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Transcription

Part 1 – Introductions & CEO/CFO Strategy

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Introduction and Presentations

Ross Hawley

Well, good morning, ladies and gentlemen, and thank you very much for joining us here for our 2016 Governance Event. My name is Ross Hawley and I'm a member of the Investor Relations team at Rolls-Royce. Your host for the event today is Ian Davis, Chairman of the Board. And before I hand over him to introduce the event and his board colleagues, I'll quickly run through the format of the sessions and some housekeeping points.

The running order of today is as follows. We'll be in this room and in plenary session for a couple of hours. And in that time, you'll hear a strategy presentation from our CEO and CFO, followed by a short Q&A and then they will depart around 09.00. We will then move straight on to the presentation by Ian Davis covering the board and the workings of its committees, and followed by separate presentations from the chairs of the audit and the remuneration committees. And this should take us through to just before 10.00.

At that time, we will move you from this room into three smaller breakout rooms at the other end of the venue. And the coloured spot on your badge will tell you which room you've been allocated to. There'll be tea and coffee available in the atrium for you to take through with you, but we are keen to keep to time, principally so you can make sure you can be away on time.

So once settled in your rooms, you will have three dedicated Q&A sessions, each lasting for just under 20 minutes with a committee chair, and they will rotate between the rooms to minimise disruption, so please feel free to lay out all your papers. We hope this is going to give you the greatest opportunity to engage in discussions with each committee, and ask whatever questions you'd like in a smaller forum more suited to such a dialogue. And we'll finish the programme at the end of the breakout Q&A sessions. We hope that will be shortly before 11.00 this morning.

So just turning to the housekeeping notices: there are no planned safety alerts, so if the alarms do go off, please follow the signs and proceed to the exits in an orderly fashion. There are no plans to provide any material new information this morning, but as we may include forward-looking statements in the presentation or in the Q&A, you should read our Safe Harbour statement which we put at the back of the pack when considering these comments.

So finally, before we begin, could I please ask that you ensure your mobile devices are either turned off or silent, for the duration of the sessions. And with that, I'd like to hand over to Ian.

Ian Davis

Well, thanks Ross, and welcome, everyone. I really appreciate you joining us this morning. The last two years have been challenging and testing I think for everyone, not least for you, our investors. And over this period, we've been working really hard to try and improve our engagement and our communication with all our stakeholders, not least our investors and the analysts. This has been a very sustained effort by the board.

This morning is part of that process. There is no one on the board, least of all me, that doesn't recognise that governance is a very important part of sustainable performance. Obviously, as a company, we're focusing very, very much on strategic positioning, performance and delivery. We'll talk about that, but governance has been a very important part of it because we're managing this business for the long term. And that's really what we want to talk about today.

What I hope you will get out of today is you'll get a better understanding of our governance arrangements. And in particular, the board governance, how the board operates, how we're dealing with the situation we're in, and what we're planning to do going forward.

Specifically, what I hope you'll get and what we're looking to do today is to do three things. The first is to give you a reminder of what our strategy and priorities are. I absolutely believe that good governance is an absolute goal in itself. But it's at its most effective when it's linked to the priorities and strategy of the company. And so we wanted to set that context, and Warren and David are going to be talking about strategy priorities. Not to start a debate about it, but just to set the context for our governance.

And then we're going to get into our more formal governance arrangements, particularly the composition of the board; what's the board been doing, what's it been focusing on, and specifically what is it focused on for this year and in the future. So those are the three things that we want to cover today. And our hope is you're going to have a better sense of what we're doing, what our governance approach is and obviously, from my point of view, some reassurance that we are doing the right things.

Obviously, we will be using the chance to listen to you, for you to ask questions. And I'd very, very much hope, as all of us do, that you will treat this as part of an ongoing engagement. So this is a meeting, but anybody who at any time wants to ask afterwards, it's an open door through the IR team or to us directly.

I am joined today by the chairs of all the board committees as well as by Warren East, our CEO; and David Smith, our Chief Financial Officer. Helen Alexander chairs our Remuneration Committee. Lewis is the Chair of the Audit Committee as well as the SID. He will be stepping down as SID at the May AGM meeting, but he's still currently the SID. Ruth will be taking over as Chair of the Remuneration Committee after the AGM in May, and so she's joining us and you'll hear a little bit from her. Frank Chapman chairs our Safety and Ethics Committee, a very, very important ongoing part of the company. And Kevin Smith, who will become the SID after the AGM in May, is here as Chairman of the Science and Technology Committee. So you have here, in addition to myself, the chairs of all our committees as well as our CEO and CFO, who will be staying for the first hour of the session to go through the strategy and priorities.

So just to remind you, what we will start with: Warren and then David will talk about our priorities, our focus and our financial framework. I will then come back and talk about the workings of the board, what we're focused on and then two of our individual chairmen of the board will then describe what we're doing on audit and remuneration. And then we will break out and give you the chance to ask questions about the workings of the board.

I would also just say now, and I'll say it again at the end: we will be available. For those of you that feel that they didn't get the chance to ask a question, or that would like to have a further discussion with all or any of us, we will be around for 20 minutes after the close of the period.

So with those few words of introduction, perhaps I can hand over to Warren, our CEO, to give us a context on how we're thinking about our strategy and priorities.

Warren East

Thank you, Ian. Good morning, everybody. As Ian said, the purpose of this is context and we will have a short Q&A afterwards. But some of you, or at least some of your fund managers, have heard David and me present these slides or slides very similar before, and they and you have lots of opportunity for discussing these with us. But it's important to set a context.

So when I came in halfway through last year, I looked at what was required by way of what we were going to do in the second half of 2015. And certainly to start with, I needed to get my head around the operations of the business, and it was clear that we needed to look for areas for improvement. But at the same time, we need to keep the wheels on the bus and keep focusing on delivery, not least for the customers expecting deliveries from us, and hopefully generating profitable growth or at least laying the foundations for profitable growth.

It was also clear that we needed to do something about communications. And as Ian said a moment ago, the board's been working hard on this for some time, but in the middle of last year we still needed – and I think it's a work in progress that we need to work on our communications and transparency.

And then last of course, looking forward into 2016 and looking beyond, we needed to see, what are the priorities for 2016 and onwards. And I think we accomplished all those in 2015.

Now, the first thing that hit me was there was quite a lot of uncertainty about the strategy of the business; are we an aerospace business, what are we doing with activity in marine areas and so on? And with that level of uncertainty outside also generating uncertainty inside, it's very hard to concentrate on fixing operational issues within the business. And therefore, I thought the first thing we needed to do was establish some strategic clarity. So we are a power systems business. We are about engines and propulsion systems. We develop intellectual property and products in those areas. We deliver those products, service those products and we target that intellectual property at a range of different related market sectors. And aerospace is certainly a very important market sector for us, but we are a power systems business.

Now, I put these words up on this slide with our full-year results at the beginning of February, and mentioned that these exact words are as of then and indeed as of today, still actually work in progress. But the sentiment in these words is broadly correct. And right now the priority, having established some strategic clarity, is to focus on the business in hand and operations, and actually refining how we express our vision and how we express our strategy is more of a background activity in 2015 and 2016.

So what about the goals for 2016? Coming into this year, there are three areas. And coincidentally of course, it's on the front page – or on the front cover – of our annual report: it's about focus, it's about transformation and it's about delivery. And what do we need to focus on? We need to focus on the strengths of our business, we need to focus on building the strengths of our engineering, developing more operational excellence. And we also have a very strong business model. And I'll talk a little bit more about the business model in due course. But that's about making our installed base – which people have been working very hard on building over the last multiple decades, and we continue to work hard on building that installed base – it's about leveraging that installed base to grow profit.

And so those are the three areas that we're going to focus on. And I'll talk about those in a moment. It's clear that operational improvement does need to happen right across the business; and therefore in November we talked about a transformation programme. And the company has been talking about transformation programmes for some time. There are a handful of different programmes, and I hope to inject a little bit of clarity into what we're talking about there later in this presentation.

And the third thing is about establishing trust and confidence in our long-term prospects outside of the business; amongst our investor stakeholders, amongst our customers, and inside of the business amongst our employees. This is a very sound business that's had a few issues over the last several years, but fundamentally it's a very strong business with excellent growth prospects. And it's important that we deliver. And in delivering, improve the confidence that we all have in this business.

So the first of these focus areas, engineering excellence. I mentioned we are a power systems business. We're about building engines and propulsion systems. And if there's one thing that Rolls-Royce is well-known for it's our engineering. And actually, these are quite difficult engineering challenges that we are wrestling with on a day-to-day basis. And here's an illustration of how we are improving the efficiency of large jet engines. So several years ago, the industry got together and concluded that by 2050, then aeroplane travel needed to be 75% more efficient in terms of emissions. And as part of that, the engine manufacturers are signing up to about a 30% reduction in CO_2 by 2050. This is compared with about 2000. And what we've been doing over several generations of Trent engines is improving that efficiency. And obviously that delivers commercial benefits for our airline customers, but it also delivers benefits for society at large, because actually these things are getting cleaner.

