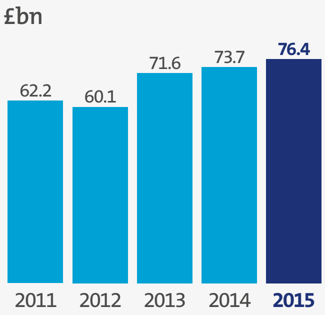
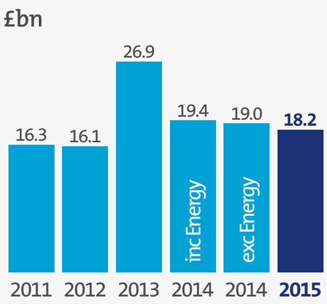
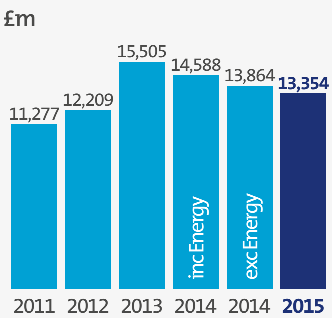
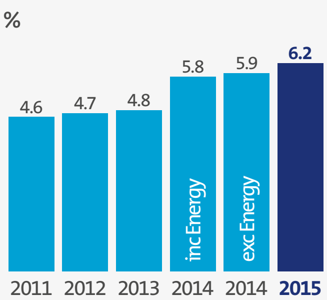
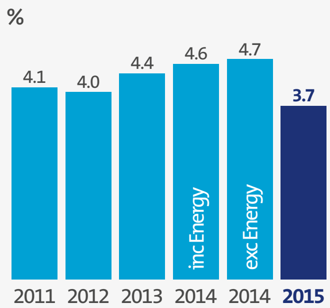
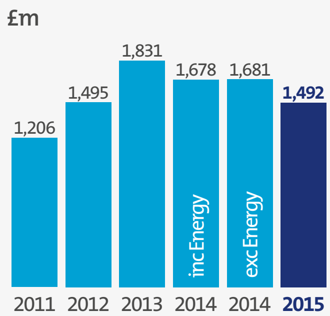
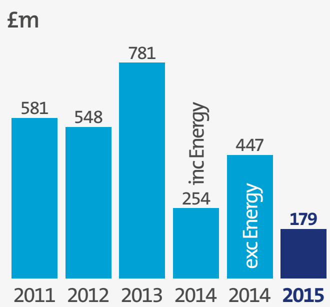
KEY PERFORMANCE INDICATORS

Financial performance indicators are shown below. The areas of focus of the Board and its committees are described on pages 63 to 104, and other non-financial performance indicators are shown in the Sustainability section on pages 50 and 51.

Description	Why we measure it	How we have performed	
Order book **+4%**	The order book provides an indicator of future business. We measure it at constant exchange rates and list prices and include both firm and announced orders. In Civil Aerospace, it is common for a customer to take options for future orders in addition to firm orders placed. Such options are excluded from the order book. In Defence Aerospace, long-term programmes are often ordered for only one year at a time. In such circumstances, even though there may be no alternative engine choice available to the customer, only the contracted business is included in the order book. Conservatively, we only include the first seven years' revenue of long-term aftermarket contracts.	The order book grew by £2.7bn. An increase of £3.8bn in Civil Aerospace was offset by a reduction of £0.4bn in Marine, reflecting the current weak market conditions.	
Order intake **-4%**	Order intake is a measure of new business secured during the year and represents new firm orders, adjusted for the movement in the announced order book between the start and end of the period. Any orders which were recorded in previous periods and which are subsequently cancelled, reducing the order book, are included as a reduction to intake. We measure order intake at constant exchange rates and list prices and, consistent with the order book policy of recording the first seven years' revenue of long-term aftermarket contracts, include the addition of the following year of revenue on long-term aftermarket contracts.	An increase of £0.9bn in Civil Aerospace order intake was offset by weaker intake in Defence Aerospace and Marine.	
Underlying revenue **-4%** -1% excluding FX	Monitoring of revenue provides a measure of business growth. Underlying revenue is used as it reflects the impact of our FX hedging policy by valuing foreign currency revenue at the actual exchange rates achieved as a result of settling FX contracts. This provides a clearer measure of the year-on-year trend.	The reduction reflects a 9% reduction in OE revenue, offset by a 3% increase in services revenue. Marine revenue fell by 23%, reflecting the weak market conditions.	
Net R&D expenditure as a proportion of underlying revenue **6.2%**	This measure reflects the need to generate current returns as well as to invest for the future. We measure R&D as the self-funded expenditure before both amounts capitalised in the year and amortisation of previously-capitalised balances. We expect to spend approximately 5% of underlying revenues on R&D although this proportion will fluctuate depending on the stage of development of current programmes. We expect this proportion will reduce modestly over the medium term.	The increase is largely due to changes in net capitalisation, reflecting the phasing of new Civil Aerospace programmes, in particular the Trent XWB-84 and the Trent 1000 TEN.	

