executive Director bonuses will be awarded using a simple additive approach: • 80% of the award will be based on Group performance. • 20% of the award will be based on individual performance.	*Simplification*
	40% of any bonus will be deferred into shares for two years.	*Stewardship*
Long-term incentive plan	CPS, EPS and TSR remain our long-term measures of success and reflect the strategic focus on profitable growth, the quality of profit, and returns to shareholders. During shareholder consultation we received strong support for the continued use of cash flow as the central measure of long-term performance.	*Transformation*
	The structure will be amended so elements are measured independently, rather than using an EPS hurdle and a TSR multiplier.	*Simplification*
	The introduction of a two-year shareholding period following the three-year performance period. This includes a requirement to continue to hold shares after participants have left the Group. 20% of the maximum award will vest for threshold performance (a reduction from 30% in the current remuneration policy).	*Stewardship*
	The new remuneration policy includes an overall maximum of up to 300% of salary for the Chief Executive and 250% for other Executive Directors. The intention is that this flexibility will only be used in recruitment (to secure talent across a global and diverse talent pool). The intended operational maximum for the three-year period of this policy is 250% of salary for the Chief Executive and 225% of salary for other Executive Directors.	*Talent*

Remuneration policy table

The table below sets out each element of Executive Directors' remuneration.

Pay element – fixed pay	
Base salary	
Purpose and link to strategy	The Company provides competitive salaries suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Salaries are reviewed, but not necessarily increased, annually. Decisions on salary are informed but not led by reference to companies of a similar size, complexity and international reach.
Maximum opportunity	Any salary increases will be assessed annually and will not normally exceed average increases for employees in other appropriate parts of the Group. The Committee may exercise discretion to make larger increases in circumstances where it is necessary to address particular issues or risks, including growth in the role for new appointments.
Benefits	
Purpose and link to strategy	The Company provides competitive benefits suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Benefits may include car or car allowance and related costs, financial planning assistance, private medical insurance, life assurance and other appropriate benefits at the discretion of the Committee. Relocation support or support for accommodation and travel may be offered to executives where necessary. Executive Directors may participate in all-employee share plans including ShareSave and the Share Incentive Plan.
Maximum opportunity	Benefits excluding all employee share plans, and any accommodation, relocation and associated tax costs will not exceed £100,000 per annum.
Pension	
Purpose and link to strategy	The Company provides competitive pension schemes suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Executive Directors are offered membership of a defined contribution pension plan. A cash allowance may be payable in lieu of pension contributions, reduced to allow for additional National Insurance incurred. There are a number of legacy pension arrangements, including defined benefit plans, which were in place before 27 June 2012 and have not changed. Commitments to these arrangements will be honoured.
Maximum opportunity	The maximum employer contribution to defined contribution plans (or to be taken as a cash allowance) is 25% of salary. Pension contributions are based on base salary only. Defined benefit legacy plans, now closed to new members, accrue pension up to a maximum of two thirds of final salary.

Pay element – variable pay	
Annual bonus	
Purpose and link to strategy	To incentivise the execution of the business strategy, delivery of financial targets, and the achievement of personal objectives.
Operation	Bonuses are determined primarily by Group financial performance, but the Committee may apply non-financial metrics that support the underlying strategic priorities for the forthcoming year and/or adjust the payout level to ensure the outturns reflect performance. The bonuses payable are also linked to personal performance of the Executive Directors. The financial and non-financial metrics are set with reference to the prior year and to the budgets and business plans for the coming year, ensuring the levels to achieve base, on-target and maximum payout are appropriately stretching. At least 40% of the bonus is compulsorily deferred into shares for a further two years, and released subject to continued employment. Deferred shares may attract an issue of C Shares or equivalent during the deferral period. Awards are subject to malus and clawback provisions where there has been a material misstatement of audited results; serious financial irregularity which invalidates the targets set; reputational damage; material failure of risk management a serious breach of the Group's Global Code of Conduct; or individual gross misconduct. These provisions apply from the date of deferral until three years after the release of shares.
Maximum opportunity	The annual maximum for the Chief Executive is 180% of salary and 150% for other Executive Directors.
Performance measures	The bonus is weighted 80% on Group metrics, and 20% on individual performance. Within the Group metrics: • At least 60% is based on Group financial targets (for example profit and free cash flow). • Up to 40% of the bonus is based on non-financial metrics such as employee engagement and customer delivery. • Individual objectives are set and agreed with the Remuneration Committee at the start of each year, to reflect the prevailing business context. • The Committee may, in the context of the underlying business strategy, use different performance measures.
Long-term incentive plan (LTIP)	
Purpose and link to strategy	To reward the development and execution of the business strategy over a multi-year period.
Operation	Executive Directors are granted awards over shares annually with a three-year performance period. The number of shares relative to the proportion of the award that vests is determined at the end of the performance period according to the achievement against the performance measures. The proportion of award that vests is then held for a further two-year holding period. Awards are subject to malus and clawback provisions where there has been a material misstatement of audited results; serious financial irregularity which invalidates the targets set; reputational damage; material failure of risk management; a serious breach of the Group's Global Code of Conduct; or individual gross misconduct. These provisions apply from the date of the award until three years from the date of vesting.
Maximum opportunity	Normal annual awards: • Chief Executive – 250% of salary. • Other Executive Directors – 225% of salary. The maximum face value of annual awards is 300% of salary for the Chief Executive and 250% for other Executive Directors. This flexibility would only be used in recruitment to secure individuals with the required skills and experience. This flexibility would not be used in the normal course of business.
Performance measures	Performance measures may include CPS, EPS, and/or relative TSR. For 2017 awards the measures will be weighted 60% CPS, 20% EPS, 20% TSR. No more than 20% of awards will vest for threshold performance. The Committee may, in the context of the underlying business strategy, use different performance measures and/or vary the weightings of the measures.

The table below sets out the main elements of Non-executive Directors' remuneration.

Pay element	
Fees	
Purpose and link to strategy	To reward individuals for fulfilling their role and attract individuals of the skills and calibre required.
Operation	The Committee makes recommendations to the Board on the Chairman's remuneration. The Chairman and the Executive Directors determine the remuneration of the Non-executive Directors. Levels take into account fees paid by other companies of a similar size and complexity. The Chairman is paid a single fee. Other Non-executive Directors are paid a base fee covering Board and Board Committee membership, with committee chairmen and the Senior Independent Director receiving an additional fee.
Maximum opportunity	The maximum total remuneration payable to Non-executive Directors, including the Chairman, is £1,600,000 per annum.
Benefits	
Purpose and link to strategy	To devote maximum time and attention to the requirements of the role.
Operation	The Chairman has occasional use of chauffeur services. Travel, hotel and subsistence incurred in attending meetings are reimbursed by the Company. The Group may pay tax on such benefits, or provide support with tax matters for Non-executive Directors based outside the UK.
Maximum opportunity	Maximum value for chauffeur services will not exceed £15,000 per annum. £5,000 maximum towards tax advice and filing per annum.

Performance measures and targets

The Committee will set Group financial targets for annual bonus and LTIP awards with reference to the prior year and to forward-looking business forecasts, ensuring the levels of performance required to achieve base, on-target and maximum bonus awards are appropriately challenging.

The Committee may, in the context of the underlying business strategy, use different performance measures for incentives and/or vary the weightings of the measures used for LTIP awards. For example, during the next two years we will transition to IFRS 15 which will impact the reporting of revenue and profit. The Committee may choose to increase the weighting on EPS as this new reporting standard becomes more established.

The measurement of performance against performance targets is at the Committee's discretion, which may include appropriate adjustments to financial or non-financial elements and/or consideration of overall performance in the round.

Performance conditions may also be replaced or varied if an event occurs or circumstances arise which cause the Committee to determine that the performance conditions have ceased to be appropriate. If the performance conditions are varied or replaced, the amended conditions must, in the opinion of the Committee, be fair, reasonable and materially no less difficult than the original condition when set.

Policy on new appointments

The Committee will appoint new Executive Directors with a package that is in line with the remuneration policy in place and agreed by shareholders at the time. Base salary may be set at a higher or lower level than the previous incumbent. The Committee may use its discretion to make individual incentive awards up to the maximum policy headroom limits outlined in the policy table.

Remuneration forfeited on resignation from a previous employer may be compensated. This will be considered on a case-by-case basis and may comprise cash or shares. In general:

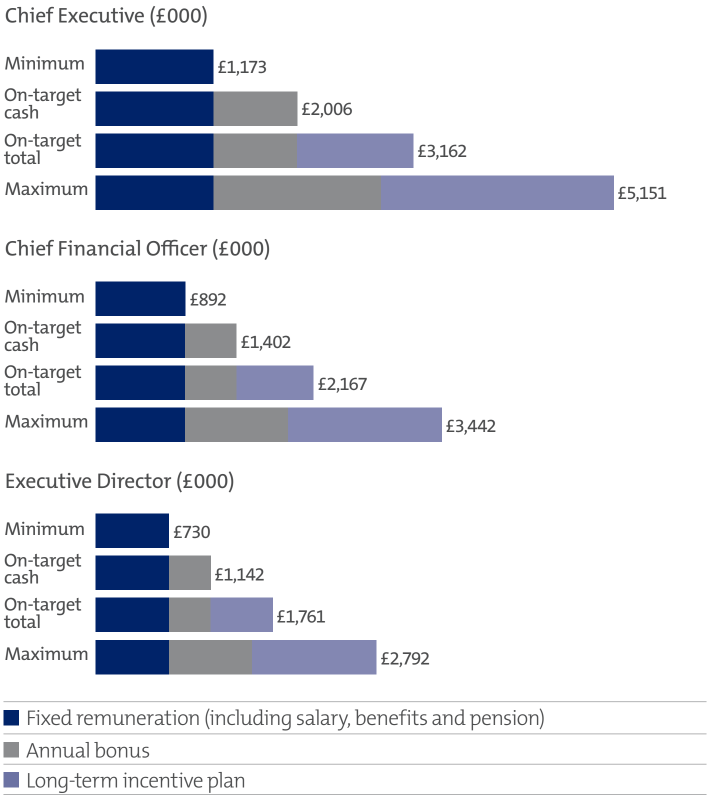
- If such remuneration was in the form of shares, compensation will be in the Company's shares.
- If remuneration was subject to achievement of performance conditions, compensation will be normally be subject to performance (either Rolls-Royce performance conditions or actual/forecast performance outturns from the previous company).
- The timing of any compensation will, where practicable, match the vesting schedule of the remuneration forfeited.

Legacy terms for internal appointments may be honoured, including pension entitlements and any outstanding incentive awards.

If an Executive Director is appointed following a merger or an acquisition of a company by Rolls-Royce, legacy terms and conditions may be honoured.

Remuneration policy – worked examples below

2017 POLICY ILLUSTRATION



Minimum – fixed remuneration (salary, pension, benefits), no bonus award or LTIP vesting.
On-target cash – fixed remuneration, 50% of maximum bonus award, no LTIP vesting.
On-target total – fixed remuneration, 50% of maximum bonus award, 50% of LTIP vesting.
Maximum – fixed remuneration, 100% of maximum bonus award, 100% of LTIP vesting.

Group employee considerations

When setting remuneration for Executive Directors the Committee takes into account contextual information about pay and conditions within the Group, including:

- Salary increases for all employees.
- Bonus awards for all employees.
- Pay ratios between Executive Directors and other employees.

We are committed to sharing business success across the organisation with all employees participating in a short-term incentive plan. At more senior levels, remuneration is increasingly long term and larger proportions are dependent on both Group and individual performance and paid in the form of shares.

The Committee has not consulted all employees when reviewing the policy, considering the scale and geography of the population.

Termination

The Company is required to give Executive Directors 12 months' notice under their service contracts. Payment in lieu of notice will not exceed the value of 12 months' salary, benefits and pension contributions. Both mitigation and the timing of payments through the notice period will be considered by the Committee where appropriate, as will the funding of reasonable outplacement and other professional fees. Pension benefits will normally be payable in accordance with the rules of the pension plan. There is no automatic entitlement to annual bonus. Taking into account the circumstances, the Committee has discretion to award a bonus in respect of performance in the financial year with appropriate consideration of time prorating.

Deferred shares will generally be released in cases such as retirement, death, injury, ill-health, redundancy or any other reason at the discretion of the Committee. In these cases any annual bonus awarded immediately prior to leaving may be delivered in cash rather than deferred shares.

For the LTIP, the rules state that unvested awards may be preserved at the Committee's discretion according to the circumstances. In such cases vesting will be at the normal date, subject to the established performance conditions, and prorated to employment in the performance period. In cases such as death and terminal illness, the Committee also has the discretion to vest the awards immediately using an estimate of future outturn. If an individual leaves after the LTIP shares have vested but during the holding period, shares will not be forfeited but the holding period will remain in force.

The treatment of leavers in ShareSave and the Share Incentive Plan is covered by the respective plan rules. Change of control provisions in respect of employee share plans are set out on page 187.

Any termination payments will be in line with the remuneration policy agreed by shareholders at that time.

Service contracts

The service contracts for Warren East, Colin Smith and David Smith include 12 months' notice of termination from the Company and six months' notice from the Executive. The service contracts of Stephen Daintith, and any new appointee, will include 12 months' notice from the Company and 12 months' notice from the Executive Director. All contracts include the entitlement to paid holidays, sick pay, and other standard employment terms including reimbursement of reasonable business expenses.

The Chairman and Non-executive Directors have letters of appointment. No compensation is payable to the Chairman or to any Non-executive Director if the appointment is terminated early or if they fail to be re-elected at an AGM.

Legacy commitments

Any remuneration payments and/or payments for loss of office made under legacy arrangements prior to the approval of the Company's remuneration policy may be paid out subject to the terms of any remuneration policy in place at the time they were agreed. For these purposes 'payments' include the Company satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are agreed at the time the award is granted.

This provision includes PSP awards granted under the previous approved remuneration policy. These awards were subject to CPS and relative TSR performance conditions, with vesting only possible if the EPS hurdle was met. The Chief Executive received awards of 180% of salary, and other executives received awards of 150% of salary (including the relative TSR multiplier).

Minor amendments

The Committee may make minor amendments to the policy (for regulatory, exchange control, tax or administrative purposes or to take account of a change in legislation) without obtaining shareholder approval.

Directors' remuneration report

The table below shows how we have applied the current remuneration policy during 2016. It discloses all the elements of remuneration received by the Directors during the year. The current remuneration policy, as approved by shareholders in 2014, is available on our website.