And if we just look at the three points on the chart here: Trent XWB, which is state-of-the-art, where we are today. Our next platform known as Advance where we changed the balance of work within the engine. And the next platform coming along after that, UltraFan, where we actually move to a much larger – an even larger fan and gears. And those are two further incremental steps. So this is an ongoing process, it's an ongoing technology roadmap. That's the sort of thing that our engineering excellence delivers. And you can see by 2025, 2030, when these new platforms are in service, then we've made a significant impact on that long-term goal to improve efficiency and reduce emissions.

And it isn't all about technology. Looking further forward, we need to do some bigger technology steps to get right down there in terms of efficiency. But some of it is about manufacturing technology as well. And some of that is developed in partnership, it's not just with Rolls-Royce. But, you know, we do have a pretty outstanding track record of collaboration with universities to develop technology, but also the manufacturing that goes behind it. And that manufacturing does deliver or does help in terms of our operational excellence as well.

So I talked about an alternative version of the 80/20 rule at our annual results. And this alternative version is delivering 80% more in terms of volume production in 20% less area comparing 2013 with 2020. This is one of the industrial improvement programmes that we're working on at the moment.

Now, by the end of 2015, what we'd actually done with the footprint is grow it a little and then start to shrink it back again. And we grew it a little because we were introducing new facilities that are more efficient; more machines – the machine-to-people ratio changing, so we have more machines for the same number of people, doing more with fewer people in less area; improving repeatability; reducing waste; reducing inventory; and improving profitability. That's what this programme is all about.

The bars on the histogram here show the number of large Trent engines that we aim to deliver year by year. And you can see there's a serious increase in that. And that's because, we have been successful over recent years in securing orders for our new engines, and we need to now deliver on those increases. In 2015, we delivered just over 300 large Trent engines. In 2016, we plan to deliver just over 400 large Trent engines. That's a huge step-up. But something which gives me some confidence that we can achieve that is that the run rate in Q4 in 2015 was approximately 100 large Trent engines. So we were at about the annual run rate for this year at the end of last year. And obviously going out of the end of this year, we'll be targeting the run rate for 2017.

The third thing that we are talking about focusing on is essentially our service business, leveraging the installed base. This business model works because we earn money from servicing the large installed base of products that we have out with our customers in operation. And the numbers on the top left of the chart here are showing the number of Trent engines that we have installed – or the number of large engines, rather, that we have installed, a mixture of RB211s and Trents. And you can see that over the next ten years, we are increasing the volume of engines that are out there significantly. And that's going to demand more capacity from our operations which service and maintain these engines.

And at the same time, our customers want us to be able to do that more cheaply, more quickly and with less operational interruption to them. And because of our business model where we take on the risk of servicing those engines for our customers, we want to do that as cheaply, efficiently, quickly as we possibly can as well. And so some of what we've done is to restructure our network to increase competition within the network, and generally improve the capacity at the same time. And so you will see us grow the absolute amount of resource that we have out in the market to do that, but you'll also see us continuing to make that more efficient.

And on the bottom of the chart, you can see that not only are we increasing the overall number of engines, but the load on this repair and overhaul part of the business is likely to grow significantly when we look at the almost ten times growth over the period from 2005 to 2025 in the number of engines that are over ten years old. And when one of these engines is ten years old, it's still barely halfway through its life. And so by 2025, we're going to still have a massive proportion of our fleet which is young but a significant proportion of our fleet which is over ten years old. And our customers want increased flexibility, and the alternative service models that we're developing in the bottom right of the slide there are indication of how we're responding to those customer requirements for better flexibility as the engines come into the second part of their life.

So the second goal for 2016 is about transformation. And what we're doing with transformation is looking at all of the different programmes that we have for cost reduction, for improving our industrial facilities and then also looking at our operation, which – my take on that is that we are over-complex and over-managed and our fixed cost base is too high, and all these things that I said in the fourth quarter of last year. What we're doing with our transformation programme is addressing those issues. And what we want to do is make sure that this isn't a one-off adjustment; this isn't, you know, you read the newspaper headlines, 'Rolls-Royce has lost so many jobs, and therefore cost has come down,' only to find that cost has increased again few years later. We want to make this enduring, and we're going to make it enduring by concentrating on simplification as well as just cost reductions. And of course we need to track progress and measure how that's done.

So I'll start by looking at the legacy programmes that we have talked about over the last several years. If we look at two of our market sectors, aerospace and marine, then at the end of 2014 we announced a headcount reduction in aerospace operations, and we expect that to deliver a run rate saving of £80 million per annum. In 2015, we actually did most of that, but we took the cost of doing that in 2015, so the net improvement for 2015 was about zero. But in 2016, we should see much of the benefit of that programme as we finish off removing that headcount.

The activity in the marine sector is a little bit later than the activity in the aerospace sector, but that involves a headcount reduction of about 1,000 individuals, or about 16% of the workforce in our marine operations. And we started that in 2015 but took a lot of the cost of that in 2015, so actually the net improvement was negative. But we expect to see more of the benefit of that in 2016 and the full benefit of that in 2017.

So over and above the legacy programmes, the transformation programme that we announced last November and we've rolled out some more details on that at the beginning of February, is about simplification. And it's about simplification of the structure of our operation. And we began that with looking at the senior management. And I said that, you know, the diagnosis is the business is a little bit over-managed, and so we are reducing management headcount. In the top two layers – we reduced approximately 20% of the top two layers, and announced that earlier this year. We have had one further round in March this year, and we will have a further round in Q2 as we reduce our management.

And we've got some savings that we talked about. We talked about a target of £150–200 million per annum. It is actually going to cost us in 2016, but by 2017 we expect to have the full range of those cost savings targeted and we expect to be through that part of the process.

Now, there are two parts to it. As I said, this isn't just a straight 'Let's remove some headcount and hope that the cost goes away,' because actually the cost won't go away. So it's about simplifying the operation as well so that we can – we're actually doing less overhead-wasteful work as an organisation. And I describe this as the organisational software. It's the sort of 'what people do' rather than the organisational hardware, the structure of the organisation, the people that we employ. And we're just at that stage now where we are really starting to concentrate on simplifying processes, on binning processes altogether, processes that have grown up over multiple years and are now no longer relevant for our operation going forward. So it's about the processes and looking forward to make sure that this is enduring, and it's also about the behaviours that exist in the organisation and make the thing work.

The third goal is about rebuilding trust, delivering on the various commitments that we make. I mean obviously, the single worst thing you can do in terms of destroying trust is not to deliver on what you say you're going to deliver. And probably the most important thing to do to rebuild trust is deliver on what you say you're going to deliver. And so we very much have that as a mantra within the business in 2016.

As far as rebuilding trust with the investment community is concerned, then a lot of it is around our transformation programme, the effectiveness of that transformation programme, and around the transparency with which we report our progress. And so in the back half, or back quarter, of 2015 and a little bit at the beginning of this year, we were still really in scoping the problem and establishing a transformation team. We're now really into the implementation phase and developing measures of success, and we'll continue to report on that as we go through the year.

Now, the emphasis is very much on, you know, day-to-day operations. And with that emphasis, then it's very easy to forget the strategy and portfolio piece. But that's on the slide at the bottom to let you all know that we haven't forgotten the strategy and portfolio piece. That's an ongoing background activity and indeed, I have the executive team spending a full day on that tomorrow. So we are working on that, too.

Looking forward: now, why bother with all this? Well, 'why bother' because it's an excellent business in targeting structurally growing markets; growing our market share within those structurally growing markets with a business model that exploits that market share. And everything I've just talked about with transformation is about growing our profitability. And so actually, the reason we should be doing this is because we're grow, grow, grow: growing market share into growing markets with growing profitability.

And how do we fuel that? Well, it is back to the beginning, back to the engineering roadmap – it's about maintaining that pipeline of innovation: listening to customers, addressing their needs in an innovative way so that we can drive growth in market share, growth in the installed base so that we can make the business model work. And as obviously we grow our share in the growing marketplace, then there is some benefit in terms of scale as well.

And our order book reflects the fact that we're achieving that. Our wide-body order book is strong. We reported that at the – and we reported growth in that when we came into the year and talked about our full-year results for 2015. That's going well as far as 2016 is concerned. We've had a number of questions about the robustness of our pricing but I can assure people our pricing is robust as a measure of the quality of our business. I mean, basically for our engines in whatever market sector, then the more powerful the engine, the more benefit it delivers to our customers and the more value it delivers; and therefore, the more that we're able to charge for that both in terms of the sale of the engine and in terms of the servicing of the engine.