Description	Why we measure it	How we have performed	
Capital expenditure as a proportion of underlying revenue **3.7%**	To deliver on its commitments to customers, the Group invests significant amounts in its infrastructure. All proposed investments are subject to rigorous review to ensure that they are consistent with forecast activity and will provide value for money. We measure annual capital expenditure as the cost of property, plant and equipment acquired during the period and, over the medium term, expect a proportion of around 4%.	Expenditure reduced to £494m (2014: £668m) principally reflecting the major investment in Civil Aerospace facilities nearing completion.	
Underlying profit before financing **-11%**	We measure underlying profit before financing on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements. In particular: (a) revenues and costs denominated in US dollars and euros are presented on the basis of the exchange rates achieved during the year; (b) similar adjustments are made in respect of commodity derivatives; and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis.	The reduction reflects the reduction in revenues and the Group's high level of fixed costs, which the transformation programme is addressing.	
Free cash flow **£179m**	In a business requiring significant investment, we monitor cash flow to ensure that profitability is converted into cash generation, both for future investment and as a return to shareholders. We measure free cash flow as the movement in net funds/debt during the year, before movements arising from payments to shareholders, acquisitions and disposals, and FX.	The reduction reflects the lower profits and the utilisation of provisions.	

Average cash is no longer being monitored as a key performance indicator, as the focus is now on the free cash flow.

Non-financial KPIs

As we undertake significant restructuring, reorganisation and transformation, it is imperative that we do not lose focus on our customers, and that we ensure our employees are fully engaged in the transformation. So for 2016, we are introducing two non-financial measures to the Annual Performance Related Award relating to customers and employees. In line with our remuneration policy, financial performance will still be required for any payout, as the non-financial measures will be subject to achieving a profit before taxation threshold.

Description	How performance is measured
Customer satisfaction	This is measured by the percentage of 'on-time to purchase order' and includes measures for new equipment, spare parts, equipment repair and overhaul. This is tracked Group-wide in our scheduling and order fulfilment system.
Employee engagement	This is measured through our Employee Opinion Survey which produces a composite engagement score. The targets will be based on absolute scores.

REMUNERATION COMMITTEE REPORT P74

PRINCIPAL RISKS

Risk management

Risk management is built into our daily activities and is an integral part of how we work: from our engineering design, through to engine production, servicing and how we run our operations.

The Board is responsible for the Group's risk management and internal control system and reviewing its effectiveness. The system is designed to identify and manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss. More information about our internal control system can be found in the Audit Committee report on page 95.

Our risk management system (RMS) helps us make better decisions and to deal with problems if they occur. It is implemented through: a Group-wide framework mandated in the Group risk management policy; a network of trained risk management facilitators; and a software tool.

In 2015, we performed a comprehensive review of our RMS and are implementing a programme of work to enhance our RMS which will continue to be embedded throughout 2016. This activity is sponsored by the General Counsel and Chief Financial Officer and is regularly reviewed by the Audit Committee. The enhancements touch all areas of our RMS including: categorisation, governance, operating model, reporting and infrastructure.

Our RMS is designed so that principal risks can be identified from multiple sources. Key bottom-up risks are identified by businesses and functions and the detail of risks that meet the Group threshold are subject to review and challenge by the Executive Leadership Team (ELT) and the Board during their risk reviews. This includes monitoring the status of mitigation actions, adequacy of controls and any incidents that have occurred since the last review. Risks are also captured during the strategy and business planning activities to inform the development of the principal risks.