Single figure of remuneration (audited)

	Salary/fees (A) £000		Benefits (B) £000		Bonus (C) £000		LTIP (D) £000		Other (E) £000		Sub-total £000		Pension (F) £000		Total £000	
	2016	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015
Executive Directors																
Warren East[1]	**925**	421	**17**	8	**916**	–	**–**	–	**–**	–	**1,858**	429	**231**	114	**2,089**	543
Colin Smith[2]	**550**	546	**156**	150	**413**	–	**–**	–	**–**	–	**1,119**	696	**176**	140	**1,295**	836
David Smith	**540**	535	**51**	35	**405**	–	**–**	–	**–**	–	**996**	570	**173**	171	**1,169**	741
Former Executive Directors																
James Guyette[3]	**–**	274	**–**	47	**–**	–	**–**	–	**–**	–	**–**	321	**–**	262	**–**	583
Mark Morris[4]	**–**	–	**–**	–	**–**	–	**–**	–	**–**	597	**–**	597	**–**	–	**–**	597
John Rishton[5]	**–**	519	**3**	82	**–**	–	**–**	–	**–**	–	**3**	601	**–**	153	**3**	754
Sub-total	**2,015**	2,295	**227**	322	**1,734**	–	**–**	–	**–**	597	**3,976**	3,214	**580**	840	**4,556**	4,054
Chairman and Non-executive Directors																
Ian Davis	**425**	425	**2**	1	**–**	–	**–**	–	**–**	–	**427**	426	**–**	–	**427**	426
Lewis Booth	**100**	110	**14**	11	**–**	–	**–**	–	**–**	–	**114**	121	**–**	–	**114**	121
Ruth Cairnie	**83**	70	**2**	3	**–**	–	**–**	–	**–**	–	**85**	73	**–**	–	**85**	73
Sir Frank Chapman	**90**	90	**2**	4	**–**	–	**–**	–	**–**	–	**92**	94	**–**	–	**92**	94
Irene Dorner[6]	**70**	30	**–**	–	**–**	–	**–**	–	**–**	–	**70**	30	**–**	–	**70**	30
Lee Hsien Yang	**70**	70	**3**	8	**–**	–	**–**	–	**–**	–	**73**	78	**–**	–	**73**	78
John McAdam	**70**	70	**–**	–	**–**	–	**–**	–	**–**	–	**70**	70	**–**	–	**70**	70
Bradley Singer[7]	**58**	–	**–**	–	**–**	–	**–**	–	**–**	–	**58**	–	**–**	–	**58**	–
Sir Kevin Smith[8]	**98**	12	**2**	–	**–**	–	**–**	–	**–**	–	**100**	12	**–**	–	**100**	12
Jasmin Staiblin	**70**	70	**4**	7	**–**	–	**–**	–	**–**	–	**74**	77	**–**	–	**74**	77
Former Non-executive Directors																
Dame Helen Alexander[9]	**31**	90	**–**	–	**–**	–	**–**	–	**–**	–	**31**	90	**–**	–	**31**	90
Alan Davies[10]	**62**	12	**1**	–	**–**	–	**–**	–	**–**	–	**63**	12	**–**	–	**63**	12
Warren East[1]	**–**	45	**–**	–	**–**	–	**–**	–	**–**	–	**–**	45	**–**	–	**–**	45
John Neill[11]	**–**	25	**–**	3	**–**	–	**–**	–	**–**	–	**–**	28	**–**	–	**–**	28
Sub-total	**1,227**	1,119	**30**	37	**–**	–	**–**	–	**–**	–	**1,257**	1,156	**–**	–	**1,257**	1,156
Total	**3,242**	3,414	**257**	359	**1,734**	–	**–**	–	**–**	597	**5,233**	4,370	**580**	840	**5,813**	5,210

[1] Warren East was appointed as Chief Executive on 3 July 2015, having served as a Non-executive Director from 1 January 2014 to 2 July 2015.

[2] Colin Smith's benefits have been restated for 2015 due to late receipt of invoices relating to accommodation costs totalling £10,000.

[3] James Guyette left the Board on 8 May 2015.

[4] Mark Morris left the Board on 4 November 2014.

[5] John Rishton stepped down as Chief Executive and left the Board on 2 July 2015. A final payment in settlement of chauffeur expenses was made to John Rishton in December 2016.

[6] Irene Dorner was appointed as a Non-executive Director on 27 July 2015.

[7] Bradley Singer was appointed as a Non-executive Director on 2 March 2016.

[8] Sir Kevin Smith was appointed as a Non-executive Director on 1 November 2015.

[9] Dame Helen Alexander left the Board on 5 May 2016.

[10] Alan Davies was appointed as a Non-executive Director on 1 November 2015 and left the Board on 18 November 2016.

[11] John Neill left the Board on 8 May 2015.

Notes to the table

A. Salary and fees

BASE SALARY

The Executive Directors' salaries are normally reviewed, but not necessarily increased, with effect from 1 March each year. In 2016 there were no increases.

EXECUTIVE DIRECTORS' BASE SALARY

	Base salary as at 1 September 2017	**Base salary as at 1 March 2016**	Base salary as at 1 March 2015
Warren East	£943,500	**£925,000**	£925,000
Colin Smith[1]	n/a	**£550,000**	£550,000
David Smith[2]	n/a	**£540,000**	£540,000
Stephen Daintith[3]	£680,000	**n/a**	n/a

[1] Colin Smith will step down as an Executive Director on 4 May 2017.
[2] David Smith will leave the Company on 28 February 2017.
[3] Stephen Daintith is expected to take up his role in Spring 2017.

The Committee reviewed Executive Directors' salaries in early 2017 and concluded that an increase of 2% will be made to Warren East in line with those made to other employees. All salary increases for management are being deferred until 1 September 2017. No increases are being made for other Executive Directors.

NON-EXECUTIVE DIRECTORS' FEES

The Chairman's fee is reviewed by the Board as a whole on the recommendation of the Remuneration Committee and the review of the Non-executive Directors' fees is reserved to the Executive Directors, who take recommendations from the Chairman. No individual may be involved in setting his or her own fee. The Executive Directors and the Chairman reviewed Non-executive Directors' fees in December 2016 and resolved that there will be no increase in fees in 2017. The Non-executive Directors' fees were last increased in 2014.

The Chairman and Non-executive Directors are not eligible to participate in any of the Group's share schemes, incentive arrangements or pension schemes. We have in place a facility to enable Non-executive Directors to use some or all of their fees, after the appropriate statutory deductions, to make market purchases of shares in the Company on a monthly basis. Ruth Cairnie, Sir Frank Chapman, Ian Davis, Lee Hsien Yang, John McAdam and Sir Kevin Smith participate in this facility.

NON-EXECUTIVE DIRECTORS' BASE FEES

	2017 £000	**2016 £000**	2015 £000
Chairman	425	**425**	425
Other Non-executive Directors	70	**70**	70
Chairman of the Audit Committee	25	**25**	25
Chairman of the Remuneration Committee	20	**20**	20
Chairman of the Safety & Ethics Committee	20	**20**	20
Chairman of the Science & Technology Committee	20	**20**	20
Senior Independent Director	15	**15**	15

B. Benefits

Benefits are provided to ensure that remuneration packages remain sufficiently competitive to recruit and retain Directors and to enable them to devote themselves fully to their roles. The benefits for the Non-executive Directors relate predominantly to travel and subsistence associated with attending Board meetings, although for Directors who are based outside the UK, the Company may pay towards tax advice and filing. The taxable value of all benefits paid to Executive Directors in the year is shown below.

BENEFITS PAID TO EXECUTIVE DIRECTORS (AUDITED)

	Car or car allowance including fuel allowance £000		Chauffeur services £000		Financial planning £000		Medical insurance £000		Club membership fees £000		Travel and subsistence £000		Accommodation costs £000		Total £000	
	2016	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015
Warren East[1]	**15**	7	**–**	–	**–**	–	**2**	1	**–**	–	**–**	–	**–**	–	**17**	8
Colin Smith[2]	**30**	30	**–**	–	**6**	6	**2**	2	**–**	–	**7**	4	**111**	108	**156**	150
David Smith	**28**	16	**–**	–	**–**	–	**2**	2	**–**	–	**6**	5	**15**	12	**51**	35
Former Non-executive Directors																
James Guyette[3]	**–**	5	**–**	–	**–**	20	**–**	–	**–**	6	**–**	–	**–**	16	**–**	47
John Rishton[4]	**–**	14	**3**	14	**–**	6	**–**	1	**–**	–	**–**	–	**–**	47	**3**	82
Total	**73**	72	**3**	14	**6**	32	**6**	6	**–**	6	**13**	9	**126**	183	**227**	322

[1] Warren East was appointed as Chief Executive on 3 July 2015, having served as a Non-executive Director from 1 January 2014 to 2 July 2015.

[2] Colin Smith's benefits have been restated for 2015 due to late receipt of invoices relating to accommodation costs totalling £10,000.

[3] James Guyette left the Board on 8 May 2015.

[4] John Rishton stepped down as Chief Executive and left the Board on 2 July 2015. A final payment in settlement of chauffeur expenses was made to John Rishton in December 2016.

C. Annual bonus outcome

Annual bonuses may be awarded under the annual performance related award plan (APRA).

Executive Directors receive any annual bonus awarded in March following the performance period. The bonus is paid partially in cash and partially in deferred shares. The deferred shares are held in trust for two years before being released, subject to the recipient still being employed by the Group. Ordinary shares held as deferred shares will include the right to receive an enhancement equal in value to the C Shares issued during the deferral period.

Malus and clawback provisions apply where there has been: a material misstatement of audited results; serious financial irregularity which invalidates the targets set; reputational damage; material failure of risk management; a serious breach of the Group's Global Code of Conduct; or individual gross misconduct. Clawback will apply within three years from the date of grant.

Following consultation with shareholders at the start of 2016, the Committee introduced two new measures relating to customer delivery and employee engagement, subject to any bonus in relation to these targets being underpinned by the underlying profit threshold. The maximum bonus opportunity for Executive Directors was 180% for the Chief Executive and 150% of salary for other Executive Directors.

The Remuneration Committee reviewed the 2016 outturn against the performance measures, which are shown below:

APRA 2016 PERFORMANCE MEASURES AND OUTTURN (AUDITED)

GROUP PERFORMANCE

	Profit	Cash	Customer delivery	Employee engagement
Weighting	37.5%	37.5%	12.5%	12.5%
Base (30%)	£650m	(£250m)	80%	73
Target (60%)	£712m	(£169m)	90%	75
Maximum (100%)	£790m	0	100%	78
2016 performance	£713m	£48m	88%	75
Bonus outturn (as a % of maximum)	60%	100%	54%	60%

Discretion was applied to reduce the overall Group performance outturn to on-target (60% of maximum).

Definitions used for performance measures:

Profit – underlying profit before tax that is reported by the Group for 2016, adjusted to exclude unbudgeted acquisitions and disposals.

Cash – free cash flow which is cash flow before acquisitions and disposals, shareholder payments, foreign exchange and share buybacks.

Customer delivery – % on-time to purchase order, measured for new equipment, spare parts or equipment repair and overhaul.

Employee engagement – measured through our long-standing global employee opinion survey.

For the purposes of assessing performance the Committee adjusted the actual underlying profit of £813m downwards to £713m and free cash flow of £100m downwards to £48m to remove gains from unbudgeted foreign exchange movements and cash receipts as well as restructuring payments.

INDIVIDUAL PERFORMANCE

The individual performance multiplier can increase or decrease the business outturn in a range of 0 – 120%, where on-target is 100%.

Personal performance objectives are set at the beginning of the year and are aligned with the Group's internal strategic priorities.

For Executive Directors these have included:

- Driving the transformation programme; simplification, cost reduction and improved behaviours.
- Engineering excellence – advancing our world-class technology.
- Operational excellence – embedding a lean enterprise and high-performance culture.
- Capturing aftermarket value and providing outstanding service to customers.
- Restoring investor confidence.
- Developing our people and our culture in a safe and ethical environment.
- Improving profitable growth.

The Committee assesses performance against the objectives and the overall assessed multiplier is based on the Committee's judgement and may include other factors and achievements in the year.

The following provides an overview of key achievements during the year for each Executive Director:

Warren East	Colin Smith	David Smith
Launched transformation including cultural change and process improvements, delivering cost reduction at the top end of the target range.	Progressed engineering supply chain interface, lead time reductions and product cost improvement ahead of target.	Continued to develop the finance function including review of management structures and achievement of key hires.
Drove the reorganisation of the Group with restructuring at many levels in the organisation.	Built talent within engineering to support succession planning.	Finalised plan for cost and margin work streams, tracking transformation and underlying cost actions.
Strengthened engagement with shareholders.	Drove transformation, including cultural and behavioural change programmes with cost reduction at the top end of the target range.	Improved effectiveness of forecasting and management information systems.

BONUS OUTTURN

	Warren East	Colin Smith	David Smith
Group performance (% of salary)	90%	75%	75%
Individual performance multiplier	1.1	1.0	1.0
Total bonus (% of salary)	99%	75%	75%
Total bonus (% of maximum)	55%	50%	50%

D. LTIP

PSP 2016 AWARD CPS TARGETS (AUDITED)

The cash flow per share targets for awards made in 2016 were as follows and straight-line vesting will apply between these points.

Aggregate CPS over the three-year period	Maximum award released %
Less than 10p	0
10p	30
50p	100

2016 PSP Awards are based on CPS and TSR measures with an EPS hurdle. As disclosed in the 2015 Annual Report, for the 2016 awards, the EPS hurdle will be measured over the period 2017 and 2018. This change reflected business circumstances and the intended level of stretch of the EPS hurdle which is used as an underpin rather than a primary performance measure. In recognition of the change the maximum vesting level for 2016 awards was reduced from 180% to 150% of salary for the Chief Executive and from 150% to 130% of salary for other Executive Directors.

PSP AWARDS MADE IN MARCH 2016

In 2016, Executive Directors received PSP awards in line with the remuneration policy as follows:

	Date of award	Number of shares awarded	% of salary	Face values (% of salary maximum)	Performance period end date
Warren East	1 March 2016	164,202	120	150	31 December 2018
Colin Smith	1 March 2016	81,361	100	130	31 December 2018
David Smith	1 March 2016	79,882	100	130	31 December 2018

All awards are made as performance shares based on a percentage of salary and the value is divided by the average share price over a three-day period before the date of grant, being 676p for the award on 1 March 2016.

Malus and clawback provisions apply where there has been: a material misstatement of audited results; serious financial irregularity which invalidates the targets set; reputational damage; material failure of risk management; a serious breach of the Group's Global Code of Conduct; or individual gross misconduct. Clawback will apply for three years after the vesting of an award.

If the EPS and base CPS targets are not achieved, no awards vest.

PSP AWARDS VESTING IN MARCH 2017

The following sets out details in respect of the March 2014 PSP award, for which the final year of performance was the 2016 financial year. Subject to performance conditions, the vesting date of these awards is in March 2017, three years after the award was made.

	Targets for 2014 – 2016 period	Performance against targets
EPS growth (hurdle)	Awards may vest if EPS growth exceeds the OECD index of consumer prices. Awards will lapse if hurdle not met.	EPS growth of (53.42%) over the three-year period underperformed the hurdle which was 3.06%.
Aggregate CPS	Aggregate CPS over three-year period of less than 117p – zero vesting. Aggregate CPS over three-year period of 147p – 100% vesting.	Aggregate CPS performance over three years of 27p.
Relative TSR	Relative TSR versus FTSE 100 constituents less than median – 1x multiplier. Relative TSR versus FTSE 100 constituents equal to median – 1.25x multiplier. Relative TSR versus FTSE 100 constituents equal to upper quartile – 1.5x multiplier.	Relative TSR performance over three years was below median versus FTSE 100 companies. No multiplier applied.
Outcome		None of the 2014 awards will vest in March 2017.