It must be said, and we've got the bottom bullet on [the slide] here: you know, visibility is strong. These growing markets are very tightly correlated to underlying growth in GDP. And so it's very easy to see that growth over a sort of 10/15-year-type time period. But in terms of what's happening over the next six months, then visibility is a bit tougher and that's where we need to work on some of the communication. That long-term growth, you know, just to bring it to life in our aerospace business, then the chart shows the installed base of engines. And you can see there the growth that was on that histogram a few slides ago, you can see that reflected in what it does to the installed base. And of course our aftermarket revenue in a given year is proportional to the size of the installed base, not just the number of engines that we sold the previous year. And so you can see the way in which our service business actually develops significant growth.

This chart is based on our order book at the moment. Our order book at the moment runs out to 2027, getting on for 2028 by now I should think. The chart doesn't go out quite that far, but it's there and it's accurate. And by the way, for those followers of the detail in the industry, it also takes account of the parked aircraft. And in November, we put up a couple of slides and the purpose of today is not really to go into the detail of that, but you can flow through from this installed base and see how the cash flow over the next five years, the next ten years, improves as some of the engines become more mature, and the money that we're spending on developing and delivering those engines turns over into money generated by servicing those engines in the marketplace.

Outside of our aerospace business, there are opportunities as well to drive more profitable growth. And that's about evolving services and evolving products. It's about driving cost competitiveness through manufacturing, through looking at where we're actually sourcing parts in the world, through where we're assembling engines in the world. And importantly, it isn't just about how we design and make these things, but it's about how we deliver them to our customers as well. And then the bottom section here about strengthening route to market is something that we're working on and we've been quite successful at in our power systems business, the reciprocating engines part of our business with partnerships, joint ventures and getting us into different geographic regions.

If I look at the portfolio as a whole, this is a chart from last November, and why it makes sense to drive the long-term here. If you look at our products and markets, we analyse them by just how competitive are we at the moment and how attractive is the market? We've got a large portion of our portfolio in the attractive, competitive box. And some parts of our portfolio are competitive in a less attractive market area; what can we do about improving those, about developing relationships to target perhaps different geographies? What can we do about improving the competitiveness where we are in attractive markets? And for those parts of the portfolio where over the next several years we possibly see, you know, less scope for improvement, then that's the type of portfolio optimisation that we're talking about when we're talking about optimising the portfolio. So it's not radical change to the Rolls-Royce product and service portfolio, but more optimisation that we need to talk about.

So to conclude, the business has been through a period of quite a lot of change and continues to go through change: product mix, business mix, all sorts of issues that we need to address in terms of improving our industrial footprint, ramping up our production and so on. But my take on coming into the business is that actually the outlook is very positive. We're making good progress with the transformation and we're targeting growing markets with growing market share.

And with that, I'll hand over to David who's going to run through some of our numbers.

David Smith

Thank you very much, Warren. So I'm actually going to be quite brief on the numbers. This was the 2015 result; the headline was down versus the prior year. And clearly, as we've signalled strongly, the outlook for 2016 is much tougher. It is a very challenging market environment.

The positive I think from last year is actually we did deliver numbers in line with the guidance that we had given back in July; and in fact, with the exception of marine, with the original guidance we gave in February. But clearly during the year, we had to significantly change the outlook for the developments of the business for this year and for the next couple of years that we talked about previously in 2014. And as a result of that more challenging environment, we took the decision obviously in February to cut the final dividend for 2015, and also told you that we would also cut the first dividend for 2016 by 50%.

The balance sheet therefore is really important. We're very focused on financial strengths of the business at the moment. We took a lot of action last year around this, particularly given the more challenging conditions coming at us. We refinanced our revolving credit facilities, increased those. We also did a $1.5 billion US bond last year. And actually now we have relatively light refinancing requirements over the next couple of years. The biggest ones really are starting in 2019.

So we spent a lot of time talking with the rating agencies about this whole picture and talking with them about credit metrics and where we need to be in terms of maintaining our single A rating, which clearly they have done for the time being based on projections around operational improvements.

Capital allocation is a critical issue within the whole business. I think of this both as a continuum between what we're looking at internally and what we're thinking about for the broader decisions that we make for the business. So clearly, internally we've got to think about how we're spending our money on projects – whether they're investment projects in products, in capital, in our aftermarket – and making sure we have the right discipline and flexibility around how we run those programmes and challenge them.

We're also taking a lot of action, as Warren outlined, around structural costs right through the business at the moment. And there is money required to spend on that, and trying to balance those internal needs with the ongoing needs to provide the right return to shareholders over time. So the dividend policy that we've changed effectively is still trying to reflect that need to provide shareholder payments over time.

These are my internal priorities for my finance team. I'm not going to go through these. But the reason I wanted to put them up is you'll see a very strong correlation with what Lewis will talk about in terms of the work of the audit committee later around all of these themes.

So it's highly connected in terms of what we're trying to do internally within the business, and also connected to the financial governance of the business. And therefore, improving the financial framework for the business is a critical part of what I and my team are doing at the moment. I've talked about capital allocation. That also goes into a much better understanding of the sensitivities of the business and making sure that we provide appropriate stress testing around that. Personally, I've now been through a number of reporting cycles as well as cycles going through the longer-term planning process for the business and getting more comfortable with that process, and as you know, working on management information as part of that. And Lewis will come back to that later.

So a real focus actually on the whole forecasting and planning process. And one of the things that my 30-plus years' career which has really all been in industrial companies, that it's incredibly important that you connect the physical things and the financial things going on in the business. And this chart just tries to describe what I'm talking about here: that we've got to be able to understand the impact of changes in operational metrics, as you see on the right-hand side, to the financials. And that's a very clear part of what we're doing within our own management forecasting process. But more critically, it's actually about changing behaviours in the business: making sure everybody's focused on the right things and making sure we have accountability deep into the organisation around those operational metrics.

Now, we have other things to deal with. We have some of the confusion, I guess I would describe it, that's caused by some of our contract accounting within the business as much as it is outside the business. So we're trying to find ways to mitigate that with the way that we actually measure performance now within the business.

And this links in obviously then to the improved disclosure that we're doing to help our investment community to really understand. And for me, this is actually more than just providing more numbers. We have been trying to do that; we've provided quite a degree of additional data around the business to help people build and understand their models. But as importantly, it's this same concept of connecting the physical things going on with the business qualitatively with where the numbers are coming out, and a lot of what Warren was talking about earlier, and making sure that we talk about and have a good understanding with you around market dynamics and what the competitive forces are around the business.

So really focused then on operational delivery, making sure we can deliver our plans over the next two of three years, and the transformation programme that Warren outlined. So that's all for me. What we're going to do now is go into a short Q&A session for Warren and myself, and any other questions that you may have. And I think we're due to finish in about 15 minutes, so it's a short session.

Q&A

Harry Jack

Hi Warren. It's Harry Jack from Schroders. Hugely appreciating you rebuilding trust in the investor base; I'm just wondering what extent trust needs to be rebuilt in other stakeholders, namely customers and employees?

Warren East

So I would say that the relationships we have with our key customers, from what I've seen, are very good. And that applies whether they are partner-type customers like an airframer, or whether they're an airline-type customer – their customer. And so our customers and our customers' customer. I think where we need to do some improvement is with some of our suppliers and, also importantly, internally. We have 50,000 people who are all normal, clever people. And they have seen and they've read in the newspapers about how we've lost trust with our investors. And they reasonably question, 'are we doing the right thing? Does this management know what it's doing?'. And so I think the customer piece is all right. We need to work more internally, and some of those internal people are actually sort of external supply chain people as well. But that is frankly where we are at the moment.

Ashish Sinha

Hi. This is Ashish from GAMCO. You briefly mentioned portfolio optimisation, briefly touched upon it. Could you elaborate a bit more in terms of how you're thinking it has developed from November and February earlier this year when you talked to investors?

And within some of those areas which you defined – or some of those businesses which you identified you need to step up your game, I mean how is the motivation within the employees over there? Do they think there's quite a lot of uncertainty in those divisions?

Warren East

Uncertainty, by the way – I'll just pick up on the last part of that question – is improving across the business, across the whole business. Because as well as improving, as I hope David showed, some of the external communication we're doing, we're also doing a lot of effort into internal communication and improving that there. So people have a much better idea of what we're talking about and where we're going.

In terms of portfolio optimisation, then it applies across the range of market sectors that we target. But just to sort of talk about some examples: I think in our power systems business, which target land-based applications, sectors – defence and non-defence, things like backup power supply, land equipment and so on – then if you look at the sheer number of products that we service those markets with, then frankly there are too many. There are too many product variants which are not scalable to build.