The Board, assisted by the ELT, has carried out a robust assessment of, and reviewed our appetite for, the principal risks facing the Group. These include those that threaten the business model, future performance, solvency and liquidity. These reviews have been complemented by financial scenario modelling of our principal risks which is also used to support our viability statement on page 57.

The Board, or the most appropriate Board committee, undertakes periodic in-depth reviews of our principal risks in which it assesses our material controls and the effectiveness of our risk management and mitigation activities.

Business units and functions are accountable for identifying and managing risk in line with the Group risk management policy. Business continuity plans are in place to mitigate continuity risks.

The Group's enterprise risk team, led by the Director of Risk, is responsible for disseminating risk policy and processes and co-ordinating the effective operation of the RMS. Progress of actions to mitigate risks and the adequacy of risk controls are also now regularly reviewed by the sector audit committees.

Joint ventures constitute an increasingly large part of the Group's activities. Responsibility for risk and internal control in joint ventures lies with the managers of those operations. We seek to exert influence over such joint ventures through board representation. Management and internal audit regularly review the activities of these joint ventures.

The Board is aware that the effectiveness of risk management is highly dependent on behaviours, as a good process does not automatically lead to a good outcome. Our ethics and compliance improvement programme, aimed at securing compliance with our ethical standards, and the Global Code of Conduct are reinforcing the values and behaviours required, which in turn will continue to strengthen our risk management culture.

Principal risks

During the year, the Board and ELT focused on the principal risks and the actions and controls in place to manage them.

This involved: discussing changes to the risks; reviewing the risk indicators for principal risks; and hearing from management about how risks will be managed.

This ongoing review of risks has resulted in a further principal risk being added this year: talent and capability. This risk has been added to reflect the significant transformation agenda ahead and our future growth requirements and plans.

Management of principal risks

Our risk framework ensures that risks are identified, managed and communicated at every level of the Group.

Risk or uncertainty and potential impact	How we manage it	Strategic priorities
Product failure Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.	• Embedding and operating a safety-first culture. • Applying our engineering design and validation process from initial design through production and into service. • The Safety & Ethics Committee reviewing the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards (see Safety & Ethics Committee report on page 99). • Operating a safety management system (SMS), governed by the product safety review board, and subject to continual improvement based on experience and industry best practice. Product safety training is an integral part of our SMS. (see Safety & Ethics Committee report on page 100 for details of the SMS). • Improving our supply chain quality. • Crisis management team jointly chaired by the Group President and the General Counsel. **This principal risk is subject to review by the Safety & Ethics Committee.**	1 2 3
Business continuity Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results.	• Continued investment in adequate capacity and modern equipment and facilities. • Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and our people skills. • Selecting and developing stronger suppliers. • Developing dual sources or dual capability. • Developing and testing incident management and business continuity plans. • Crisis management team jointly chaired by the Group President and the General Counsel. • Customer excellence centres providing improved response to supply chain disruption. **This principal risk is subject to review by the Audit Committee.**	2 3
Competitive position The presence of large, financially strong competitors in the majority of our markets means that the Group is susceptible to significant price pressure for original equipment or services, even where our markets are mature, or the competitors are few. Our main competitors have access to significant government funding programmes, as well as the ability to invest heavily in technology and industrial capability.	• Accessing and developing key technologies and service offerings which differentiate us competitively (see Engineering and innovation on page 18). • Focusing on being responsive to our customers and improving the quality, delivery and reliability of our products and services. • Partnering with others effectively. • Driving down cost and improving margins (see Chief Executive's review on page 12). • Protecting credit lines. • Investing in innovation, manufacturing and production, and continuing governance of technology programmes (see Engineering and innovation on page 18 and Science & Technology Committee report on page 103). • Maintaining a strong balance sheet to enable access to cost-effective sources of third-party funding. • Understanding our competitors. **This principal risk is subject to review by the Board.**	1 2 3
Political risk Geopolitical factors that lead to an unfavourable business climate and significant tensions between major trading parties or blocs which could impact the Group's operations. For example: explicit trade protectionism, differing tax or regulatory regimes, potential for conflict, or broader political issues.	• Where possible, locating our facilities and supply chain in countries with a low level of political risk and/or ensuring that we maintain dual capability. • Diversifying global operations to avoid excessive concentration of risks in particular areas. • The international network of Rolls-Royce and its business units proactively monitoring local situations. • Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base (see Chief Executive's review on page 8). • Proactively influencing regulation where it affects us. **This principal risk is subject to review by the Board.**	2
Major programme delivery Failure to deliver a major programme on time, within budget, to specification, or technical performance falling significantly short of customer expectations, or not delivering the planned business benefits, would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation.	• Major programmes are subject to Board approval (see Additional financial information on page 176). • Reviewing major programmes at levels and frequencies appropriate to their criticality and performance, against key financial and non-financial deliverables and potential risks throughout the programme's life cycle (see Additional financial information on page 176). • Conducting technical audits at pre-defined points which are performed by a team that is independent from the programme. • Requiring programmes to address the actions arising from reviews and audits and monitoring and controlling progress through to closure. • Applying knowledge management principles to provide benefit to current and future programmes. **This principal risk is subject to review by the Board.**	1 2