IMPLEMENTATION OF REMUNERATION POLICY FOR 2017*

<table>
<tr><td>Base salary</td><td>Warren East's salary will be increased by 2% in line with increases made to other employees. All salary increases for management are being deferred until September 2017. Base salaries from September 2017 will be:
Warren East – £943,500.
Stephen Daintith – £680,000 (expected to take up his role in Spring 2017).</td></tr>
<tr><td>Benefits</td><td>There will be no change to our approach to benefits in 2017, which includes car or car allowance, financial planning assistance, insurances and other benefits.</td></tr>
<tr><td>Pensions</td><td>There will be no change to our approach to pensions in 2017. Pension arrangements will be:
Warren East: cash allowance of 25% of salary.
Stephen Daintith: cash allowance of 25% of salary.</td></tr>
<tr><td>Annual bonus</td><td>For 2017, bonuses will be awarded using a simple additive approach:
80% of the award will be based on Group performance.
20% of the award will be based on individual performance.
For 2017, the Group measures will be unchanged:
Profit (37.5%).
Free cash flow (37.5%).
On-time customer delivery (12.5%).
Employee engagement (12.5%).
Maximum opportunities will remain unchanged:
Chief Executive – 180% of salary.
Other Executive Directors – 150% of salary.</td></tr>
<tr><td>LTIP awards</td><td>For awards to be granted in 2017 performance measures will be weighted:
60% on CPS.
20% on EPS.
20% on relative TSR (versus FTSE 100 and Global S&P Index, to recognise that Rolls-Royce is a global company).
Performance will be measured over three years to 31 December 2019. Performance targets will be:
<table>
<tr><th></th><th>CPS</th><th>EPS</th><th>Relative TSR</th></tr>
<tr><td>Threshold (20% vesting)</td><td>60p</td><td>115p</td><td>Median</td></tr>
<tr><td>Mid (50% vesting)</td><td>80p</td><td>135p</td><td>Between median and upper quartile</td></tr>
<tr><td>Maximum (100% vesting)</td><td>110p</td><td>160p</td><td>Upper quartile</td></tr>
</table>
<p>Performance below threshold will result in that element lapsing in full.</p>
<p>The above targets are not an indication of forecast numbers for the three-year period.</p>
<p>Methodologies
CPS – calculated as reported cash flow before the cost of business acquisitions or proceeds of disposals, foreign exchange translation effects, special payments into pension schemes and payments to shareholders, divided by the weighted average number of shares in issue. CPS is cumulative over a three-year period. The Committee will review CPS performance to ensure that it is a fair reflection of achievements over the period.</p>
<p>EPS – calculated as cumulative absolute underlying EPS over the three-year performance period. With the introduction of IFRS 15 in 2018, the first three-year period starting in 2017 will use existing contract accounting, but will be restated in 2018 under IFRS 15. The Committee will ensure that translated targets are based on the same underlying assumptions under both accounting bases.</p>
<p>Relative TSR – measured 50% against the constituents of the FTSE 100 and 50% against the constituents of the S&P Global Industrials index.</p>
<p>Award sizes for maximum performance</p>
Chief Executive: 250% of salary.
Other Executive Directors: 225% of salary.
<p>Threshold vesting at 20% equates to 50% of salary for the Chief Executive and 45% of salary for other Executive Directors.
LTIP awards will be subject to an additional shareholding period of two years following the three-year performance period.</p></td></tr>
</table>

* Subject to shareholder approval at the 2017 AGM.

The SFO, DoJ and MPF agreements relate to legacy matters and the legal judgment was clear that there was no culpability in relation to existing management. The future impact of these agreements are therefore excluded from incentive targets.

E. Other

PAYMENTS FOR LOSS OF OFFICE (AUDITED)

Mark Morris left the Group on 4 November 2014 and contractual payments of £597,000 were made to him in 2015 in respect of the termination of his employment. No further payments were made in 2016.

PAYMENTS TO PAST DIRECTORS (AUDITED)

Dr Mike Howse retired from the Board on 30 June 2005. Following his retirement he was retained by the Company for his expertise in engineering and received his final payment of £2,520 under this arrangement in January 2016.

No other payments were made to former Directors.

F. Pension entitlements (audited)

The Group's UK pension schemes are funded, registered schemes and were approved under the regime applying until 6 April 2006. They include both defined contribution and defined benefit pension schemes. In the defined benefit pension schemes normal retirement age is 62. During the year, the Group restructured its UK defined benefit arrangements. Four of the five UK schemes merged together into a consolidated scheme, renamed the Rolls-Royce UK Pension Fund. The merged scheme is estimated to have a material surplus on its statutory funding basis, with a largely de-risked investment strategy. All future defined benefit accrual will be provided from this scheme (limited to employees who joined the Group before 1 April 2007). The scheme merger will simplify future administration and governance. As part of this merger, three transferring schemes are being wound up and over 3,400 former employees with benefits below statutory limits elected to receive lump sums in exchange for their existing benefits. The liabilities of the fifth scheme, the Vickers Group Pension Scheme have been fully insured with Legal & General Assurance Company Limited and that scheme is also in the process of being fully wound up. Neither of these transactions required any additional funding by the Group.

John Rishton, who left the Company and started to receive his pension on 2 July 2015, was a member of one of the Group's UK defined contribution pension schemes and received employer contributions restricted to the annual allowance limits with any excess paid as a cash allowance. The cash allowance was calculated as equivalent to the cost of the pension contributions after allowing for National Insurance costs.

Warren East and David Smith receive a cash allowance in lieu of pension accrual. Stephen Daintith will receive a cash allowance in lieu of pension accrual.

Colin Smith opted out of future pension accrual with effect from 1 April 2006 and opted out of salary linkage with effect from 30 November 2015. He started to receive his pension from 1 December 2016. He receives a cash allowance in lieu of pension accrual.

DEFINED BENEFIT SCHEME

Details of the defined benefit of the Executive Directors as at 31 December 2016 in the Group's pension schemes are given below.

	2016 £000 pa	2015 £000 pa
Colin Smith	**350**	385

OTHER INFORMATION

BOARD CHANGES DURING 2016

On 22 September 2016, it was announced that David Smith would leave the Group after three years to pursue other business interests. Stephen Daintith is expected to take up his role in Spring 2017. Remuneration arrangements in respect of these changes are set out below.

David Smith

On leaving Rolls-Royce, David Smith will receive payment in lieu of any outstanding portion of his 12 months' notice period, which started on 21 September 2016. He may also receive a payment in respect of any unused leave. He remained eligible for an APRA award for 2016. He will not participate in the incentive plans for 2017. Mitigation will be applied to reflect his new employment at QinetiQ Group plc.

His outstanding PSP awards will be prorated for time based on his leaving date. The performance conditions will be assessed following the end of the three-year performance period and any vested shares will be released at the normal vesting date. The 2014 and 2015 awards are not expected to meet the performance measures.

Stephen Daintith

On appointment Stephen Daintith's annual base salary will be £680,000. He will receive a pension allowance of 25% of salary.

For 2017 he will be eligible to participate in annual bonus up to a maximum of 150% of salary per annum. His maximum 2017 LTIP award will be 225% of salary.

Following his appointment he will be made awards to compensate for unvested incentives awarded to him at Daily Mail and General Trust plc which were forfeited as a result of him joining Rolls-Royce. All such awards will be of equivalent value to the awards forfeited and match or exceed the time horizons and reflect performance conditions.

His forfeited bonus awards will be replaced with Rolls-Royce shares vesting over the same time horizons. Buy out awards in respect of forfeited LTIP awards with a performance period to October 2017 will be assessed against the original Daily Mail and General Trust plc performance conditions and will vest at that time. For LTIP awards with performance measured to October 2018 and October 2019, buy-out awards will be assessed against the 2016 Rolls-Royce PSP performance conditions. All awards will be in Rolls-Royce shares and will be forfeited in the event of resignation within two years of his appointment. Full details of the buy out awards will be provided at the time the awards are granted and will be included in the 2017 Annual Report.

PAY ACROSS THE ORGANISATION

This section of the report enables our remuneration arrangements to be seen in context by providing:

- A comparison of the year-on-year percentage change in our Chief Executive's remuneration with the change in average remuneration across the Group.
- A year-on-year comparison of the total amount spent on employment costs across the Group and shareholder payments.
- An eight-year history of our Chief Executive's remuneration.
- Our TSR performance over the same period.

PERCENTAGE CHANGE IN CHIEF EXECUTIVE REMUNERATION

The following table compares the percentage change in the Chief Executive's salary, bonus and benefits to the average percentage change in salary, bonus and benefits for all UK employees from 2015 to 2016.

CHANGE IN REMUNERATION

	Salary	Benefits	Annual bonus[2]
Chief Executive	–	(82)%	n/a
UK employees[1] average	2.35%	(4.31)%	n/a

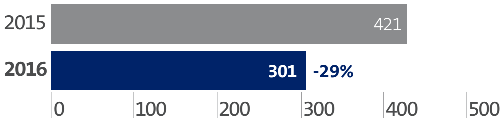
[1] UK employees were chosen as a comparator group in order to avoid the impact of exchange rate movements over the year. UK employees excluding apprentices, graduates and interns, make up 43.5% of the total employee population.

[2] No annual bonus was paid for the financial years 2014 or 2015. For 2016, the annual bonus paid out at 78% of the maximum bonus level. The Chief Executive received 55% of his maximum bonus. The percentage of maximum is shown above. No bonus was paid in 2015.

RELATIVE SPEND ON PAY

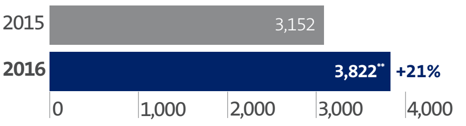
The following chart sets out the percentage change in payments to shareholders and overall expenditure on pay across the Group.

PAYMENTS TO SHAREHOLDERS (£M)*
(Cash flow statement)



* Value of C Shares issued during the year.

GROUP EMPLOYMENT COSTS (£M)
(note 7 – Financial statements)



** Includes £306m costs of restructuring the UK defined benefit pension schemes.

CHIEF EXECUTIVE PAY

Year	Chief Executive[1]	Single figure of total remuneration £000	Annual bonus as a % of maximum	PSP as a % of maximum
2016	Warren East	2,089	55	–
2015	Warren East	543	0	–
2015	John Rishton[2]	754	0	–
2014	John Rishton	2,596	0	45
2013	John Rishton	6,228	55	100
2012	John Rishton	4,577	85	–
2011	John Rishton	3,677	63	–
2011	Sir John Rose[3]	3,832	–	75
2010	Sir John Rose	3,914	100	100
2009	Sir John Rose	2,409	29	93

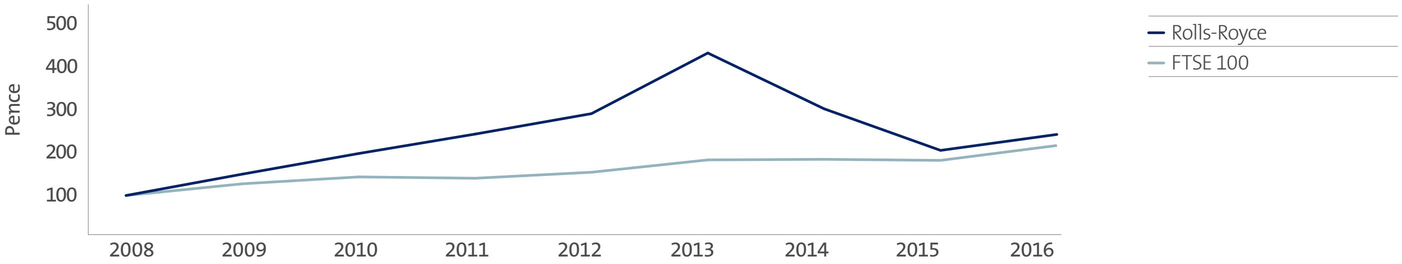
[1] On 31 March 2011, Sir John Rose retired and John Rishton was appointed. John Rishton retired on 2 July 2015 and Warren East was appointed as Chief Executive on 3 July 2015.

[2] John Rishton received a special grant of shares on joining the Company on 1 March 2011 to mirror the shares he forfeited on resigning from his previous employer. The share price had increased from 483.50p at the time this grant was made to 870p at the end of 2014. These are the main reasons why John Rishton's remuneration in 2012 and 2013 exceeded that of his predecessor.

[3] The remuneration for Sir John Rose does not include any pension accrual or contribution as he received his pension from 1 February 2008.

TSR PERFORMANCE

The Company's TSR performance over the previous eight years compared to a broad equity market index is shown in the graph below. The FTSE 100 has been chosen as the comparator because it contains a broad range of other UK listed companies. The graph shows the growth in value of a hypothetical £100 holding in the Company's ordinary shares over eight years, relative to the FTSE 100 index.



CONTRACTUAL ARRANGEMENTS

The Executive Directors have service agreements that set out the contract between each Executive Director and the Company. Executive Directors retain payments received from serving on the boards of external companies, the details of which are given below.

The Chairman and other Non-executive Directors have letters of appointment. Each Non-executive Director serves for a term of three years, which may be extended twice up to a total of nine years.

EXECUTIVE DIRECTORS' SERVICE CONTRACTS

	Date of contract	Notice period Company	Notice period individual
Warren East	21 April 2015	12 months	6 months
Colin Smith	1 July 2005	12 months	6 months
David Smith	19 November 2014	12 months	6 months
Stephen Daintith*	21 September 2016	12 months	12 months

* Stephen Daintith is due to take up his role in Spring 2017.

PAYMENTS RECEIVED FOR SERVING ON EXTERNAL BOARDS

	Directorships held	Payments received and retained £000
Warren East	Dyson James Group Limited	80
Warren East[1]	Micron Technology, Inc.	6
David Smith	Motability Operations Group plc	43

[1] Warren East stepped down from the board of Micron Technology Inc on 27 January 2016.

NON-EXECUTIVE DIRECTORS' LETTERS OF APPOINTMENT

	Appointment date	Current letter of appointment end date
Ian Davis	1 March 2013	28 February 2019
Lewis Booth	25 May 2011	24 May 2017
Ruth Cairnie	1 September 2014	31 August 2017
Sir Frank Chapman	10 November 2011	9 November 2017
Irene Dorner	27 July 2015	26 July 2018
Lee Hsien Yang	1 January 2014	31 December 2019
John McAdam	19 February 2008	4 May 2017
Bradley Singer	2 March 2016	3 May 2018
Sir Kevin Smith	1 November 2015	31 October 2018
Jasmin Staiblin	21 May 2012	20 May 2018

DIRECTORS' INTERESTS IN SHARES (AUDITED)

Each Executive Director's total shareholding, for the purposes of comparing it with the shareholding requirement, includes shares held: by connected persons; in the all-employee Share Incentive Plan; and PSP shares that have vested, but does not include unvested PSP awards.

Shareholding requirements are 250% of salary for the Chief Executive and 200% of salary for the other Executive Directors. APRA deferred shares do not count towards their shareholding requirement. Participants in the PSP are required to retain at least one half of the number of after-tax shares released from the PSP, until the value of their shareholding reaches the percentage of salary shown in the table below. When this level is reached it must be maintained until retirement or departure from the Group.

SHAREHOLDING REQUIREMENT

	Base salary £000	Total shareholding	Shareholding requirement as % of salary	Shareholding requirement[1]	Actual shareholding as % of requirement
Warren East	925	25,365	250	342,086	7
Colin Smith	550	222,798	200	162,722	137
David Smith	540	42,038	200	159,763	26

[1] Salary divided by the March 2016 PSP grant price of 676p multiplied by percentage of salary.

The Directors and their connected persons had the following interests in the ordinary shares and C Shares of the Company at 31 December 2016, as shown in the following table.