Now, if you look at the scope of the market, this is a classic product marketing problem: I can win lots and lots of market share by doing things exactly right for your product versus your product. But actually if you've both got very similar product requirements, perhaps with a little bit of applications and marketing wrapped around it, I can service both of your needs perfectly adequately with one product. And if I do just one generic product, then I'm probably not going to gain much market share at all. And so it's getting that balance right in the product marketing. And that will result in a trimming of the number of products on offer. And we're working actively on that in our power systems business at the moment.

If you look at parts of our marine product portfolio, some of the system products are very close to engine and propulsion systems, and it makes good sense for a customer to buy and for us to deliver more of a complete system. There are some other system products which are much further away from the engine and propulsion systems, for which you have to question: is Rolls-Royce really the right supplier for those products? And so within our marine portfolio, again, there's a little bit of slimming that we're working on right at the moment. Is there anything to add to that, David?

David Smith

Yes. I think that this is a natural process, but maybe one that's overdue. And I think what we're going through now is a careful process to make sure essentially the contribution we're getting from the product portfolio makes sense from a scale point of view, and it is focused in the right place in the marketplace. And there are clearly areas I think we know we need to change and will be changing. But it's different I think from what many people think about portfolio, which is: are you going to own a piece of the business? We want to continue to own the main businesses, but actually absolutely rationalise and focus where we're doing our effort and our product development effort.

Speaker

Thank you. In essence, it's an extension of that question. I was interested by your two by two matrix of competitiveness and market positioning. Where you got the top right corner, the attractive bit, 70% of the business. The annual report shows that currently it's about 50%.

Warren East

Yes, that was a 2020 snapshot.

Speaker

And I'm just interested by what gets you from today to there? Is that simply the growth of the installed base over the period of time, or does that actually build in some decision making such as you've been talking about just now?

Warren East

No, it's actually where the existing portfolio would be in 2020. So it is largely driven by the increased penetration of our Trent engines, so as we grow market share and installed base.

Deborah Gilshan

Deborah Gilshan from the Railways Pension Fund. Could you talk about culture within the organisation, and whether you think the current culture that you have and what you're trying to engender is actually what you need going forward, given the challenges you face?

Warren East

Well, interestingly, I have once been told, 'Never talk to investors about culture,' because it's a big warning sign. However, since you raised the question, I've got to. So one of the little comments which is on a couple of the slides, which I didn't really stress in here, was: 'with pace and simplicity'. And I talked about the company being over complex and over managed. We have added process over years all for very good reason; something goes – something happens in the market, particular customer requirement, you can't quite do it, and the process that you operate, you need to modify. And we've done that over multiple years for good reasons. And like David's answer on the product portfolio a moment ago, a sort of normal course of business would be every now and again to sort of clean up, and we're a little bit overdue.

So that complexity means we're quite slow. And injecting some pace into our operation is very much a cultural change, because over years, people get used to operating at a slow pace. And the natural thing to do is to call a meeting. And if you can't get 20 people to the meeting then you put off the meeting until you can get all the people to the meeting and so on. Whereas actually, if you only needed four people in the meeting in the first place, then you could arrange the thing a bit quicker.

So pace and simplicity are inextricably linked. And that is sort of the crux of the cultural change that we're trying to make, which is why in the transformation bit, when I talked about organisational software, it's about changing what people actually do; making sure that you don't have 20 people in the meeting because you look at the 16 people and you say, 'Well, what are they actually doing? What contribution are they going to make to the discussion?' Because, you know, once upon a time, they got introduced to the meeting for good reason. And maybe that function, that individual should be, an occasional expert witness at such a meeting as was probably the reason they got introduced to it in the first place back in 2008. But they've never actually been removed. And so those are the sorts of changes we're making, plus better communication. I think they are two very tangible examples of the culture that we're trying to change. The very fact that we're having this sort of event today should be an illustration of how we want to behave going forward.

Tim Goodman

Tim Goodman from Hermes. And it somewhat follows on from that, but a question that struck me: you've got a lot do, volume is ramping up in the aero engines business; safety and quality springs to mind, particularly with everything else that's going on that's on your plate. How do you make sure that those standards are inviolable?

Warren East

There's no rocket science to make sure those standards are there. You have to make sure that, you know, you keep communicating that and keep underlining the importance of that to the people within the business. So when we did our senior leadership conference the other day with 100 people, and it was all about transformation and delivery, you know, we kicked off with safety and ethics as the sort of inviolable sort of goal posts, if you like, outside of which nobody is able to go. So there is no rocket science. Constant communication. So Frank is chairing our safety and ethics committee, and probably a good question for later if I can pass that one at this stage.

David Smith

I was just going to add to that, having worked in a couple of different industries, our product safety focus in Rolls-Royce is by far the highest I've ever seen. And that's true from automotive, from semiconductor industry. We are really focused also around employee safety, and making sure that both our own employees and our contractors are safe on the plants that we're in.

And I'd say on quality, that's an area where we know that we can make further progress. We've got probably all the right tools around those at the moment, and what we're trying to drive now is a lot more consistency on how we're applying those right through the business. But absolutely, it's a real focus of the whole transformation process.

Speaker

Yes, thank you. It's in a way slightly linked to the two previous questions: could you give us some additional flavour – you've talked about simplification, transformation, but how you've altered the interaction and process between commercial and the technologies; whether significant changes have had to be made there?

Warren East

Yes. The question, in case you didn't hear it, was: what sort of changes are we making about the interaction between commercial people and technical people? Actually, we do a pretty good job at this, and we have done a pretty good job at this. I was with an airline customer last week, and we have the commercial guy and technical guy in the room. It's a joined-up type of conversation.

In terms of wider sort of product planning, then, how can we inject some simplification into that? Well, one of the things we're doing is having a more streamlined organisation. So we do have an engineering and technology team that runs across the business. But most of the engineers involved in product development actually report in to the line of business. And by looking at that balance, and we're actually sort of slimming down the layer that goes across and making more people report into the line of business, that would be an example of how we're making some small changes. But that isn't one that needs a dramatic change, I don't think.

David Smith

I think we see processes as just a huge opportunity at the moment, because of the complexity that we all see and deal with day to day. So, I think what's changed is a change in the willingness to tolerate that complexity; we're just going to do something about it.

Warren East

And with that, David and I have to leave to get on with the rest of the governance day. So thank you.

Transcription

Part 2 – Governance Workshop

Title: Rolls-Royce LSE 2016 Governance Event

Date: 12.04.2016

Part 2 Speakers: Ian Davis, Lewis Booth, Helen Alexander and Ruth Cairnie

Conference Ref. No: N/A

Introduction and Presentations

This transcript is of the second part of the plenary session, focused on the workings of the board & its committees.

Ian Davis - Introductory comments extracted from Part 1

Well, thanks Ross, and welcome, everyone. I really appreciate you joining us this morning. The last two years have been challenging and testing I think for everyone, not least for you, our investors. And over this period, we've been working really hard to try and improve our engagement and our communication with all our stakeholders, not least our investors and the analysts. This has been a very sustained effort by the board.

This morning is part of that process. There is no one on the board, least of all me, that doesn't recognise that governance is a very important part of sustainable performance. Obviously, as a company, we're focusing very, very much on strategic positioning, performance and delivery. We'll talk about that, but governance has been a very important part of it because we're managing this business for the long term. And that's really what we want to talk about today.

What I hope you will get out of today is you'll get a better understanding of our governance arrangements. And in particular, the board governance, how the board operates, how we're dealing with the situation we're in, and what we're planning to do going forward.

Specifically, what I hope you'll get and what we're looking to do today is to do three things. The first is to give you a reminder of what our strategy and priorities are. I absolutely believe that good governance is an absolute goal in itself. But it's at its most effective when it's linked to the priorities and strategy of the company. And so we wanted to set that context, and Warren and David are going to be talking about strategy priorities. Not to start a debate about it, but just to set the context for our governance.

And then we're going to get into our more formal governance arrangements, particularly the composition of the board; what's the board been doing, what's it been focusing on, and specifically what is it focused on for this year and in the future. So those are the three things that we want to cover today. And our hope is you're going to have a better sense of what we're doing, what our governance approach is and obviously, from my point of view, some reassurance that we are doing the right things.

Obviously, we will be using the chance to listen to you, for you to ask questions. And I'd very, very much hope, as all of us do, that you will treat this as part of an ongoing engagement. So this is a meeting, but anybody who at any time wants to ask afterwards, it's an open door through the IR team or to us directly.