DIRECTOR'S SHARE INTERESTS

			Unvested awards			Vested awards
	Ordinary shares	C Shares[1]	Conditional shares not subject to performance conditions (APRA)	Conditional shares subject to performance conditions (PSP)	Options over shares subject to savings contracts	Vested shares and options exercised in 2016
Executive Directors						
Warren East	25,365	–	–	290,845	1,264	–
Colin Smith	222,798	–	–	192,960	758	8,977
David Smith	42,038	–	–	155,373	758	–
Chairman and Non-executive Directors						
Ian Davis	42,049	–	–	–	–	–
Lewis Booth	60,000	–	–	–	–	–
Ruth Cairnie	11,137	–	–	–	–	–
Sir Frank Chapman	22,091	5,061,879	–	–	–	–
Irene Dorner	5,132	–	–	–	–	–
Lee Hsien Yang	4,005	–	–	–	–	–
John McAdam	3,230	–	–	–	–	–
Bradley Singer	–	–	–	–	–	–
Sir Kevin Smith	20,587	–	–	–	–	–
Jasmin Staiblin	–	–	–	–	–	–

[1] Non-cumulative redeemable preference shares of 0.1p each.

DIRECTOR'S CHANGE IN SHARE INTERESTS

	Ordinary shares		C Shares	
	31 December 2016	Changes from 31 December 2016 to 13 February 2017	**31 December 2016**	Changes from 31 December 2016 to 13 February 2017
Executive Directors				
Warren East	**25,365**	174	**–**	–
Colin Smith	**222,798**	1,525	**–**	–
David Smith	**42,038**	329	**–**	–
Chairman and Non-executive Directors				
Ian Davis	**42,049**	873	**–**	–
Lewis Booth	**60,000**	–	**–**	–
Ruth Cairnie	**11,137**	649	**–**	–
Sir Frank Chapman	**22,091**	1,178	**5,061,879**	–
Irene Dorner	**5,132**	35	**–**	–
Lee Hsien Yang	**4,005**	317	**–**	–
John McAdam	**3,230**	71	**–**	–
Bradley Singer	**–**	–	**–**	–
Sir Kevin Smith	**20,587**	924	**–**	–
Jasmin Staiblin	**–**	–	**–**	–

DIRECTORS' INTERESTS IN UNVESTED AND VESTED AWARDS

WARREN EAST

	31 December 2015	Granted during year	TSR uplift/ dividend enhancement	Vested awards	Lapsed	**31 December 2016**	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2015	126,643	–	–	–	–	126,643	730.00	01/09/2015	01/09/2018	–
PSP 2016	–	164,202	–	–	–	164,202	676.00	01/03/2016	01/03/2019	–
Total	**126,643**	**164,202**	**–**	**–**	**–**	**290,845**				
ShareSave (options)[1]	1,264	–	–	–	–	1,264	616.80	12/10/2015	01/02/2021	–
Total	**1,264**	**–**	**–**	**–**	**–**	**1,264**				

[1] For ShareSave, the share price shown is the exercise price which was 85% of the market price at the date of the award.

COLIN SMITH

	31 December 2015	Granted during year	TSR uplift/ dividend enhancement	Vested awards	Lapsed	**31 December 2016**	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2013	51,304	–	–	–	51,304	–	1023.33	01/03/2013	01/03/2016	–
PSP 2014	53,336	–	–	–	–	53,336	984.33	07/05/2014	03/03/2017	–
PSP 2015	58,263	–	–	–	–	58,263	944.00	02/03/2015	02/03/2018	–
PSP 2016	–	81,361	–	–	–	81,361	676.00	01/03/2016	01/03/2019	–
Total	**162,903**	**81,361**	**–**	**–**	**51,304**	**192,960**				
APRA 2013	16,000	–	939	16,939	–	–	984.40	07/05/2014	03/03/2016	687.78
Total	**16,000**	**–**	**939**	**16,939**	**–**	**–**				
ShareSave (options)[1]	758	–	–	–	–	758	616.80	12/10/2015	01/02/2019	–
Total	**758**	**–**	**–**	**–**	**–**	**758**				

[1] For ShareSave, the share price shown is the exercise price which was 85% of the market price at the date of the award.

DAVID SMITH

	31 December 2015	Granted during year	TSR uplift/ dividend enhancement	Vested awards	Lapsed	**31 December 2016**	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2014	18,287	–	–	–	–	18,287	984.33	03/03/2014	03/03/2017	–
PSP 2015	57,204	–	–	–	–	57,204	944.00	02/03/2015	02/03/2018	–
PSP 2016	–	79,882	–	–	–	79,882	676.00	01/03/2016	01/03/2019	–
Total	**75,491**	**79,882**	**–**	**–**	**–**	**155,373**				
ShareSave (options)[1]	758	–	–	–	–	758	616.80	12/10/2015	01/02/2019	–
Total	**758**	**–**	**–**	**–**	**–**	**758**				

[1] For ShareSave, the share price shown is the exercise price which was 85% of the market price at the date of the award.

Committee members and attendance

The Committee membership and attendance throughout 2016 is shown on pages 54 and 61. In addition to the Committee members, the Chairman, the Chief Executive, the Chief Financial Officer and any of the Non-executive Directors may attend one or more meetings at the Committee's invitation, although none was present during discussion of his or her own remuneration package.

The Committee is supported by the Company Secretary, the Group Human Resources Director and the Global Performance, Reward & Pensions Director.

Advisers to the Committee

During the year, the Committee had access to advice from Deloitte LLP's executive compensation advisory practice. Total fees for advice provided to the Committee during the year by Deloitte were £159,175 (2015: £125,150). Deloitte also advised the Company on tax, assurance, pensions and corporate finance and Deloitte MCS Limited provided consulting services. The Committee is exclusively responsible for reviewing, selecting and appointing its advisers.

Deloitte is a founding member of the Remuneration Consultants Group and adheres to its code in relation to executive remuneration consulting. The Committee requests Deloitte to attend meetings periodically during the year. The Committee is satisfied that the advice it has received has been objective and independent.

Statement of shareholder voting

	For	Against	Votes withheld
Results of the resolution approving the 2015 remuneration report at the AGM held on 5 May 2016			
Percentage of votes (%)	98.71	1.29	0.85
Number of votes cast	1,370,054,216	17,870,398	11,922,905

The current remuneration policy was approved by shareholders at the 2014 AGM. We monitor carefully shareholder voting on our remuneration policy and implementation. The full 2014 policy is available on our website, www.rolls-royce.com. We have undertaken a comprehensive review of our remuneration policy, with significant contribution from shareholders. The 2017 remuneration policy on pages 76 to 82 and available on our website, will be put to shareholders for approval at the AGM on 4 May 2017.

Statutory requirements

The Directors' remuneration report has been prepared on behalf of the Board by the Remuneration Committee. We adopt the principles of good governance as set out in the UK Corporate Governance Code and comply with the regulations contained in Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, the Listing Rules of the Financial Conduct Authority and the relevant schedules of the Companies Act 2006. The Companies Act 2006 and the Listing Rules require the Company's auditor to report on the audited information in their report on pages 176 to 182 and to state that this section has been properly prepared in accordance with these regulations. The Directors' remuneration report and the Directors' remuneration policy are subject to shareholder approval at the AGM on 4 May 2017. The Directors' remuneration report was approved by the Board on 13 February 2017 and signed on its behalf.

Ruth Cairnie
Chairman of the Remuneration Committee

Audit Committee report

Lewis Booth
Chairman of the
Audit Committee

Highlights

- Implementation of enhanced risk management system.
- Issue of governance framework for internal controls.
- Review of key judgements and estimates and consistency of accounting policies.
- Significant progress on the adoption of IFRS 15.
- PwC selected as auditor for 2018.

2016 overview

Introduction

I am pleased to present the 2016 report of the Audit Committee which describes how the Committee has carried out its responsibilities during the year. I would like to thank the members of the Committee, the executive management team and KPMG for the open discussions that take place at our meetings and the importance they all attach to its work.

All members of the Committee are independent Non-executive Directors. Alan Davies stepped down from the Board and the Committee in November 2016. For the purposes of the Code, Irene Dorner and I have recent and relevant financial experience. Our biographies are on pages 55 and 56.

Operation of the Committee

The Committee's responsibilities are outlined in its terms of reference which we review annually and refer to the Board for approval. During 2016, we recommended revisions to reflect the review of Directors' and senior managers' expenses that we undertake and to remove the requirements for the Committee to review payments to shareholders, which are considered by the Board as a whole.

The Committee met six times in 2016. In addition, the audit tender steering group (see page 102) also met six times. The Chief Financial Officer, Deputy CFO & Group Controller, Group Chief Accountant, Director of Internal Audit, General Counsel, Director of Risk and representatives from our external auditor are also invited to attend. Lord Gold also attended the Committee's meetings in July and December.

Principal responsibilities

The principal responsibilities of the Committee are to assist the Board in fulfilling its oversight responsibilities.

Financial reporting

- Review financial results announcements and financial statements, focusing on:
  - the appropriateness of critical accounting policies, judgements and estimates and consistent application of those accounting policies;
  - inclusion of appropriate disclosures;
  - compliance with relevant regulations; and
  - reporting to the Board as to whether the Annual Report, as a whole, is fair, balanced and understandable.

Risk and control environment

- Assess the scope and effectiveness of the systems to identify, manage and monitor financial and non-financial risks.
- Assess the management of principal risks allocated to the Committee: business continuity, market and financial shock and IT vulnerability.
- Review the procedures for detecting, monitoring and managing the risk of fraud.
- Review the system of internal control over the business processes and the risks identified through the risk management process.

Internal audit

- Review the scope, resources, results and effectiveness of internal audit.

External auditor

- Oversee the relationship with the external auditor, review the effectiveness of the external audit process and make recommendations to the Board for the external auditor's appointment and fees.

Areas of focus for 2016

- Overseeing the ongoing projects to enhance the systems for risk management and internal control.
- Assessing the effectiveness of internal control over financial reporting.
- Reviewing key accounting judgements and estimates and the consistent application of accounting policies which had the most significant impacts on the financial results in 2016. In addition, we requested a comprehensive review of the application of all accounting policies across the Group.
- Reviewing the Group's basis for the viability statement.
- Overseeing the project for the implementation of IFRS 15 *Revenue from Contracts with Customers*, which will be adopted in 2018.
- Reviewing the progress of the management information systems project.
- Reviewing principal risks on behalf of the Board.
- Leading the audit tender process.

At a glance

Area of focus	Matters considered	Outcome
Financial reporting	The appropriateness of accounting policies and key accounting judgements and estimates, including: • estimates used in accounting for long-term contractual arrangements, including the regular review of the methodologies for taking account of uncertainties in these estimates and the financial impact; • further impairment of goodwill in Marine; • carrying value of goodwill in Rolls-Royce Power Systems AG; and • disclosures of contingent liabilities. The consistency of the application of accounting policies across the Group. The form and content of the Annual Report. The implementation project for IFRS 15 and the communication to investors in November 2016.	The accounting policies and key judgements and estimates are appropriate and key estimates used are balanced. The reviews of consistent application of accounting policies identified some minor differences, which have now been amended. The Annual Report, taken as a whole, is fair, balanced and understandable. IFRS 15 will introduce some very significant changes in accounting policies, particularly in the Civil Aerospace business.
Risk and control environment	Improvements to the risk management and internal controls systems to address requirements of the Code. Management's assessment of the risk of a disruptive event. The procedures for preventing, monitoring and combatting breaches of the security of the Group's IT systems. The processes for identifying and managing risks. The model for assessing the effectiveness of the Group's systems of internal control. The process and assumptions underlying the viability statement.	Appropriate procedures are in place to identify and manage principal risks and all of these have been subject to a review by the Board or an appropriate Board committee. Appropriate procedures are in place to manage business continuity, cyber-security and market shock risks. The internal control system meets the requirements of the Code. It will continue to be enhanced during 2017. Reported to the Board that an appropriate process is in place to make the viability statement.
Internal audit	The effectiveness of the internal audit function, its key findings and trends arising, and the resolution of these matters.	The scope, extent and effectiveness of internal audit are appropriate.
External audit	The approach and scope of external audit and the effectiveness and independence of the external auditor and the review of the 2015 Rolls-Royce audit by the FRC's Audit Quality Review team. The extent of non-audit services provided by KPMG and the tendering firms during the tender process. The requirements of the FRC's new Ethical Standard on non-audit services. The audit tender process.	Assessed KPMG as effective and independent and recommended their re-appointment at the 2017 AGM. No concerns over the nature and scale of the non-audit services provided. Approved a revised policy on the provision of non-audit services. A thorough process resulted in the Committee recommending to the Board that PricewaterhouseCoopers LLP (PwC) be proposed at the 2018 AGM to succeed KPMG as the Group's auditor.

Business and function presentations

We have a regular schedule of presentations from each of the Group's businesses and its key functions. During 2016, we received presentations from the following:

- **Civil Aerospace** – key business risks (including major product failure, on-time and profitable delivery of new programmes, business continuity risks including supply chain disruption and market shock due to external events or factors reducing air travel); accounting policies; key accounting judgements, estimates and controls; credit risks associated with customers; and TotalCare and CorporateCare accounting.
- **Defence Aerospace** – key business risks (including the impact of government spending and pricing in the traditional UK and US markets and the protection of our position in the transport and patrol markets); and key accounting estimates (which principally relate to long-term contracts, in particular the contract loss provisions on the contract for TP400 development and production); and controls.
- **Marine** – key business risks (including the impact of the current low oil price to the offshore business and the restructuring programme); and key accounting estimates (which principally relate to the carrying value of goodwill and inventory, warranty and restructuring provisions); and controls.
- **Group Tax Director** – approach to managing the Group's tax affairs; key tax risks and how they are managed (with specific consideration of tax disputes); key sources of estimation uncertainty (in particular the recognition of deferred tax assets); and key tax-related disclosures (in particular we considered the disclosure of the Group's approach to managing its tax affairs).

We also reviewed the introduction of enhanced management information systems. To date, these have covered the introduction of new dashboards and forecasting processes which have improved visibility to the ELT and the Board, although more work is required. The full benefits will also be dependent on the implementation of improvements to underlying IT systems over the next few years.

Financial reporting

We place considerable emphasis on making sure that the accounting policies are appropriate and are consistently applied so that the financial statements faithfully represent the results and financial position of the Group and its underlying contractual arrangements.

Given the long-term nature of the Group's businesses, most of the accounting policies subject to significant judgement do not change materially year-on-year. However, the facts and circumstances on which those judgements are based do vary over time, with a consequential impact on the application of the policies. The key areas of focus in 2016 are set out in the table opposite. In part, these reflect the current weak trading conditions in Marine. Overall, we are satisfied that the judgements and estimates made are balanced.

In July, the FRC wrote to the Company following its review of the 2015 Annual Report. This review, which was based solely on the Annual Report, did not identify any questions or queries which the FRC wished to pursue, although a number of suggestions for improvements were noted, and these have been taken into account in preparing the 2016 Annual Report.

During the year, we reviewed the conclusions reached by the implementation project on IFRS 15, which will be applicable for 2018.

This new standard will have a significant impact on our accounting policies for revenue recognition, most particularly in our Civil Aerospace business. We agreed with the conclusions reached that will require us to account for OE and aftermarket contracts separately and to recognise aftermarket revenues based on activities performed rather than flying hours.

These changes were presented at an investor event in November 2016 and are discussed further in the accounting policies on page 130.

The Group continues to consult with other companies in the aerospace and defence sector. We believe that the new policies will be broadly comparable across the sector.

Since the year end, we have reviewed the form and content of the Company's 2016 Annual Report together with the processes used to prepare and verify it. We have reported to the Board that, taken as a whole, we consider the Annual Report to be fair, balanced and understandable. We further believe the Annual Report provides the necessary information for shareholders to adequately assess the Company's performance, business model and strategy. In making this assessment, we considered:

- The process for preparing the Annual Report, including a steering committee, the core team, and instructions to contributors.
- Written representations from management in respect of the business reviews, sustainability, principal risks and financial statements.
- The completion of a regulatory compliance checklist.
- All reviews performed (including the Board, the ELT and KPMG). We ensured that all feedback was appropriately reflected.

Financial reporting: key areas of focus

Key issues	Matters considered	Outcome
Indications of impairment of the carrying values of intangible assets in Civil Aerospace	The assessments of the value-in-use of the principal intangible assets, including the key assumptions and estimates on which they are based.*	We are satisfied that there were no indications of impairment.
The estimates used in accounting for long-term contractual arrangements in Civil Aerospace are appropriate	The basis on which the estimates are prepared and, in particular, how the inherent uncertainties are reflected in these estimates. In particular: • Lifecycle cost improvements. • Long-term exchange rates.	We are satisfied that the process produces balanced estimates, with appropriate consideration of the uncertainties. The Civil Aerospace business continued to review the estimates and compare them to the actual outcome. Based on this actual experience, which was generally better than previously assumed, this led to a revision to the estimates, which resulted in a net profit benefit of £90m. The estimates for long-term exchange rates were reviewed against third-party forecasts. This led to a reduction in these forecasts, resulting in a one-off profit benefit of £35m.
The sale of engines to joint ventures	The basis for assessing the selling price.	We are satisfied that the price represents the fair value of the engines.
Impairment of goodwill in Marine	The forecasts for each of the relevant cash generating units, including the key assumptions on which they are based.*	We are satisfied with the analysis and that impairments should be recognised where these did not support the carrying value of the goodwill.
Whether there is any impairment to the carrying value of the goodwill in Rolls-Royce Power Systems AG	The business plan and the underlying assumptions on which it is based.*	We are satisfied that, although the headroom has reduced as a result of the current trading environment, there is no indication of impairment.
Warranty and contractual provisions in Marine	The basis for specific warranty and contractual provisions.	We are satisfied that the estimates reflect a balanced assessment of the likely outcome.
Post-retirement benefits	The impact of the restructuring of the five UK defined benefit schemes.	We are satisfied that the impacts are reflected in accordance with IAS 19 *Employee Benefits*, in particular their recognition in the Income Statement and Other Comprehensive Income. We were also satisfied that the exclusion of the settlement and related costs of £306m from the underlying results is appropriate (see page 157).
Deferred tax assets (DTAs)	The recognition of DTAs arising from tax losses in the UK and Norway.	Based on the Group's forecasts, we are satisfied that it is appropriate to continue to recognise the UK DTAs, and that, given the current uncertainty in the oil & gas market, those in Norway should cease to be recognised.

* See note 9 to the financial statements for further details of the assumptions.

Sector audit committees

In support of our work, each of the Group's businesses and principal functions has its own sector audit committee, each of which comprises senior finance personnel and is attended by business and functional leaders and KPMG. These committees:

- Allow the review of accounting policies and their consistent application, risk management, internal systems and issues arising at a more detailed level.
- Give us further assurance as to the extent of management control and accountability.
- Promote the governance culture within the Group.
- Inform areas for further consideration at our meetings.

All the committees meet twice a year to consider the accounting policies, judgements and estimates and the internal control environment. They are chaired by the Director of Internal Audit, who then reports to us. During the year, both Irene Dorner and I attended sector audit committee meetings.

In 2016, the sector audit committees have focused on the improvement project for internal control and risk management processes.

Risk and control environment

Assessment of principal risks

Risk management is a fundamental and integral part of how we work. All risks are managed through a risk management system (RMS) (described on page 48) in accordance with policies and guidance established by the Director of Risk and his team and approved by the Board.

Judgement is required in evaluating the risks facing the Group in achieving its objectives, in determining the risks that are considered acceptable, in determining the likelihood of those risks materialising, in identifying the Group's ability to reduce the incidence and impact on the business of risks that do materialise, and in ensuring the costs of operating particular controls are proportionate to the benefit provided.

On behalf of the Board, we monitored the RMS. During 2016, we focused on the continued implementation of the enhancements identified in 2015. These are described in more detail on page 48.

This process and the principal risks arising (see page 50) then formed the basis for our assessment of the going concern and viability statements which are discussed later in this report. The processes are designed to identify and manage, rather than eliminate, the risk of failure to achieve our business objectives.

We satisfied ourselves that the processes for identifying and managing the principal risks are appropriate and that all risks and mitigating actions had been subject, during the year, to a detailed review by the Board or an appropriate committee. Based on this and on our other activities, including consideration of the work of internal and external audit and presentations from senior management of each business which include risk management, we reported to the Board that a robust assessment of the principal risks facing the Company had been undertaken.

Review of principal risks

We considered in detail the principal risks that have been allocated to us by the Board. We reviewed:

Business continuity

- The generic design of the Civil Aerospace supply chain and the risks that arise due to constraints (such as single sources of supply).
- The management of these risks using business continuity processes and controls.
- Improvements planned to enhance the visibility of key risks.

IT vulnerability

- The changing threat landscape (in particular the Nation State threat has diminished, but there has been an increase in targeting of supply chain, joint ventures and other partners, and a very significant increase in organised crime threats).
- How the principal risks are being tracked and managed.
- Improvement activities over the past year.
- Plans for the future.

Market and financial shock

- The Group's exposure to market risks (in particular: exchange rates, oil prices, interest rates, liquidity, credit risk reductions in air travel or other disruption to customers' operations).
- The Group's policies, procedures and controls for identifying, managing and mitigating these risks, in particular through the Financial Risk Committee which meets quarterly, chaired by the Chief Financial Officer.

We are satisfied that appropriate procedures are in place to monitor and manage these risks.

Internal control

The Board has overall responsibility to the shareholders for the Group's system of internal control over its business and risk management processes and the risks identified through the risk management process. The Committee has responsibility for reviewing the system's operation and effectiveness.

The Group has a long-standing process for identifying risks and planning mitigating actions and for assessing the effectiveness of internal control. In assessing the Code requirements in 2015, the Group identified improvements to the existing processes. In 2016, the implementation of these improvements has continued. Our model for representing the system comprises:

- Entity-level controls covering leadership and direction from the top.
- Specific control activities, covering detailed process controls, and internal and external assurance activities.

In 2016, the Group issued a governance framework providing an overview of how internal control frameworks to manage risk in key business activities are established. This gives a framework for the entity-level controls. The Group has continued to document and assess the effectiveness of core financial controls, and we routinely review controls over the Group's principal risks, and the key risks and critical processes in each of the Group's businesses. Both the sector audit committees and this Committee also consider KPMG's observations on the Group's control environment. We noted a general improvement in the control environment, including the ongoing improvements to the controls around the accounting for long-term aftermarket contracts in Civil Aerospace referred to in the Independent auditor's report on pages 177 and 178.

The Group has also used the internal control framework as an opportunity to improve the consistency of reporting, in particular from the Group's smaller operations. We paid particular attention to internal controls over financial reporting and have implemented a wide-ranging plan to improve controls in this area.

We have conducted a review of the effectiveness of the Group's systems of risk management and internal control, including those relating to the financial reporting process, in accordance with the Code. The Group's systems of risk management and internal control have been in place throughout 2016. We consider that these existing systems, together with the enhancements made in 2016, are sufficient to meet the requirements of the Code and the FCA's Disclosure Guidance and Transparency Rules.

Going concern and viability statements

We reviewed the processes and assumptions underlying the statements set out on page 53. In particular, we considered:

- The Group's forecast funding position over the next five years.
- An analysis of impacts of severe but plausible risk scenarios, ensuring that these were consistent with the risks reviewed by the Board as part of its strategy review.
- The impact of multiple risks occurring simultaneously.
- Additional mitigating actions that Group could take in extreme circumstances.
- The current borrowing facilities in place and the availability of future facilities.

As a result, we were satisfied that the going concern and viability statements have been prepared on an appropriate basis.

Internal audit

We receive a quarterly dashboard from the Director of Internal Audit identifying key trends and findings from internal audit reports, and the resolution of actions agreed. Twice a year, we review detailed updates of significant findings. In particular, we review the nature and number of issues raised by internal audit and the time to complete the related actions. The small number of overdue actions received particular attention and the time to complete all actions has reduced, and is now in line with expectations. In November, we reviewed and approved the internal audit plan. I am confident that the plan is strongly correlated to the key risks facing the business, and we monitor changes during the course of the year.

We also receive two reports each year setting out the Director of Internal Audit's perspectives on the internal control environment. These are used to drive management responses to underlying root causes and systemic issues. Topics discussed in 2016 included: process and control design; compliance to process; data integrity; and management behaviours.

The Committee considered and reviewed the effectiveness of the Group's internal audit function, including resources, plans and performance as well as the function's interaction with management. The outcome of the 2016 review was positive and identified opportunities for ongoing improvement which have been implemented.

I meet the Director of Internal Audit privately before each meeting and on an ad-hoc basis throughout the year, as do other members of the Committee. As a whole we have a private meeting with him at least once a year. These discussions cover the activities, findings, resolution of control weaknesses, progress against the agreed plan and the resourcing of the department.

We are satisfied that the scope, extent and effectiveness of internal audit work are appropriate for the Group and that there is a sound plan for ensuring that this continues to be the case as our business progresses and risks change.

External audit

2016 audit

During the year, KPMG presented the audit strategy, which identified their assessment of the key audit risks and the proposed scope of audit work. We agreed the approach and scope of audit work to be undertaken. Key risks and the audit approach to these risks are discussed in the Independent auditor's report (pages 176 to 182), which also highlights the other significant risks that KPMG drew to our attention.

As part of the reporting of the half-year and full-year results, in July 2016 and February 2017, KPMG reported to the Committee on its assessment of the Group's judgements and estimates in respect of these risks and the adequacy of the reporting. KPMG also reported on its assessment of the Group's control environment.

We also undertook an assessment of KPMG's qualifications, expertise and resources, independence and the effectiveness of the external audit process. This included:

- A presentation to the Committee of KPMG's Quality Control Framework and Internal Quality Evaluation, the experience of the key members of the audit team and the extent of their individual involvement in the audit work. This also included KPMG's responses to matters identified by management in a survey conducted following the 2015 audit.
- Consideration of the FRC's Audit Quality Inspection (AQI) Annual Report 2015/16 on KPMG.
- The results of the AQI review of KPMG's audit of Rolls-Royce. The FRC's Audit Quality Review (AQR) team monitors the quality of audit work of UK audit firms, including inspections of a sample of audits. During 2016, the AQR reviewed the 2015 audit. The review findings noted limited areas for improvement and commended KPMG on the particularly high standard of its auditor's report. We have discussed these findings with the AQR and KPMG; KPMG's responses to the areas for improvement were incorporated into the 2016 audit work.

The Committee does not consider any of the findings to have a significant impact on KPMG's audit approach. We also reviewed the fees of the external auditor. Our conclusions were that the external audit was carried out effectively, efficiently and with the necessary objectivity and independence.

We continue to support the extended auditor's report and KPMG's approach which goes beyond the minimum requirements, providing additional clarity on the key judgements and estimates.

I meet with the lead partner prior to each meeting and the whole Committee has a private meeting with KPMG at least once a year.

Re-appointment of KPMG

The Committee reviews and makes recommendations to the Board with regard to the re-appointment of the external auditor. In doing so, we take into account auditor independence and audit partner rotation. KPMG was appointed as auditor in 1990. No contractual obligations restrict our choice of external auditor. The lead audit partner is required to rotate every five years and other key audit partners are required to rotate every seven years. Jimmy Daboo took over as lead audit partner in 2013, and will be required to rotate after the 2018 AGM. For the first time since KPMG's appointment, in 2016, we have tendered the audit for appointment in 2018, coinciding with Jimmy Daboo's rotation.

The Committee and the Board have recommended KPMG's re-appointment at the 2017 AGM.

Non-audit services provided by KPMG

In order to safeguard the auditor's independence and objectivity, we do not engage KPMG for any non-audit services except where it is work that they must, or are clearly best suited to, perform. Fees paid to KPMG for audit, audit-related and other services are set out in note 8 to the Financial Statements and summarised below.

All proposed services must be pre-approved in accordance with the non-audit services policy which is reviewed and approved annually. Above defined levels, my pre-approval is required. The Committee also reviews the non-audit fees charged by KPMG quarterly.

Non-audit related fees paid to KPMG during the year were 12% (2015: 29%) of the audit fee. Our annual review of the external auditor takes into account the nature and level of all services provided.

	2016		2015	
	£m	%	£m	%
Audit	**6.8**		5.9	
Audit-related[1]	**0.6**	**9**	1.3	22
Tax compliance	**0.5**	**7**	0.4	7
Other	**0.1**	**1**	–	–
Non-audit	**1.2**	**17**	1.7	29

[1] Includes £0.3m for the review of the half-year report.

Based on our review of the services provided by KPMG and discussion with the lead audit partner, we concluded that neither the nature nor the scale of these services gave any concerns regarding the objectivity or independence of KPMG.

As part of the EU audit reform, with effect from 1 January 2017, the FRC's Ethical Standard places further restrictions on auditors undertaking non-audit services. Accordingly, we have revised our policies for the engagement of the auditor to undertake non-audit services, broadly limiting these to audit-related services such as reporting to lenders and grant providers.

During the audit tender process, we also implemented additional procedures to monitor engagements with each potential future auditor to ensure that we can discontinue or transition any engagements with the new auditor as required.

Audit tender

As reported last year, we are required to appoint a new auditor no later than 2020. As planned, we tendered the audit in 2016, for the appointment of a new external auditor for the financial year 2018. The process was led by an audit tender steering group (comprising the Committee members, the Chief Financial Officer and the Director of Internal Audit and supported by Group Finance and Purchasing), which met six times from May until November. We issued a request for proposal in August 2016 to suitable, appropriately experienced candidates to participate in the tender.

The process included: provision of data on the Group operations, finances and processes; meetings with key management from the businesses and Group functions and two presentations to the Committee. In December, the Committee concluded that PwC was the preferred firm to conduct the audit engagement, judged against the selection criteria including quality of the proposed team, experience within the aerospace and defence industry, and available resources and organisation.

The Committee recommended that the Board propose, to the 2018 AGM, the appointment of PwC as the external auditor of the Company for the financial year 2018. On behalf of the Committee, I would like to thank all the candidates for the quality and professionalism of their proposals.

The Committee considers that the Company has, throughout the year ended 31 December 2016, complied with The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014.

Looking forward

During 2017, we will monitor the transition activities so that PwC can take over the audit in 2018 in a seamless manner.

We will also continue to monitor:
- The implementation of IFRS 15, focusing on the development of the supporting processes and controls.
- The key accounting judgements and estimates.
- The continuous improvements planned for the documentation of controls.
- The continuing development of the management information systems and improvements to the underlying systems and tools.

IFRS 16 *Leases* will be applicable to the Group in 2019. The Group will address its implementation during 2017, and we will review the development of these plans.

In addition to the continuing oversight by the Safety & Ethics Committee of the Company's ethics and compliance programme (see pages 105 and 106), we will monitor the Group's actions relating to risk management, internal controls and other matters relevant to the Committee that arise out of Lord Gold's recommendations, and from the agreements with prosecuting authorities.