I am joined today by the chairs of all the board committees as well as by Warren East, our CEO; and David Smith, our Chief Financial Officer. Helen Alexander chairs our Remuneration Committee. Lewis is the Chair of the Audit Committee as well as the SID. He will be stepping down as SID at the May AGM meeting, but he's still currently the SID. Ruth will be taking over as Chair of the Remuneration Committee after the AGM in May, and so she's joining us and you'll hear a little bit from her. Frank Chapman chairs our Safety and Ethics Committee, a very, very important ongoing part of the company. And Kevin Smith, who will become the SID after the AGM in May, is here as Chairman of the Science and Technology Committee. So you have here, in addition to myself, the chairs of all our committees as well as our CEO and CFO, who will be staying for the first hour of the session to go through the strategy and priorities.

> *[These introductory remarks were followed by a presentation from Warren East, CEO and David Smith, CFO on group strategy, together with a short Q&A].*

Part 2 Presentations: Governance Workshop

Ian Davis

Well, thanks David and Warren. And hopefully, that just gave you at least a flavour of our strategic context and our priorities. I would reiterate: if there's any clarity needed, we are open for further conversations. And now that Warren is safely out of the room, I'd just like to say I think he's made an absolutely excellent start as CEO. The board and I feel very, very good about the way he's grasping it internally and externally, not least with customers. So I just want to just say, you know, a really, really good start on that side, which we're very pleased about.

Now, what I want to do is to try and set that strategic context as a basis for talking about our governance, particularly our board governance. But just to summarise: in essence, what Warren and David are saying is that over the next two to three years we'll focus on delivery. It's time for us to monetise the investments and the assets that we've got. You the investors have been investing very heavily into this business over the last ten years, particularly into the civil aerospace business, and our absolute focus is, quite frankly, to show you the money. And that's what we're focused on doing. And I hope you can see from the outline charts that we absolutely believe that the prospects are there. We've been investing to build that installed base; the cash comes from five years after the install base. So we're going through a big trough at the moment with two new products currently in investment, but right now the absolute focus of the board and the company is to monetise that asset base and deliver the profits and cash flow for the next three to five years that you deserve.

Once we do that, that will be the time for the next big debate about strategy; what do we do with the cash and the profit? But for now, Strategy with a big 'S' is not a key priority of the board. We can debate that if you wish, but we've really looked at it; the long-term growth prospects are there, the business model, we've really, really looked at it; we believe it's robust. And it's now just to deliver on the major investment that you have made.

I hope that you have picked up that what we haven't done in the last two years, in all the trials and tribulations: we have not cut our R&D investment; that has been maintained. We are absolutely maintaining our optionality for the long term. We have stuck with our CAPEX programme; we've invested a major amount in CAPEX. That's coming down now, but that was planned. So there's been a massive capital investment over the last three to four years. It's all come at the same time; benefit of hindsight, unfortunate when we have this massive downturn in marine, but we kept going on that.

So I hope you also have picked up that we have sustained over a very difficult period. Those investments will sustain the long term. And we keep saying we're a long-term business, I hope that reflects the numbers. But we do know and we do understand that at some point, you've got to deliver. And that's what we're going to focus on now. And we will be judged by that, we know, in three or four years' time. And I think that came through very clearly from what Warren and David were saying.

So against that context, what I'd like to do now is talk a little bit about the board, the governance; how we're trying to support that priority of the business as well as ensure that we are responsible and decent company, which as I said, it's an absolute good in its own right, but also is crucial for running for running a sustainably successful business.

Let me just start off by talking a bit about the board: who's on it and why who's on it is on it. Because the composition of the board is a big decision; I do think the skills and mindsets of the board – I'm a great believer in having a varied board - you need a mix of experienced but particularly domain expertise as well.

This gives you a sense of the non-executives on the board. All but one, Brad Singer at the bottom, are independent non-execs. And I'll talk a little bit later about ValueAct. We have two longstanding board members; Helen Alexander, who has been an absolute stalwart of the board, sadly will be stepping down at the AGM, having completed her nine years. John McAdam, Chairman of United Utilities and Rentokil has been on the board for many years. And then we go on to 2011: Lewis Booth, formerly CFO of Ford, and Frank Chapman, former CEO of BG, came on the board in 2011: very strong manufacturing and technology experience. Jasmin Staiblin, who is now the CEO of Alpiq in Switzerland, was the head of technology of ABB, joined in 2012.

And then you can see seven members who've joined in the last few years. So it's quite a new board. I joined in 2013. Hsien Yang Lee, former Chairman and CEO of Singapore Telecom, and also the Chairman of the Audit Committee at ANZ Bank, joined 2014.

He brings real Asia expertise. Those who know him will know he's a very prominent and admired businessman in Asia, not least in China; a really, really important market for us.

Ruth Cairnie had a stellar career at Shell, with a technology and strategy background. Also worked a lot in continental Europe - very important, Scandinavia and Germany for us. Irene Dorner was President of HSBC North America; a very strong risk assurance and ethics background, as well as finance. Alan Davies, CFO at Rio Tinto, now Head of their Minerals division. Kevin Smith, I think you know as Kevin, the former CEO of GKN; very, very strong and leading industrial engineering background. And there, Brad Singer from ValueAct has a very, very strong finance background; I know everybody thinks of him as ValueAct, but he's been a CFO of two public companies in the States, both of which went through major operational improvements, and before that was at Goldman Sachs.

So I hope that just gives you a flavour of the type of skills. What I want to emphasise is, and it's no accident, that the people who've joined in the last three years have a predominantly finance systems and operational orientation. And that reflects that priorities that we have in the business. Now, we're not only going to be doing that; it's very, very important you have a broad perspective on the board. But I felt, and we felt as a nomination committee, that strength in those skills, for reasons which will be obvious to you, was important. So it is no accident that risk, finance, operations as the main skill has been the predominant focus of the people joining the board, as well as industrial and engineering.

So just to look at the composition; well, why is it what it is? 100% of the people on the board have had global business experience. And 70% of the board have worked for a substantial amount of time outside the UK; absolutely crucial for a company like Rolls-Royce. We have to be a global company. I've been pushing this very hard. There is a tendency for Rolls-Royce to be regarded as a great British company. Well, firstly, we've got to demonstrate that we're great. And secondly, we are British but we're not British; we are a global company. We have to do that, and the board has reflected that.

Almost two-thirds of the board have been, or are chairmen and CEOs, of leading public companies. There's a lot of experience; between us as board members, we've had experience of over 40 boards. So there's been quite a lot of people who've been there and done it. I know there have been questions about that the last two or three years, but that is reality. And again, that's something we want to sustain; that people who know what it's like to run a very, very complicated business – and this is a very, very complicated business.

75% of the board have manufacturing, engineering or technology backgrounds. You can debate, is this too much or too little. Again, I think diversity on a board, in the broadest sense of the word 'diversity', I believe is very, very important. But I think to understand the context of a company like this, but not be too sympathetic to it – somebody asked a question about culture. This is a very strong technology and engineering culture. Personally, I'd like to make it a bit more commercial, and so we've got to get that balance right.

And 100% of the science and technology committee, as you would expect, has an engineering and technology background. And half the board has deep financial experience. That's not quite the same as relevant under the formal governance recent and relevant, but people who've been CFOs, chaired audit committees or worked heavily on finance.

So I just hope that gives you the sense. We do think very, very hard as a nomination governance committee. And I certainly, as chairman, think very, very long about what types of personalities, skills, the main expertise and lens do we want on the board. And I hope that gives you a sense of global experience, strong empathy towards engineering and technology but also a very strong financial and systems orientation to reflect where we are at the moment.

Just a few words on ValueAct and the ValueAct relationship. I mentioned that Brad Singer is a board member. He was appointed because of his skills as an individual. Obviously, the fact that ValueAct was on the shareholder list was a catalysing event for that, but he as a person was our focus. We went through all the normal board review processes; does he meet our criteria? And reality is we were looking for someone with deep finance, US experience, as well as credibility with investors. And he ticks all those boxes. He's a really impressive individual who I hope you'll meet.

But just to remind you, independent of Brad, what relationship agreement with ValueAct is. It is on our website. I would – if you haven't - recommend you look at it. We spent a lot of time thinking about that, and we're very aware that we might be sending a precedent in the UK. But there are quite strong restrictions and controls which were embraced by ValueAct who, I have to say, have been extremely collaborative and easy to work with from my point of view. So if any of you are worried that this is going to be a destabilising force: a) I don't think it will be culturally, and b) for two years, because of the agreement, it can't be. So there are quite a lot of governance protections around ValueAct.

For those of you that may be concerned, as I said, their mindset and their attitude in terms of strategy and priorities is very aligned with ours. I've spent a lot of time on that, and I think that will go well. But I just wanted to just leave that with you. But I do just want to remind you that he is not an independent director; he's a dependent director, which means that he cannot be a voting member of the audit or the remuneration committee. If there are any questions on that in the breakout, then please, of course, do follow up with me on that.

Now, what's the board been up to? And I'll come on to more importantly, what are we going and we're doing? And I know the question of what we've been up to has been on some of your minds. We've been doing what you would expect us to be doing in 2014 and 2015. I'm sure there are questions about pace, but one of the things that we had to do with the board, and has come out to this room is, with all the problems that beset us – and it was never just one thing – you had to bear in mind that we were ramping up production investment massively at the same time, and getting the balance between systems and cost reduction and ramping up production, not making sure you drop the ball on quality and safety - a really, really fine balancing act for a board. We knew the pressure from the investors and financial community to improve the financial roles, but the pressure from customers was completely different.

So we were trying to get this balance in 2014 and 2015, and responding to very, very disappointing financial out-turns, but at the same time, massive ramp up in production and customer demand. I won't go through each of these; a lot of time on forecasting. I mean, clearly our forecasting has let us down; we're aware that, we're really working hard on that. It's partly systems, partly organisational structure. Warren and David talked about that. And Lewis will talk about that a bit more when we come on the audit. We've thought a lot about capital allocation. And I hope you're clear about where we are allocating capital and where we are not allocating capital. And the clear message that came through from David is: we are focusing on the capital which will support improved efficiency and support our long-term growth, and maintaining a strong balance sheet. Anything else is secondary in terms of priority.

So this is still fundamentally a growth story, and we are managing our balance sheet and our capital allocation behind that. What you need to believe, and we've got to demonstrate, is that growth can be profitable growth, and we haven't done a good job of that in the last few years. I know I keep coming back to it; that's what we've got to do in the next three years.

We spent a lot of time on the CEO and board appointments, particularly the CEO appointment. As you know, changing a CEO is probably the biggest thing a board does, and probably the most important thing a board does. We went through a very, very thorough process – external, international – before we landed on Warren. And that was a big, big time commitment of the board. You've seen the outcome of our operational view on strategic priorities, which started before Warren joined the board, but Warren has really accelerated that and grasped that by the scruff of the neck. And then into transformation: how we respond to ValueAct, and I hope you're seeing much, much more openness to engaging with stakeholders. And I really do hope you're feeling that, even if the numbers that we're, you know, being transparent with you aren't what you or I would want. I hope you at least feel that we're trying to be open and respond. This is a new skill, frankly, for the company and we've invested in both capability and time. And we always stand open to suggestions or input from you on that.

Now more importantly, what are we going to be doing in the future? The then was then, and now is now. I think the priorities of the board, over and above what a board would do, is really what you'd expect us to be doing. And I hope there are no surprises. If there are, then either Warren or I have blown it completely. This is really about operation, performance and oversight. A lot of scrutiny – and you've got to be careful on the board about going too far into the management's underwear and keeping the appropriate distance - but the board is absolutely focused on trying to get at operational performance. There's things in this sort of business that you can never predict and never be sure of. This is an industry where stuff happens, and that we can't budget for. But really getting into the operational details and trying to improve that is something we're absolutely focused on for this year, and it will be true next year.

Getting our forecasting better, getting our risk management we talked about, and controls. Lewis will talk about this. Absolutely the centre page. We do need to strengthen our organisation; we're working on succession as you would expect us to do. But strengthening the organisation; Warren has talked a little bit about that at previous meetings, particularly in the operational area: what he calls strategic marketing. And some of the businesses, we do need to upgrade our management qualities and capabilities. It's an easy thing to say, as you know, as well as I do; not always so easy to do, but absolutely important. And then making the – what we're calling a transformation programme, which is partly operational, partly cultural, is absolutely an ongoing task and something that Warren has hoisted his flag to very clearly.

So for the board really this is quite an operationally focused agenda. As I said, Strategy with a big 'S' is not on our agenda. Are there other things we could do? Yeah. Is it worth it in the context of what our priorities are? Our conclusion is no. So no major strategic initiatives insofar as events out there on the agenda.

And in addition to that – I mean, that's what the board does, but the governance side is very, very important. I've been spending quite a bit of time with Pamela Coles, our Company Secretary, on this over the last 18 months, and I absolutely believe this has a value of itself. And it's very important that we don't get so consumed by our short-term pressing problems and not pay attention to those issues that are important for the future or which could undermine us. The question about safety was absolutely bang-on. You know, you can do all this and get it all right, and if you have a safety problem you're dead in the water if it's serious.

So we really are focused on this. And I don't want to give the sense that we're not worrying about the things that really are fundamentals to do that. We spent two years completely reviewing our whole governance framework and documentation going back to subsidiaries, joint ventures, voting rights, to the software side of that. That's nearly completed now, and I think we're hoping to make that public to you. I hope you're realising everything we're doing, we're trying to put on our website, engage with you. In the summer I think, we're hoping for that to be there. So there's been a lot of work going on there.

We're very, very focused on sustainability in the broadest sense of the word, and diversity; not just gender diversity. Gender diversity is important. We're making progress; we've got a long way to go. This is really not a great industry for gender diversity. But if anybody can do it, we can do it. Rolls-Royce still has a huge pulling power amongst graduates and people around the world. And we have an extraordinary brand: you go to Scandinavia or China, or Spain, people really, really want to work for Rolls-Royce. That includes very talented women. So we're really going to try and push on this because we have a competitive advantage here. But we are fighting against an industry which is not quite as bad as private equity and asset management, but, you know, getting close!! You will understand the difficulties there. The point I want you to understand is this is an opportunity for us.

Diversity is not just, though, gender diversity. And again I agree with that. I do think we want to get more functional diversity, more commercial skills. And it is a very engineering, technology culture. It needs to be, but I think we are, and Warren touched on that, also looking to get a broader diversity there. And sustainability, I'll say a few words about later; very, very important to what we do. It's partly mandated sustainability, there's a lot of environmental pressure. But there's a huge internal desire, particularly amongst our younger employees, on environmental sustainability.

We've created a science and technology committee. Yeah, it's just a committee you could say, but science and tech are so important, we just found it difficult to deal with this as a board. It's quite technical: R&D, capital allocation, technology capabilities both near and far term. You know, we've got some very big major technology discontinuities: are we going to have electric planes, for example, in the future? That would be huge for Rolls-Royce. So there's some big E&T, and we haven't forgotten that. This committee is really, really looking at this. And everything we do, you make an investment now, you don't get the cash for ten years. We're thinking 2035 right now on our technology, and we have to. And that means that which partners we link with, which geographies we link, that's the job of the science and technology committee; how we think about the intellectual property, how we think about big data. These are questions that we couldn't deal with as a board given our other focus. So I set out a science and technology committee, which Kevin will be chairing, to deal with issues like this.

We've really strengthened board evaluation. We have Independent Audit who do a very, very thorough evaluation, and we've also massively increased board training and benchmarking against other boards to make sure that we're following best practice.

Just quickly on sustainability, a big focus of ours, it's something that's very motivating internally. Frank may talk about this, or you may want to ask him about that. Just to say we were very, very pleased that we were awarded the Dow Jones Sustainability Prize for the leader in the industry. So, you know, with all the problems and the bad news over the last two years, on this side and indeed on the customer side by the way, our customer ratings have been highest that they've been; some good news here.

And then just finally, just to go through the committees because this will set up what's happening now. I've talked at a very high level about nomination and governance. And please, in the breakout group ask me all the questions to that. I'll just quickly summarise: we're not going to have a separate session on science and technology and safety and ethics. These are really important. Science and technology, I said what it does; it's what you'd expect.

Safety and ethics, chaired by Frank. Very, very important, really focused on product safety, human safety. It also deals with regulatory and ethics and code of conduct. Now I cannot say – we cannot say much about the SFO as usual in this meeting. That's obviously a big part of what this committee is they're doing. If you want to ask questions, please do. Although, I have to say, we are very constrained about how much we say on that. And then anti-bribery and corruption programme is also an important part.

So those two committees I just summarised now, that's what we're doing. I'd now like to pass on to Lewis to talk about the audit committee, and then Helen will talk about remuneration committee. But what I hope this has done is just given you a sense of why is the board what it is, the composition, and just get the sense of the skills that we're emphasising at the moment to align with the priorities. How we operate, how we think in terms of the board agenda and the focus. Again, any questions you have, please ask, but I hope you feel that's aligned with what you and we need to do, and then some of the structural aspects of the individual committees that make up the board.

So with that, Lewis, talk about audit.