Lewis Booth
Chairman of the Audit Committee

Safety & Ethics Committee report

Sir Frank Chapman
Chairman of the Safety & Ethics Committee

Highlights

- Ethics and compliance improvement programmes well embedded and reaching sustainable steady state.
- Detailed review of product safety management in Marine undertaken, providing good levels of assurance.
- Key safety and ethics Group policies rolled out to Power Systems.
- Improved score in Dow Jones Sustainability Index.

2016 overview

Introduction

The Committee assists the Board in fulfilling its oversight responsibilities in respect of safety and ethics matters, which include:

- Product safety.
- HS&E (occupational health, process safety, asset integrity, personal security and the environment).
- Sustainability.
- Ethics (business ethics, anti-bribery and corruption, data privacy and export controls compliance).

The Committee has been allocated responsibility on behalf of the Board for overseeing the Group's principal risks of product failure and compliance (see pages 50 and 52). These topics form a core part of discussions at our meetings.

In addition to its oversight role for the Board, the Committee supports management in its aim to create, promote and maintain an ethical, compliant, safety-conscious, environmentally-aware and socially-responsible culture across the Group as a means of delivering its safety and ethics goals.

Principal responsibilities

Under its wide remit, the Committee's key responsibilities are:

- To maintain an understanding of and keep under review the Group's frameworks for the effective governance of safety and ethics and the Group's culture in these areas.
- To oversee and review annually the Group's key safety and ethics policies, including: the Global Code of Conduct, anti-bribery and corruption and export controls, product safety, HS&E and sustainability policies, and ensuring appropriate independent scrutiny of policies and practices.
- To review compliance with relevant legislation and regulations and make recommendations in key policy areas.
- To oversee training in respect of safety and ethics, including ensuring adequate arrangements exist to enable employees and contractors to raise concerns in confidence.
- To review reports on issues raised through the Ethics Line and review the results of any investigations into ethical or compliance breaches or allegations of misconduct.
- To review reports on risks in relation to products not meeting safety expectations.
- To review reports on health and safety risks and proposed actions to manage such risks.
- To review remedial actions and lessons learned in relation to material investigations.
- To review disciplinary action taken following safety and ethics concerns.
- To keep under review the key performance indicators in relation to safety and ethics.

The Committee regularly reports to the Board and refers any concerns about possible financial improprieties to the Audit Committee. Two of the four members are also members of the Audit Committee; this enables strong links to be made between the oversight of behavioural and cultural issues, and the detection and control of the consequential financial risks and implications.

The Group President, Group Director – Engineering and Technology, General Counsel, Director of Risk and other senior safety and risk executives attend Committee meetings. Lord Gold attended the Committee's meetings in July and December. More on Lord Gold's role and his work is on page 105.

The Committee considered its terms of reference during the year and proposed certain revisions for the Board to consider. This included: the deletion of reference to oversight of fraud policy, since fraud prevention and risk management procedures are reviewed by the Audit Committee; and minor definitional amendments to reflect the breadth of topics overseen by the Committee. The terms of reference otherwise remained appropriate.

At a glance

Area of focus	Matters considered	Outcome
Ethics and compliance	Progress with ethics and compliance improvement programme.	Continuing very good progress made in implementing plans and Lord Gold's independent recommendations. Lord Gold relayed his views to the Committee from his participation in employee focus groups at various locations during 2016. Ethics and compliance KPIs established.
	Monitoring deployment of anti-bribery and corruption (ABC) policies.	Global ABC policies adopted and published by Power Systems after approval by works councils.
	Promotion of an ethical culture, and handling of cases of unethical behaviour.	Employee performance assessments now include review of behaviours including creating trust and being a positive role model for ethical behaviour, fairness and integrity.
	Review of maturity of ethics and compliance processes and policies at joint ventures.	Mixed picture highlighting areas where more focus is required to increase maturity.
	Impact of local ethics advisers (LEAs).	Met with LEAs to discuss their experiences. Presence of LEAs means more concerns being raised and dealt with locally.
	Use of commercial intermediaries and advisers.	Significant reduction in number of commercial intermediaries and advisers used.
	Response to the General Data Protection Regulations.	Application made to the Information Commissioner's office for Binding Corporate Rules.
Product safety	Product safety incidents in service and the Group's response. Annual review of product safety metrics and the product failure principal risk dashboard.	Satisfactory response to incidents and support to investigations. Product failure risk can never be fully mitigated but the Group's exposure is well-managed and reducing through better identification and controls.
	Management of personal and product safety risks during transformation and organisational changes. The role and impact of culture on product safety.	Consistent, regular messaging from senior leadership and the safety teams serve to keep safety front of mind to reduce risk. Expected cultural safety behaviours defined and endorsed. Plans are in place to drive improvement where gaps identified.
	The product safety policy, elements of the product safety assurance framework and aspects of safety management systems.	The framework and systems are robust and provide appropriate governance and accountability.
	Workshop on product safety in Marine, followed by visit to facilities in Norway.	The Marine business has made significant improvements in its governance of product safety, the maturity of its processes and the embedding of its safety culture.
Sustainability	Consideration of Modern Slavery Act disclosure requirements, and the mechanism for imposing assurance requirement on suppliers.	We reviewed and strengthened the policy and processes relating to human rights and facilitated the disclosure statement that will be required in 2017.
	The Group's Dow Jones Sustainability Index submission and results.	Improved score versus 2015 and industry-best scores in several categories.
Travel security	Review of travel security programme.	Robust and well-managed arrangements are in place.

Area of focus	Matters considered	Outcome
Health, safety & the environment (HS&E)	Review of HS&E risk profile, total reportable injuries (TRI) performance reports, learning from incidents and global HS&E improvement programmes.	Risk profile updated to reflect identified risks and their likelihood. TRI performance improved in all businesses, though remains high in Power Systems. We reviewed Power Systems' improvement plan concluding that it was robust. New standards and procedures on control of contractors are being implemented and electrical safety will remain an area of focus.
	Review of HS&E governance as adjusted following removal of the Aerospace and Land & Sea divisions in January 2016.	Governance changes considered appropriate for new organisational structure.
	Review of HS&E strategy and assurance.	We endorsed the HS&E strategy. HS&E assurance methodology was adapted to improve quality of audits.
	Implementation of new HS&E management system.	Progress is being made which will facilitate better reporting and shared learning across the Group.
	HS&E learning and development.	Strong crossover between product safety and HS&E could be better exploited. The new human resources system will allow training requirements to be added to employees' work plans.
	Visit to the Group's Precision Castings Facility examining HS&E management of processes.	HS&E methodologies and good practices common with other facilities were observed.

Ethics and compliance

Ethics and compliance are at the heart of the Group's culture and are part of everything that we do at Rolls-Royce. There is continued recognition that the Board and the ELT must demonstrate leadership around ethical and behavioural standards. The Board is determined to ensure that ethical conduct remains embedded in the culture of the business. The Committee plays a vital role in providing dedicated focus and attention on behalf of the Board to this critical area.

Regulatory investigations

Following a lengthy period of investigation into allegations of bribery and corruption, in January 2017 the Group entered into deferred prosecution agreements with the UK Serious Fraud Office and the US Department of Justice, and a leniency agreement with the Brazilian authority, MPF (together the DPAs). During 2016, the Committee was kept informed on the ongoing status of the investigations and developments and discussions with the relevant authorities. We fully supported and endorsed the Group's approach of full and open co-operation with the investigations, for which the Group was highly praised in the judgment of Lord Justice Leveson.

Lord Gold's work

Lord Gold, a leading expert on regulatory compliance matters, was appointed by the Group in 2013 to conduct an independent review of its ethics and compliance procedures and to provide oversight of the Group's ethics and compliance improvement programme, under which the recommendations contained in his interim reports to the Company in 2013 and December 2014 have been implemented.

As part of his work, Lord Gold has reviewed the Group's policies and procedures, met with many members of management, the ethics and compliance teams, and a wide range of other employees to gain an understanding of the extent to which ethics and compliance awareness and adherence to the Group's Global Code of Conduct (Global Code) is embedded in the Group's culture, and the robustness of the risk management, controls and assurance framework that supports this.

Lord Gold is invited to meetings of the Committee, and attended in July and December 2016. He updated us on his findings and observations to date, including insights from the latest focus groups that he held with a range of employees in different businesses across different countries. We discussed his observations and identified areas for continued focus. Lord Gold's latest report was issued to the Company in January 2017, and will be considered by the Committee during this year.

Lord Gold will continue his role as an independent specialist in 2017 and beyond, to report on findings and where appropriate advise and make recommendations to be implemented. His ongoing oversight is an important factor that led to the investigating authorities deciding not to appoint their own monitor to oversee the Group's adherence to the terms of the DPAs. We welcome Lord Gold's ongoing valuable insight and counsel as we maintain our focus on sustaining a culture of compliance and zero tolerance for unethical behaviour and misconduct.

Our ethics and compliance programme

Over the last few years the Group has continued to invest significantly in its ethics and compliance programme. The Committee and the Group's management recognise that companies that are run ethically and have a strong compliance culture are sustainable, enabling profitable and long-term partnerships with their customers, suppliers and investors.

We have continued to oversee significant progress in the Group's ethics and compliance improvement programme throughout 2016. Having established the programme, there was increased focus in 2016 on the oversight and assurance of ethics and compliance issues ensuring that 'we do what we say we do'.

The size, structure and skills of the risk function were kept under review during the year with regard to the required resourcing to deliver and maintain the appropriate level of focus. This included a restructuring of the Power Systems' senior ethics and compliance leadership to allow more central oversight, specialist expertise and better integration.

Anti-bribery and corruption (ABC) policies

During 2016, the full suite of ABC Group policies, which had been revised in 2014 and 2015, were rolled out into the Power Systems business following approval by the local works councils, providing coverage across the entire Group for the first time.

Since the introduction of the Group's new adviser policy in 2014, all advisers engaged by the Group are rigorously vetted through the Group's advisers panel, presently comprised of the Director of Risk, Lord Gold, and a partner from an external law firm. The new adviser policy has significantly reduced the number of advisers engaged by the Group including at Power Systems which has a large network of distributors and is more reliant on the services of third parties to sell, distribute and support its products, in a similar way to automotive dealerships. In 2016, the review of Power Systems' advisers in accordance with the Group adviser policy progressed well towards completion during 2017.

Ethics Line and local ethics advisers

Ethical questions and concerns that are raised by employees and other stakeholders are recorded as contacts in the Ethics Line system, the Group's confidential reporting helpline. The total number of Ethics Line contacts marginally decreased in 2016 to 683 (2015: 729 contacts) with the number of ethical concerns discussed remaining at a similar level to last year at 428 (2015: 439 concerns). The Ethics Line oversight group continued to review cases, analyse the contact trends, focus on the root cause of reported cases and provide updates to the Committee, highlighting any high-risk cases. We share any concerns about possible improprieties in matters of financial reporting with the Audit Committee.

In December 2016, the Committee met with some of the Group's local ethics advisers (LEAs) to hear from them about their experiences and engagement with employees on ethics issues. The LEAs are appointed from the existing workforce, are trained in how to respond to ethical issues raised, and are in place to promote speaking up and tackling of ethical issues locally where appropriate to provide staff with an alternative to using the Ethics Line. At the end of 2016 there were a total of 80 LEA roles across the Group.

Data privacy

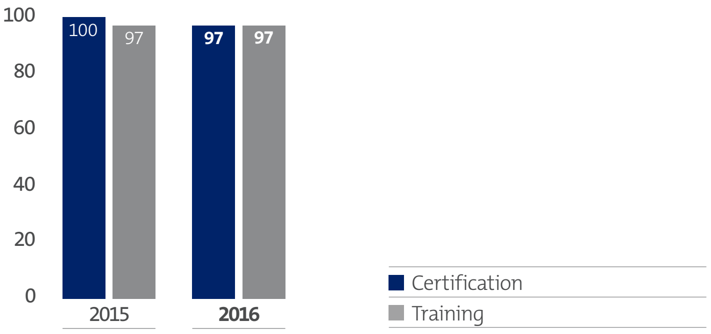
Recognising the importance of data privacy to employees, customers, suppliers and other stakeholders, the Group is investing in data privacy compliance by preparing to adopt the Binding Corporate Rules regime. We were briefed on the implications for the Group of the rules, which are due to come into force in May 2018, and reviewed the Group's plans to ensure compliance with them.

Training

The Committee attaches significant importance to regular, relevant and focused training and therefore has spent time reviewing the Group's ethics and compliance training programme including the levels of participation and feedback from the 2015 business ethics training programme. It approved the proposal for the 2016 business ethics training, built on manager-led group discussions based on real ethical dilemma scenarios. Annual ethics training is mandatory for all employees across the Group.

ABC training is mandatory for all employees who have dealings with persons outside of the Company and focused face-to-face training is provided to those employees whose roles have higher exposure to ABC risk. Monthly dilemma-based stories drawn from real cases also continued to be published on the Group's intranet during 2016 inviting employees to vote on what action they would take. Mandatory training programmes will continue in 2017.

ETHICS EMPLOYEE CERTIFICATION AND TRAINING (% OF EMPLOYEES)[1,2]



[1] 2015 certification by managers only.
[2] 2016 certification excludes Power Systems.

Disciplinary proceedings under the Global Code of Conduct

If an employee is found to have acted in breach of the Global Code, the Group takes appropriate action to address that breach. That action may include giving a disciplinary warning, imposing another penalty or, ultimately, terminating employment in the most serious of cases. In 2016, there were 38 employees (2015: 33 employees) whose employment ended for reasons relating to breaches of the Global Code. An improved investigations protocol was introduced in 2016 to underpin the Global Code and the suite of ABC Group policies, and to support faster resolution of issues.

Behavioural expectations linked to performance and reward

In 2016, the Group updated its performance review process so that it provided an increased focus on behavioural expectations as a core assessment feature in all employees' formal performance reviews. The required behaviours include creating trust and a baseline by which employees will be recognised and rewarded for acting as a positive role model for ethical behaviour. From 2016, manager bonuses include an element based on what objectives managers have achieved and the behaviours they have demonstrated. The Committee welcomed this positive step as a means of embedding expectations and maintaining individuals' focus.

Product safety

The Group recognises that its products are critical to its customers, and the people its customers serve, all over the world. As Rolls-Royce products become increasingly technologically advanced, they are expected to always be reliable and safe whenever they are used, often in harsh operating environments. Our commitment to meet this expectation is essential to the Group's business, its reputation and its sustainability. As a Committee, we draw on our collective industry and regulatory experience to oversee the Group's work in achieving this.

A key theme in 2016 was to ensure that safety of people and product remained front of mind across the workforce during the Group's current period of transformation. We discussed this topic regularly during the year and reviewed the risk implications for safety of organisational and role changes, and the lack of focus that can emerge in times of uncertainty and change. We were pleased to see that regular and clear communications, including videos from senior leaders and poster campaigns, were taking place in order to reinforce these messages.

We discussed and endorsed a set of expected behaviours that will promote and strengthen a culture where safety is prevalent. These behaviours are aligned to many of the expectations and principles within the Group's values, the Global Code of Conduct and the product safety Group policy, as well as features of the Group's high performance culture training. Assessments against the expected behaviours have led to plans for targeted improvements.

Again this year, the Committee received detailed briefings in relation to further elements of the product safety assurance framework and safety management system. In February 2016, we reviewed the work of the product safety process council that was completed in 2015 and its plans for 2016. This body is responsible for the definition and implementation of product safety processes, process effectiveness, compliance, governance of improvements, development and training, and sharing of knowledge and best practice in the area of product safety within the Group. We also considered the role of external learning and regulation in product safety. We concluded that the framework and system remain robust and provide appropriate governance and accountability.