Lewis Booth

Thanks, Ian, and good morning. I'm going to spend a few minutes just talking about what we've been doing in the audit committee for the last year or so, and what we're looking forward to doing in this year. So let me first introduce the other audit committee members. Alan Davies from Rio Tinto; Irene Dorner was, as you heard Ian say, previously at HSBC; and Hsien Yang from Singapore, with vast Asia experience. All these audit committee members have great financial and business experience, and are actually very engaged audit committee members. As well as the audit members, all other board members are invited to attend the meeting and many of them do. The Chairman, Warren and David attend every meeting. Other board members attend periodically. For example, Dame Helen always comes to the audit committee in December. So as we're looking towards the year-end results, she understands the financial metrics that then roll into the remuneration process.

As well as our board members, we have the key financial members and we have KPMG also attending. Richard Ackland, the group engagement partner from KPMG, is here today. Unfortunately, Jimmy Daboo, the lead partner, had a pre-existing commitment with another client and couldn't make it.

It's a fairly big audit committee; deliberately so, because we use it for sharing best practices and we use it for ensuring that there's a common understanding of our expectations as an audit committee. To avoid the problems of size, I have private meetings with the audit committee themselves to make sure we're on a common agenda, and I meet privately with each of the key finance members before every audit committee to understand what's really going on. And I separately meet with KPMG. And in addition, the audit committee meets with each of those people on a periodic basis during the year.

This is my agenda. I'm going to obviously discuss financial reporting and the accounting policies and judgments we make; the risk and control environment; internal and external audit; and the management information forecasting process, on which we recognise we still have some work to do. And then I'll just close by talking about the areas of focus and forthcoming attractions for this year.

Obviously, key to the effectiveness of our audit committee is our review of the accounting policies and the judgments we make, particularly within contract accounting. There were several important judgments we made during this year. Firstly, the reversal of impairment on contractual aftermarket rights on a Trent 1000 contract with our lead customer on the Trent 1000. That reflects actually the excellent in-service performance of that engine, which enabled us to release the impairment on the CARs. We also reviewed the long-term contract accounting judgements and estimates within all our TotalCare accounting. We reviewed the impairment of goodwill and the adequacies of the warranty provisions in marine, and the review of goodwill at Rolls-Royce Power Systems which, although a little less headroom than some time ago because of the downturn in the economic environment, we still feel very comfortable with the carrying value. We also completed a little work on the disposal of the energy business.

We've also worked with management to increase disclosure on retrospective contract accounting adjustments, and financial disclosures to support the 2015 results. And finally – and you're going to hear a lot more about this, I think, during the year – we started a high-level review of the requirements and judgments necessary for the implementation of IFRS 15, which is going to have a big effect, and we talked a little bit about that in our annual report.

Overall, we believe that our accounting policies, key judgements and estimates are appropriate and balanced, but I have to say you would expect me to say that, right?

Turning briefly to the risk and control environment: following a review at the end of 2014, we spent most of 2015 strengthening our risk management process and increasing the board oversight. Previously it had been less visible to the board; we now have full board oversight, and the board as a whole has full responsibility for the risk management process and the individual principal risks, of which we have had nine. As we talk about this, I think we need to make sure that we separate out our financial controls and processes and systems, from the management behaviours that allow us to make timely forecasts and changes and guidance changes. I'm confident that we we're good at the former; I think we're very good at the accounting of our business, I'm comfortable with the judgements we make. I'm much less comfortable with our forecasting process, and that's an area I'll touch on a little bit later, and it's an area obviously you've fed back to us as well.

Turning now to the internal control process: it's been undergoing a comprehensive improvement process, and in 2015 we prioritised a review of key controls at entity level over the principal risk and critical processes. We concluded that those were operated effectively in 2015, but we can always improve. And during this year, we're working to ensure greater consistency of an effective control environment across the whole company, and that is going to be aided as Warren continues to simplify the company a little bit.

We've also increased the scrutiny of our core financial controls, given the business challenges, and have instigated a wide-ranging plan to align them with our revised management information system. The financial forecast is only as good as the inputs the financial forecasts get; that's what we were talking about the management information system, not just the financial reporting process. The initial focus of our improvements is on financial process and clearer accountabilities, but will quickly extend to non-financial measures together with a regular programme of assessment and testing.

Now, while the board remains responsible for all the principal risks and the risk management process, the audit committee has responsibility to review on behalf of the board three of the principal risks, and the overall risk management process. We spent a lot of last year, as I said, establishing a more effective risk management process with greater oversight by the board. We then had reviews: each of business continuity, market and financial shock, and IT vulnerability. I think the one that we spent most time on is IT vulnerability; the issue of cyber security is ever present. Obviously for a business like ours, we're a very attractive target for all types of intruders. And we have met with the IT team, we've met them in their facilities, and we've established a dashboard of KPIs to ensure that we fully understand what is going on and how effective they are. We are not going to prevent attacks. What we've got to make sure is that, when we are attacked, we can contain them and then eliminate them, and that's our process.

Obviously this year was the first time we prepared a viability statement; I think one of the more important judgements we made this year was to decide over how long we did the viability statement. We concluded that five years was an appropriate period; it's consistent with our business planning process, it's consistent with our medium-term strategy and I think it's consistent with the longer-term nature of our business compared to many of the other FTSE 100. So five years is longer than we've been seeing from other reporting companies, but we feel comfortable that five years is the appropriate time. We've actually found this a very valuable process, because it enabled us to take the risks we identified in the risk management process and roll them into a really seriously studied viability study, looking at individual risks and our sensitivity to individual risks, as well as a combination of multiple risks. So we found this not just a check-the-box exercise, but a useful exercise for both the executive management and the board to fully understand our viability.

We've also beefed up the internal audit team. Our biggest issue with the internal audit team last year was keeping it up to its operating level of people. Our intent is to get good people into internal audit, and unfortunately good people get sucked out by the operations as they identify those good people. So we actually now on a regular basis review inside the audit committee whether they're on their target for their headcount, because we found that if the audit committee raises a question about the headcount, then it gets a little bit more activity than if it's just a guy in the room complaining about the number of people. We monitor the findings of internal audit every quarter, with a detailed review twice a year. We use dashboard metrics to understand the control deficiencies that we're identifying and, more importantly, how quickly we're closing those control deficiencies. We also once a year have a review of the effectiveness of the internal audit function.

On external audit, we've been very pleased with KPMG's performance. We're actually particularly encouraged by the work they're doing on the extended auditor's report, which goes well beyond minimum requirements, and actually in the breakout groups I'd be interested to hear whether you find it useful or not, because that would be something we could feedback to KPMG.

And Richard will be with me in the breakout group, so you can tell him to his face. The structure was actually a basis we use in the audit committee, so it's not new news to the audit committee, but I think the new news is that we're sort of publicising it a little bit better. And I think it's also helping us in our deliberate moves forward to improving the transparency of the business, so I've been very pleased with the work that KPMG has done on that.

And now on to the *bête noire*, the management information and forecasting process. We sort of did a little schematic, because it's very easy to say, 'What are the finance folks doing?' But actually, the real issue is we have to have integrated data starting from: what's going on in the market, what's going on in our internal operations, what are the risks and opportunities, and how do we feed those into a good forecast, and with appropriate risks and opportunities so we can start thinking about how we can give guidance in a more consistent and more valuable fashion to all of you? David – I've worked with David over the last 30 years off and on; David is very familiar with what good forecasting looks like. And since he's been CFO over the last 15 or 16 months, he's been working really hard to improve our management information system. But it's not just about financing; we've got to have this end-to-end data flow. And the one thing I'm very encouraged about: as we simplify the organisation, got rid of the sort of the divisional sector, we're seeing much more clarity of the data that feeds into our forecasting system.

And finally, let's just talk about forthcoming attractions. Obviously, we'll continue our assessment of accounting principles and judgements, and one of the things we have to make sure in 2016 is that the improved risk management process really is working adequately. Because there's no use having a lovely polished risk management process on the table, unless it's being used on a day-to-day basis. And we've already started doing that inside the company.

We will be tendering our audit this year. Our intension is to tender during the year, but we'll actually formally appoint the new auditor at the 2018 AGM, and their first audit will be the 2018 annual results. The reason for making the choice early, before appointing, is we really want the new auditor to have a chance to shadow KPMG as they go through 2017 to understand the complexities of our business, also to expunge any of the sort of prohibited services that those auditors may be providing us today, but can't provide when they're appointed as our auditor, and also to help us as we implement IFRS 15.

In 2016, we will be going through IFRS 15 in detail. It's a complicated issue. As I said in the annual report, we talk about the potential implications. We're not in the position to outline those for you in more detail yet, but as we go through the process and conclude how it will affect our contract accounting, David will be updating you during this year, I expect.

We'll also, in 2019, have to implement new leasing standards, although I think that will really just bring some of the – bring our operating leases on to the balance sheet. It won't change the way we actually operate. And then finally, we'll be monitoring the effects of the new management information and forecasting systems.

So in summary, I think we've made very good progress this year. I'm comfortable with our accounting policies and judgements, uncomfortable with our forecasting systems, we've got more work to do on that. And I'm encouraged by the progress we're making in our risk management processes. I'm dismayed by the amount of work I'm going to have to do on IFRS 15, frankly; we've got a full audit committee meeting all Friday morning to start our study of IFRS 15, after a lot of work the company has done with some outside help. So there is a lot of work, and I look forward to talking to you about that next year.

And with that, I'll introduce you to Dame Helen Alexander to talk about the remuneration committee.

Helen Alexander

Good morning everybody. It's good to have a chance once – occasionally perhaps, to talk about the governance of the committee rather than actually coming to each of you with specific proposals that we have to go through.

I'm going to first just show you, the committee, as the others have done: Ruth Cairnie, Frank Chapman, John McAdam, and Kevin Smith joined us in November, when he joined the board, which was a terrific addition.

So I'd like to cover, as we have on the other committees, some of the work that we've been doing. But I thought first, perhaps, we should just look at our terms of reference. And I'm not going to go through each of these in any detail, but I would like to have a word about the kinds of discussions we have, because I think it's probably fair to say that they are robust, they are thoughtful, and I would say that they're also very open. And we also have excellent new executive support from the rem team in the company, including Natasha Rice who is over there and will be joining me in the breakout sessions.

So if we move to the current policy, which many of you are very familiar with. It was approved in 2014 like many companies, or most companies, and covered the period, of course, from that date and will cover through to the AGM of 2017. The chart reminds you of what is frankly quite a normal structure, split between fixed elements and variable elements, and amongst the variable elements there are short-term goals with deferred payments in them, and awards with longer three-year goals as well.

And of course, the executives who are covered by this are Warren and David and the other executive board directors, but also we look at the senior team below that as well. Many of you have asked me in the past, how far down does this all go? And before you ask that question, I'll tell you that there are about 800 employees who come under the PSP scheme, and about 8,000 who are covered by the APRA scheme.

And in our case, in the remuneration committee, what have we been doing? We have done a number of things over the last year. John Rishton retired as CEO in July, and obviously, we had to deal with those arrangements, and his payments reflected entirely his statutory entitlement on retirement. And he didn't participate in any PSP awards last year. Another main board director, the US CEO Jim Guyette, also retired and was, of course, treated in the same way as John.

We've also looked during the year at agreeing the terms - not just looked at, but we've agreed the terms - for the then incoming CEO, Warren. We reviewed the executive base salaries, which saw some increases for those who are joining the executive leadership team for the first time. But other than that, other than those new appointments, there were no increases for 2016. The 2015 bonus, we also had a close look at. Nothing paid out because the targets hadn't been met. And the 2013 PSP scheme which would vest in 2016; again, no pay-out.

If I also just look at the background and some of the actions that we've been looking at in relation to the current situation: we have made some adjustments to the structure because of changing market conditions, which I've talked to many of you about, and the changing business strategy. I think it's important, though, here to reflect on why we have remuneration, what's its purpose. And I think here we would say it's to incentivise, it's to motivate, it's to retain and it's to attract people to the company. But we had no bonus paid in 2014 or 2015, as I've just said, on the annual scheme, and no PSP pay-out since 2012 is expected to reach the minimum threshold. We confirm, I've just said, that the 2013 scheme won't pay out, and it is frankly very unlikely indeed that the 2014 or 2015 schemes would pay.

You heard Warren talk a lot about transformation, and I think it's also true – and many of you will have lived this – that it's much harder to motivate people during a period of transformation because of everything that is going on. So we therefore proposed a revision to the 2016 bonus and the PSP plans, and come up with what we believe is an appropriate and responsible reflection of the current targets as set out in the slide here.

The proposals are within our mandate, and we wanted to ensure when we were putting this together that we had consulted widely. And in January, 75% of the register got a letter from me and some people asked to have a conversation and to have a meeting, which we did. The messages during those meetings were, I think – I hope – very clear. We had the background that you've heard of quite a lot now about the challenging times that we have in front of us, a new CEO and a need to incentivise.

Importantly, I think it's worth saying that we were not – and this is to avoid any doubt at all – not proposing any retrospective change, and nor in fact were we proposing any change to the fundamental structure of CPS and TSR being the underlying measures. What we were looking at specifically was the underpin, the EPS hurdle, just for 2016. Because at the moment, if there'd been no adjustment whatsoever, it would be an unachievable stretch. So again, no annual bonus, no PSP, and we felt that that was in itself just not appropriate. Giving somebody a long-term scheme that you know isn't going to pay out is almost worse than not giving it to them at all.

So what we looked at was moving the base year from 2015 to 2016. We did look at a number of other options, but felt that this was the one that actually created the right balance. And it is frankly all about getting the balance right here, as in many of our decisions. And I would remind everybody, of course, that this is a scheme that won't pay out, if it pays out, until 2019, and all the other hurdles have to be met.

In order to do this, we were also mindful of other elements here, and made sure that we have reduced the reward value in the case of the CEO from 180% to 150%. We showed you all some work on the proposed targets and the maximum level we talked about at the time was 40 pence, but we've actually made that further stretch at 50 pence. And I think that in the current context, you will agree that those are reasonably stretching. We also wanted to make sure that some of the things that Warren has talked to you about were reflected in the remuneration this year, and things specifically around operation excellence and people, and so those non-financial measures but quantifiable ones have been included.

Feedback from many of you and others in your firms was very supportive, and most people understanding this as a sensible proposal, I think. One shareholder who we spoke to wasn't happy about any kind of change to any element of the policy at all until 2017, it's worth mentioning. We're not going into detail here, but of course anything that you'd like to discuss in the breakout session, or indeed before the AGM, we're happy to help.

Now, looking forward, like many companies we are due to review the policy and we'll do so for the 2017 AGM. We're already embarked on that review, and it has to do with a number of things. It has to reflect the changes in the remuneration environment, generally. And I think, above all, it not only has to take into account views of shareholders, but reflect the needs of the business. And we've got something of a unique opportunity. As Warren starts to develop and shows the kinds of plans he has and hopes and targets and goals for the next few years, we have an opportunity to tie that in very neatly, and not every remuneration has that privilege.

Now, it is all going to be handled by Ruth Cairnie who's going to take over as my successor as Chair of the committee after I step down at the end of my term at the AGM. Thank you.

But Ruth, a few words.

Ruth Cairnie

Thank you very much, Helen. Good morning. So this is going to be very brief, literally just a few words at this stage. But let me start by saying I'm very, very pleased to have been invited to take over as Chair of the Remuneration Committee. And Helen, I'd like to just acknowledge the excellent leadership that you've provided to the committee over your tenure.

As Helen has said, and as I think we heard very strongly from Warren, this is a very interesting and important time in Rolls-Royce's recent past. When we look at the significant shift in business profile that's underway, we also have the new leadership team and the transformation process in hand. And so this really is a fantastic opportunity, when we're reviewing our remuneration, to build and ensure we have that very strong linkage between remuneration and the business strategy and priorities, and that is what we will be very much aiming to do.

Now, Helen has said that the review of remuneration policy is underway. It would be very premature for me to talk about it now, so that is really not the focus for this session today. And what I will say is that, unsurprisingly, in the review we're looking broadly at all elements of our remuneration, from assumptions and pay positioning to the elements we include, the measures, holding periods, everything. So exactly as you would expect. And I will very much be looking forward when we've taken our work a bit further to be engaging with you. I want to look broadly, I want to get a lot of different inputs into our work. And as said, that will be leading to the proposal for the new remuneration policy which will be coming to the AGM next year.

So I think at this stage that's enough for me. And Ian, I'll hand it back I think to you.

Ian Davis

Okay. Well, all I'm going to do is to just say now is that hopefully this has given you a flavour of where we're at as a board, and I appreciate it can only just be a flavour. But what we want to do now is to go into breakout sessions. This is an innovation, and we hope it works, and we hope it allows a chance of focused discussion.

Each of you has been assigned different colours, so you will go to a room and we will come to you. So rather than you come to us, we will come to you. So red room will start off by talking about audit, yellow rem, and blue room nomination government and other. Take the questions, 20 minutes each. We will then rotate around.

For those of you that wish to come back, all the directors and myself will be available after it for 20 minutes but otherwise, just slip away when you finish that. But we will be available. And I do just want to reaffirm that if you don't get satisfaction or you're unclear, you're unsatisfied at this meeting, just call us. We'd like to engage with you. So if we don't get to what you want to discuss with us or express your point of view, don't feel it stops here. We do want to have an ongoing dialogue. As I said, we think the whole governance aspect of investment is really, really important and we would welcome that.

Grab a coffee, get into the rooms and chat to each other, and we will come and join you.