Rolls-Royce recognises in its product safety Group policy, reviewed annually by the Committee, that robust quality is an essential building block of product safety. In 2016, we looked at the increasing role of product quality planning which links the 'design' and 'make' parts of product safety. We also reviewed product conformity performance metrics which showed that process compliance, as indicated by audit findings, is improving. We conducted a review of the product safety training programme, and considered how the Group manages the competency of its purchasing function given the high proportion of components produced in the supply chain.

Throughout the year, we were kept regularly updated on product-related safety incidents in service and considered the potential impact on the Group and its products. This included the Airbus A400M crash near Seville, Spain in May 2015, and the Group's response to an issue detected on Trent 1000 intermediate pressure turbine (IPT) blades on All Nippon Airways' Boeing 787 aircraft.

We also reviewed the learnings from a fire arising in an engine assembled into an MTU railcar powerpack on a London Midland diesel locomotive, and had an initial briefing on the grounding of a vessel in the Scottish Hebrides.

Our work in reviewing incidents in service involved: monitoring management's progress in root cause identification; being briefed on the development and deployment of technical solutions required; testing the Group's approach in engaging with affected operators; and overseeing plans for the timely mitigation and retirement of any safety risk including through applying lessons learned back into product design. The Committee was again satisfied with the Group's response in swiftly deploying its safety assessment process to mitigate, control and monitor any potential product safety risks as they emerged. As well as incidents in service, we were also assured by seeing examples of eradication of conformity issues identified between the manufacturing and assembly phases, through design and build instruction changes.

We conducted our annual review of the product safety metrics used as a management information indicator of the performance of the safety management system. This includes trend data on the number of 'Red Tops' raised by each of the Rolls-Royce businesses, which is the document raised when a safety issue is identified on a product.

We also reviewed the Group's product failure principal risk dashboard. Although product failure can never be fully mitigated, the Group's approach to risk identification and management, assurance and controls gave us confidence that the likelihood of incidents is very low.

During the year, the Committee continued the work started in 2015 to gain a deep understanding of how the product safety management system is applied in the Marine business. This started with a half-day workshop in March 2016 with members of the Marine leadership and product safety teams, where we covered the applicable legislative and industry regulatory framework, accident prevention methodology, and each of the detailed product safety processes that underpin the product safety Group policy.

This provided a good foundation upon which we were able to examine the maturity of implementation of these processes during a visit by the Committee members in September to the Group's Marine facilities in Ålesund and Ulsteinvik, Norway. We met with local management and explored the product safety framework and processes as they apply to design, manufacturing engineering, production, assembly and testing, operator training, operational performance monitoring and servicing of some of the business' core products. It was very valuable to gain an understanding of the history and development of the business from the local teams, as well as to see up close the current and planned products and technology. This helped the Committee to understand better the journey the business had undertaken to increase the maturity of product safety governance, and the areas of continued focus for improvement.

Sustainability

The Committee oversees and helps guide the Group's approach to sustainability, as well as monitoring progress towards goals in this area.

In September, Rolls-Royce once again improved its overall score in the Dow Jones Sustainability Index (DJSI), remaining listed in the DJSI World and Europe Indexes and achieving a bronze class award. We achieved industry best scores for corporate governance, materiality, product stewardship and human capital development, and significantly improved our scores in the social reporting and risk and crisis management categories. This recognition reflects the Group's continuing focus on public disclosure and transparency, with the breadth of the 2016 submission enhanced by the inclusion of social and HS&E data sets from Power Systems.

The Committee reviewed the Group's approach and steps being taken in preparation for the statement required to be made in 2017 under the UK Modern Slavery Act 2015. This statement outlines the steps the Group has taken to minimise the risk of slavery and human trafficking taking place in any part of the Group's supply chain. Our 2016 anti-human trafficking and modern slavery statement is available at www.rolls-royce.com.

We also discussed the growing importance, underpinned by developing legislation, on engaging external suppliers on sustainability issues. The Group's principal enabler for this is its Global Supplier Code of Conduct (the Supplier Code), adherence to which is mandated through contractual terms. In 2016, the Group focused on embedding sustainability and ethical considerations into sourcing and supplier selection, on strengthening understanding and application of the Supplier Code, and on monitoring compliance with it.

You can read more about the Group's approach to sustainability on pages 40 to 45.

Travel security

In July 2016, the Committee reviewed the Group's programme and arrangements for ensuring the security of its workforce while travelling on business and were assured that these were robust and managed well.

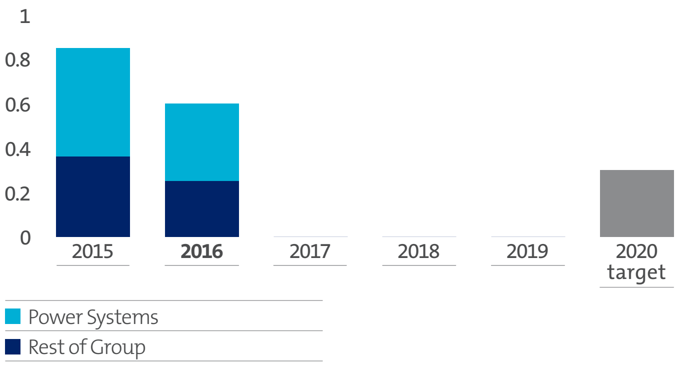
Health, safety and the environment

During the year, we received a number of briefings and presentations as part of an annual agreed cycle of HS&E topics. This enables oversight, discussion and year-on-year monitoring of the Group's progress on key aspects of its HS&E management, performance and assurance.

The HS&E strategy and corporate strategic plan were presented to the Committee, including measures and targets aligned to delivery of the strategic themes.

In February 2016, the Committee reviewed the 2015 Group HS&E performance report and a balanced scorecard showing performance trends against the Group's published target objectives on protecting health, preventing injury and reducing environmental impact. We then looked at in-year progress in June and again in December. Overall, with recovery improvements to be made in some areas, performance remained on track towards achievement of the target objectives (see the Sustainable business section on page 42), with the exception of our 2020 targets for the total reportable injury (TRI) rate and for total solid and liquid waste reduction, which remain challenging. The TRI rate for all our businesses has however improved. From 2015, the inclusion of Power Systems' TRI data has significantly impacted the Group's overall TRI rate. Extraordinary effort has been applied to improve Power Systems' performance in this area and significant improvements were achieved in 2016, but there is more to do to drive this to a level matching that of the remainder of the Group.

TRI RATE (PER 100 EMPLOYEES)*



* External assurance over STEM, Energy, GHG and TRI rate data provided by Bureau Veritas. See page 183 for the sustainability assurance statement.

In December, representatives from Power Systems attended the Committee meeting to report on their HS&E recovery plans based on implementation of Group standards, policies and processes. We were assured that the team recognised the need for improvements and are actively progressing with robust plans, supported by the central Group HS&E team.

The Committee also oversees the learning from incidents process that examines root causes of significant and major incidents, identifies any systemic issues, and defines measures to mitigate against the risk of similar incidents. We focused on the global improvement programmes, in particular on electrical safety, infrastructure integrity and control of contractors which continue to be higher risk areas for the Group contributing to several serious incidents in the year. The implementation of new Group-wide control standards and the continued use of HS&E bulletins are expected to contribute to better risk identification and hazard and incident reduction in these and other areas.

The Group's HS&E experts also provided updates to the Committee during the year on the HS&E improvement programme for field services, and on the wellbeing element of the occupational health strategy. The Committee was satisfied that good progress was being made on these programmes.

We conducted an annual review of HS&E governance, which includes a rolling calendar of executive level reviews. The governance structure was adapted following the removal of the Aerospace and Land & Sea divisional structures from the start of 2016. We concluded that this remained satisfactory.

The Committee examined the HS&E Group risk profile twice in the year, which remained largely stable against the previous reporting period. We reviewed the steps taken to contain known issues and to mitigate against the effects of future emerging risks. We were also briefed on a revised approach to corporate HS&E auditing and assurance, which had been adapted to make this more focused, effective and efficient.

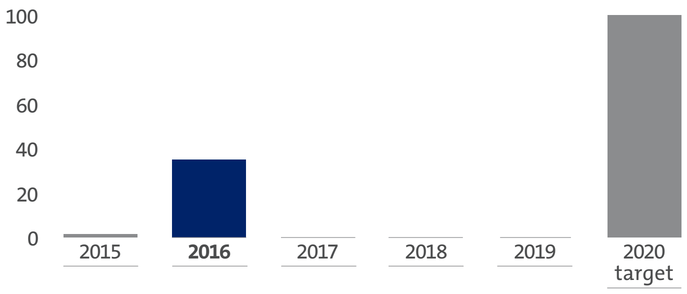
The Committee reviewed the overall HS&E learning and development programme, and were satisfied that a comprehensive enhancement of the programme through standardised global HS&E training had been endorsed and was underway. This included working with a selected training provider to produce new courses to close identified gaps, as well as making existing modules available in more languages.

In October, a Group-wide HS&E week was held with all employees encouraged to take part in activities and discussions, with very positive feedback having been received.

In December, we received an update on implementation of the Group's new HS&E management system, which provides more capability to support risk identification and reporting. This is being deployed across all of the businesses.

We also maintained our oversight of the Group's occupational health strategy, with further increase in the level of focus and resources being applied in promoting health risk management, resilience and wellbeing among the workforce. We are committed to creating workplaces that enhance the wellbeing of our people. At the end of 2016, 35% of our sites have achieved a LiveWell Award, recognising the steps they have taken to create an environment that supports employee wellbeing, where our people are motivated and enabled to make healthy choices and lead healthier lives.

LIVEWELL SITE ACCREDITATION (%)[1]



SEE FURTHER HS&E KPIS ON PAGES 42 AND 44

Looking forward

The Group continues to have a high degree of focus on the management of product safety, peoples' health and safety, environmental, ethics and compliance risks, with constant improvements being sought. With sustained support from senior leadership and the central expert teams, there is encouraging evidence that consideration and awareness of these topics is becoming ever more a part of everyday life for the Group's employees. We observe a growing peer culture of being curious, speaking up and challenging any potentially unsafe, unhealthy, unethical or wasteful behaviour. The Committee and I look forward to supporting and seeing this culture develop in 2017 and beyond.

In particular, the Committee will oversee the implementation of all outstanding recommendations made by Lord Gold and monitor compliance with the Group's obligations under the DPAs.

Sir Frank Chapman
Chairman of the Safety & Ethics Committee

Science & Technology Committee report

Sir Kevin Smith
Chairman of the
Science & Technology
Committee

Highlights

- → Review of small modular reactor nuclear technology.
- → Review of technology acquisition process.
- → Review of Advance3, UltraFan and MTU Series 5000 programmes.
- → Visit to University Technology Centres in Nottingham, UK.
- → Detailed briefing on manufacturing R&T strategy and programme.
- → Visit to facilities in Indianapolis, US and Coventry, UK to review manufacturing technologies.

Principal responsibilities

The remit of the Committee is to:

- → Review the strategic direction of the Group's research, technology and development activities.
- → Provide assurance that significant trends in science, technology, software and data are identified and incorporated into management plans.
- → Assist the Board in its oversight of major R&D investment and provide assurance on its competitiveness and adequacy.
- → Oversee the effectiveness of key engineering and technology processes and operations, including delivery of major product development and technology programmes, intellectual property management and interactions with professional and academic institutions.
- → Provide assurance on the identification and management of key technological risks.
- → Oversee processes for ensuring effective resourcing and development of required technological capability and skills.
- → Conduct visits to research and development facilities.
- → Ensure dialogue with the Group's engineering and technology leaders and employees.
- → Review industry and scientific benchmark data and best practices.
- → Review and consider any other topics or risks appropriate to the overall remit of the Committee as delegated by the Board.

The Group President, Director – Engineering & Technology and other senior engineering and technology executives attend the Committee meetings.

At a glance

Area of focus	Matters considered	Outcome
Technology acquisition process 2016 outcome	How the Group develops and acquires new technology, and the outcome of the process during 2016.	The technology process was appropriate and supported the technology development strategy of the businesses.
Technology deep dive reviews	The Committee received briefings on key technologies for small modular reactors (SMRs), and on required manufacturing capabilities and potential partnerships.	The Group's core nuclear technologies and potential partners position it well to address SMR opportunities, and the Group is focused on developing and deploying competitive manufacturing solutions.
New product programme reviews	Status of the Advance3, UltraFan and MTU Series 5000 programmes.	These programmes will bring a step-change in technology to key products enhancing their efficiency and effectiveness.
University Technology Centres (UTCs)	Review of the UTCs' role in partnering with Rolls-Royce, and tour of the work of the Gas Turbine Transmission Systems and Manufacturing Technology UTCs at Nottingham, UK.	The UTC model is highly beneficial in supporting R&D by leading academics in key technology areas for improving the Group's tools and processes and for application in future products.
Manufacturing technology	As well as the visit to the Nottingham UTCs, review of manufacturing technology strategy and development programme, including visits to facilities in Indianapolis, US and the Manufacturing Technology Centre at Coventry, UK.	The manufacturing technology strategy and programme are well defined across the businesses and there are visible signs of new technologies starting to be deployed.

2016 overview

Introduction

The Group invests more than £1 billion each year in R&D to enable it to conceive, design and deliver world-class technology that meets customers' current and future needs. The Committee was established by the Board to provide dedicated focus and support to this key area of the business especially in helping with the formulation of strategic direction. It is the aim of the Committee to provide high-level oversight and assurance of the Group's scientific and technological strategy, processes and investments.

Work of the Committee in 2016

In 2016, the Committee focused on deepening our understanding of some of the Group's existing and developing core technologies differentiators and enablers, and on reviewing critical technology programmes. These technologies help differentiate us from our competitors and enable us to meet customers' needs. We covered technologies deployed inside the Group's products as well as technologies that support their design and manufacture.

In May, the Committee undertook a review with the Group's experts of the technology capabilities necessary to address SMR opportunities. The Group has decades of experience in the design and manufacture of small nuclear-powered propulsion plants for the UK Royal Navy's submarine fleet. We also have extensive knowledge of civil nuclear reactor technology, components and systems through our instrumentation & controls and nuclear services businesses. These factors, together with proven expertise in high-volume, high-tech precision manufacturing through the aerospace businesses, provide the Group with a very strong and credible technology proposition. The Committee therefore supported the Group's initial investment in progressing the SMR opportunity as the UK Government considers its future energy options to meet projected demand.

We received a briefing on the new 'innovation accelerator' network introduced across the Group to engage our people worldwide enabling them to turn ideas into value-generating activities.

The Committee visited two UTCs at Nottingham, UK. The Group's established global network of UTCs enables long-term funded research as well as close contact with world-class academic institutions and access to leading talent and innovation in key engineering and technology disciplines.

We first met with researchers and staff at the Gas Turbine Transmissions Systems UTC where we were shown some of the expert work being undertaken in advanced fluid mechanics. This enables the modelling of fluid flow and heat transfer in complex oil flows within the gas turbine core and transmissions architectures, and analysis of the behaviours of seals, shafts, bearings and support structures in different conditions. This work impacts directly on the development of new engines in considering material strength and wear at high temperatures.

We then moved on to the UTC in Manufacturing Technology where we saw some of the innovative work being undertaken in the fields of robotic inspection and repair, and in miniature machine tools. It is easy to see the potential this brings for enabling high-precision work in restricted space environments such as within engines.

The Committee was hugely impressed by the quality of work undertaken at the UTCs and the strength of the relationships. We were also satisfied with arrangements for the protection and management of intellectual property.

At our meeting in July, we examined progress with the Group's research and technology programmes, reviewing the 2016 technology themes and master programmes for each of the Group's businesses, and the planned sources of R&T co-funding. We conducted a review of the key technologies within the Advance and UltraFan programmes, including the Rolls-Royce Power Gearbox, which are driving changes to engine architecture and component technologies to form the core of the next generation of more efficient Rolls-Royce aero engines. Representatives from Rolls-Royce Power Systems also briefed us on the core technologies planned for the new MTU Series 5000 engine programme and the modular nature of its design.

The Committee endorsed the Group's critical programmes and will continue to keep them, and their key contributing technologies, under review.

The Committee was updated in July on the Group's technology strategy and programme in the field of manufacturing technology. This is an important area as the Group drives operational improvements in the near-term, as well as positioning the Group competitively for the future. We were briefed on the activities undertaken through the Group's global advanced manufacturing research centre network, and the particular areas of focus within each of the Group's businesses. This helped provide context for the Committee's visit in September to some of the Group's facilities in Indianapolis, US where we were briefed on advanced technology across several of the Group's businesses and programmes. This included: technology used in the Advance1 engine core architecture; development by LibertyWorks of engine infrared suppression technology; a review of CastBond technology which combines cooling and manufacturing techniques; and a briefing on the Group's investment in ceramic matrix composites (CMC) in Cypress, California to serve as a dedicated centre for CMC R&D to support the development of next-generation turbine materials.

During this visit, we also received briefings on advanced methods to reduce cost and shorten schedules for development programmes, and on repair technologies that decrease lifecycle cost and enhance fleet readiness. The LibertyWorks team provided a briefing on some of their areas of technology development. This included: engine infrared signature suppression technology that provides a benefit to defence customers; integrated power and thermal management; and other aspects of improving the Group's electrical capability in all business sectors. The DARPA VTOL X-Plane project was highlighted, that will lead to a demonstration of a distributed turbo-electric powered vertical take-off/landing aircraft.

In December, the Committee visited the Manufacturing Technology Centre (MTC) at Coventry, UK, the largest of a network of advanced manufacturing research centres. Here, we saw close up how advanced technologies, in particular in additive layer manufacturing and laser welding, are being applied to bring step-change efficiency improvements to the production process. We were particularly impressed by the capability of the MTC personnel, a team of industrially experienced process experts who, together with the world-class facilities at the MTC, provide fantastic capability in manufacturing solutions to Rolls-Royce and others.

I was delighted to attend this year's Rolls-Royce Science Prize finals. This flagship annual event at the London Science Museum gives recognition and reward to teachers that have undertaken innovative work in implementing science teaching ideas in their schools and colleges across the UK. The passion and enthusiasm of all of the finalists for their projects was evident, and their achievements in inspiring the next generation to pursue learning in STEM subjects in novel and engaging ways were truly deserving of this recognition.

Looking forward

The Committee will continue to support management in overseeing the Group's technology strategy and its response to emerging technology risks and opportunities. In December 2016, the Committee was allocated responsibility for overseeing management of the Group's new principal risk of disruptive technologies and business models, which we will be examining more in 2017.

Building on the understanding we have developed on the Group's technologies and plans, in 2017, the Committee expects to have a particular focus on how they contribute to sustaining competitiveness in our key business areas. We will also review the impact of transformation on our R&T strategy. We are excited by the possibilities ahead to build on the Group's strengths and harness new technologies to create and address future market opportunities.

Sir Kevin Smith
Chairman of the Science & Technology Committee

The Rolls-Royce Science Prize

The Rolls-Royce Science Prize is an annual awards programme launched in 2004 as part of the Group's continuing commitment to science education, designed to foster, recognise and reward outstanding work in science and maths teaching. It promotes innovative and sustainable strategies for teaching science and at the same time contributes to teachers' continuing professional development. Since its launch, over £1,250,000 of prize money has been awarded to over 550 schools.

Rolls-Royce works with the National STEM Learning Centre and Network, The National Centre for Excellence in Teaching Mathematics (NCETM) and the Institute of Mathematics and its Applications (IMA) to invite teachers, technicians and teaching assistants throughout the UK to submit a proposal for any science, or combined maths and science, project that meets a need in their school or college.

Up to 60 special merit awards of £1,000 are awarded by Rolls-Royce to selected schools that have submitted proposals of a very high standard. From these shortlisted schools up to six finalists receive an additional £5,000 from Rolls-Royce to develop and enhance their projects. Finalists are lent a video camera which records their progress and are aligned to a Rolls-Royce STEM Ambassador mentor to support them through to successful project completion.

The winning entrant is announced at an annual awards ceremony held at the London Science Museum, and the school receives a prize of £10,000. You can read about the 2016 finalists and their projects on the Group's website www.rolls-royce.com.

Responsibility statements

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

The Directors, as listed on pages 54 to 57, 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 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.

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 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.
- 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.

RESPONSIBILITY STATEMENTS UNDER THE DISCLOSURE GUIDANCE AND TRANSPARENCY RULES

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:

- 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 Company and the undertakings included in the consolidation taken as a whole.
- The Strategic report on pages 2 to 53 and Directors' Report on pages 54 to 113 and pages 186 to 189 include 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.
- The Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy.

By order of the Board

Pamela Coles
Company Secretary
13 February 2017

Other statutory information

Share capital

On 31 December 2016 1,838,796,763 ordinary shares of 20p each, 28,124,943,825 C Shares of 0.1p each and one Special Share of £1 were in issue. The ordinary shares are listed on the London Stock Exchange.

Payment to shareholders

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend.

Shareholders can choose to:

- Redeem all C Shares for cash.
- Redeem all C Shares for cash and reinvest the proceeds in the C Share Reinvestment Plan (CRIP).
- Keep the C Shares.

The CRIP is operated by Computershare Investor Services PLC (the Registrar). The Registrar will purchase ordinary shares in the market for shareholders electing to reinvest their C Share proceeds. Shareholders wishing to participate in the CRIP or redeem their C Shares in July 2017 must ensure that their instructions are lodged with the Registrar no later than 5.00pm (BST) on 1 June 2017 (CREST holders must submit their election in CREST before 3.00pm (BST) on 1 June 2017). Redemption will take place on 5 July 2017.

At the 2017 AGM, the Directors will recommend an issue of 71 C Shares with a total nominal value of 7.1p for each ordinary share. The C Shares will be issued on 3 July 2017 to shareholders on the register on 28 April 2017 and the final day of trading with entitlement to C Shares is 26 April 2017. Together with the interim issue on 4 January 2017 of 46 C Shares for each ordinary share with a total nominal value of 4.6p, this is the equivalent of a total annual payment to ordinary shareholders of 11.7p for each ordinary share.

Further information for shareholders is on pages 190 and 191.

Share class rights

The full share class rights are set out in the Company's Articles of Association (Articles), which are available on the Group's website at www.rolls-royce.com, and are summarised below.

ORDINARY SHARES

Each member has one vote for each ordinary share held. Holders of ordinary shares are entitled to: receive the Company's Annual Report; attend and speak at general meetings of the Company; appoint one or more proxies or, if they are corporations, corporate representatives; and exercise voting rights. Holders of ordinary shares may receive a bonus issue of C Shares or a dividend and on liquidation may share in the assets of the Company.

C SHARES

C Shares have limited voting rights and attract a dividend of 75% of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis. The Company has the option to redeem the C Shares compulsorily, at any time, if the aggregate number of C Shares in issue is less than 10% of the aggregate number of all C Shares issued, or on the acquisition or capital restructuring of the Company.

On a return of capital on a winding-up, the holders of C 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 C 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 C Shares are only entitled to attend, speak and vote at a general meeting if a resolution to wind up the Company is to be considered, in which case they may vote only on that resolution.

SPECIAL SHARE

Certain rights attach to the special rights non-voting share (Special Share) issued to HM Government (Special Shareholder). These rights are set out in the Articles. Subject to the provisions of the Companies Act 2006, the Treasury Solicitor may redeem the Special Share 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 the Company's 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.

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 C Shares other than under the Articles (as described here), under restrictions imposed by law or regulation (for example, insider trading laws) or pursuant to the Company's share dealing code. The Articles provide that the Company should be and remain under UK control. As such, an individual foreign shareholding limit is set at 15% 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 that holding. The Special Share may only be issued to, held by and transferred to the Special Shareholder or his successor or nominee.

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 propulsion business or the assets of the Group as a whole, without the consent of the Special Shareholder.

Authority to issue shares

At the AGM in 2016, authority was given to the Directors to allot new C Shares up to a nominal value of £500m as an alternative to a cash dividend.

In addition, a special resolution was passed authorising the Directors to allot new ordinary shares up to a nominal value of £122,579,775 equivalent to one-third of the issued share capital of the Company. This resolution also authorised the Directors to allot up to two thirds of the total issued share capital of the Company, but only in the case of a rights issue.

A further special resolution was passed to effect a disapplication of pre-emption rights for a maximum of 5% of the issued share capital of the Company.

These authorities are valid until the AGM in 2017, and the Directors propose to renew each of them at that AGM. The Board believes that these authorities will allow the Company to retain flexibility to respond to circumstances and opportunities as they arise.

Authority to purchase own shares

At the AGM in 2016, the Company was authorised by shareholders to purchase up to 183,869,662 of its own ordinary shares representing 10% of its issued ordinary share capital.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2017 or 18 months from 5 May 2016 whichever is the earlier. A resolution to renew it will be proposed at the 2017 meeting.

Deadlines for exercising voting rights

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

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.

Change of control

CONTRACTS AND JOINT VENTURE AGREEMENTS

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 could be seriously prejudicial to the Company.

BORROWINGS AND OTHER FINANCIAL INSTRUMENTS

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At 31 December 2016, these facilities were less than 15% drawn (2015: 22%).

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:

- PSP – awards would vest pro rata to service in the performance period, subject to Remuneration Committee judgement of Group performance.
- APRA 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 (SIP) – consideration received as shares would be held within the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.
- New LTIP (subject to shareholder approval) – awards would vest on the change of control, subject to the Remuneration Committee's judgement of performance and may be reduced pro rata to service in the vesting period. Any applicable holding period will cease in the event of a change in control.

Other statutory information continued

Major shareholdings

At 13 February 2017 the following shareholders had notified an interest in the issued ordinary share capital of the Company in accordance with the Financial Conduct Authority's (FCA's) Disclosure Guidance and Transparency Rules.

Shareholder	Date notified	% of issued ordinary share capital
BlackRock, Inc.	23 November 2016	5.00
The Capital Group Companies, Inc.	6 January 2017	4.69
ValueAct Capital Master Fund, L.P.	27 January 2017	11.01
Harbor International Fund	2 February 2017	3.98

Directors

The names of the Directors who held office during the year are set out on page 61.

Disclosures in the Strategic report

The Board has taken advantage of Section 414C(11) of the Companies Act 2006 to include disclosures in the Strategic report including:

- Employee involvement.
- The future development, performance and position of the Group.
- The financial position of the Group.
- R&D activities.
- The principal risks and uncertainties.

Political donations

The Group's policy is not to make political donations and therefore did not donate any money to any political party during the year.

However, it is possible that certain activities undertaken by the Group may unintentionally fall within the broad scope of the provisions contained in the Companies Act 2006 (the Act). The resolution to be proposed at the AGM is to ensure that the Group does not commit any technical breach of the Act.

During the year, expenses incurred by Rolls-Royce North America Inc. in providing administrative support for the Rolls-Royce North America political action committee (PAC) was US$42,742 (2015: US$45,021). 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 Group cannot affect how they are applied, although under US Law, the business expenses are paid by the employee's company. Such contributions do not require authorisation by shareholders under the Act and therefore do not count towards the limits for political donations and expenditure for which shareholder approval will be sought at this year's AGM to renew the authority given at the 2016 AGM.

Greenhouse gas emissions

In 2016, our total greenhouse gas (GHG) emissions from our facilities and processes, including product test and development, was 587 kilotonnes carbon dioxide equivalent (ktCO$_2$e). This represents a decrease of 3% compared with 602 ktCO$_2$e in 2015.

We have introduced reporting of fugitive emissions of hydroflurocarbons (HFCs), associated with air conditioning equipment, into our GHG emissions figures for 2016. These include emissions from our facilities in the UK, US, Canada and France only. We do not anticipate that emissions from other facilities will have a material impact. Figures from prior years (2012 to 2015) exclude emissions associated with HFCs.

Total GHG emissions (ktCO$_2$e)	2012	2013	2014*	2015☑	**2016☑**
Direct emissions – facilities, processes, product test and development (Scope 1)	219	241	301	242	**240**
Indirect emissions – facilities, processes, product test and development (Scope 2)	313	313	382	360	**347**
Total for facilities, processes, product test and development	532	554	683	602	**587**
Direct emissions – power generation to grid (Scope 1)		153	155	132	**132**
Indirect emissions – power generation to grid (Scope 2)		12	14	15	**11**
Total for facilities, processes, product test and development, and power generation to grid		719	852	749	**730**
Intensity ratio (total emissions normalised by revenue) for facilities, processes, product test and development, and power generation to grid (ktCO$_2$e/£m)		0.048	0.062	0.055	**0.052**

* 2014 data has been restated to reflect the inclusion of greenhouse gas emissions data from Power Systems. Figures for prior years (2012 to 2013) do not include data from Power Systems and therefore are not directly comparable.

☑ We engaged Bureau Veritas to undertake a limited assurance engagement, reporting to Rolls-Royce Holdings plc, using the assurance standards ISAE 3000 and ISAE 3410 over the energy, GHG, TRI rate and STEM data that has been highlighted with ☑ and as set out on pages 41 to 44 and in the table above. The sustainability assurance statement is included on page 183.

With the exceptions noted above, we have reported on all of the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013. These sources fall within our consolidated financial statements. We do not have responsibility for any emission sources that are not included in our consolidated financial statements.

We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) as of 31 December 2014, data gathered to fulfil our requirements under the Carbon Reduction Commitment (CRC) Energy Efficiency scheme, and emission factors from the UK government's GHG Conversion Factors for Company Reporting 2016.

Further details on our methodology for reporting and the criteria used can be found within our basis of reporting, available to download from our website at www.rolls-royce.com/sustainability.

Branches

Rolls-Royce is a global company and our activities and interests are operated through subsidiaries, branches of subsidiaries, joint ventures and associates which are subject to the laws and regulations of many different jurisdictions. Our subsidiaries, joint ventures and associates are listed on pages 170 to 175.

Post balance sheet events

In January 2017, the Group entered into Deferred Prosecution Agreements with the UK Serious Fraud Office and the US Department of Justice, and a leniency agreement with the Brazilian authority, MPF. These agreements require that the Group pays financial penalties, the details of which are set out on page 8.

There have been no other events affecting the Group since 31 December 2016 which need to be reflected in the 2016 Consolidated financial statements.

Financial instruments

Details of the Group's financial instruments are set out in note 17 to the consolidated financial statements.

Related party transactions

Related party transactions are set out in note 24 to the Consolidated financial statements.

Information required by UK Listing Rule (LR) 9.8.4

There are no disclosures to be made under LR 9.8.4.

Management report

The Strategic report and the Directors' report together are the management report for the purposes of Rule 4.1.8R of the FCA's Disclosure Guidance and Transparency Rules.

Disclosure of information to auditors

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

- So far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware.
- 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.