1 Engineering excellence 2 Operational excellence 3 Capturing aftermarket value

PRINCIPAL RISKS CONTINUED

Risk or uncertainty and potential impact	How we manage it	Strategic priorities
Compliance Non-compliance by the Group with legislation or other regulatory requirements in the regulated environment in which it operates (eg. export controls; offset; use of controlled chemicals and substances; and anti-bribery and corruption legislation) compromising our ability to conduct business in certain jurisdictions and exposing the Group to potential reputational damage, financial penalties, debarment from government contracts for a period of time, and/or suspension of export privileges or export credit financing, any of which could have a material adverse effect.	• Taking an uncompromising approach to compliance. • Operating an extensive compliance programme. This programme and the Global Code of Conduct are disseminated throughout the Group and are updated from time to time to ensure their continued relevance, and to ensure that they are complied with, both in spirit and to the letter. The Global Code of Conduct and the Group's compliance programme are supported by appropriate training (see Safety & Ethics Committee report on page 102). • Strengthening of the ethics, anti-bribery and corruption, compliance and export control teams. • A legal team is in place to manage any ongoing regulatory investigations. • Implementing a comprehensive REACH compliance programme. This includes establishing appropriate data systems and processes, working with our suppliers, customers and trade associations and conducting research on alternative materials. **This principal risk is subject to review by the Safety & Ethics Committee.**	2
Market and financial shock The Group is exposed to a number of market risks, some of which are of a macro-economic nature (eg. foreign currency, oil price, exchange rates) and some of which are more specific to the Group (eg. liquidity and credit risks, reduction in air travel or disruption to other customer operations). Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness. This would affect operational results or the outcomes of financial transactions.	• Maintaining a strong balance sheet, through managing cash balances and debt levels (see Financial review on page 42). • Providing financial flexibility by maintaining high levels of liquidity and an investment grade credit rating. • Sustaining a balanced portfolio through earning revenue both from the sale of original equipment and aftermarket services, providing a broad product range and addressing diverse markets that have differing business cycles (see Chief Executive's review on page 8). • Deciding where and what currencies to source in, and where and how much credit risk is extended or taken. The Group has a number of treasury policies that are designed to hedge residual risks using financial derivatives (foreign exchange, interest rates and commodity price risk). **This principal risk is subject to review by the Audit Committee.**	2 3
IT vulnerability Breach of IT security causing controlled or critical data to be lost, made inaccessible, corrupted or accessed by unauthorised users.	• Implementing 'defence in depth' through deployment of multiple layers of software and processes including web gateways, filtering, firewalls, intrusion, advanced persistent threat detectors and integrated reporting (see Audit Committee report on page 95). • Running security and network operations centres. • Actively sharing IT security information through industry, government and security forums. **This principal risk is subject to review by the Audit Committee.**	1 2
Talent and capability Inability to attract and retain the critical capabilities and skills needed in sufficient numbers and to effectively organise, deploy and incentivise our people to deliver our strategy, business plan and projects.	• Attracting, rewarding and retaining the right people with the right skills globally in a planned and targeted way, including regular benchmarking of remuneration. • Developing and enhancing organisational, leadership, technical and functional capability to deliver global programmes. • Continuing a strong focus on individual development and succession planning. • Proactively monitoring retirement in key areas and actively managing the development and career paths of our people with a special focus on employees with the highest potential. • Embedding a lean, agile high performance culture that tightly aligns Group strategy with individual and team objectives. • Retaining, incentivising and effectively deploying the critical capabilities, skills and people needed to deliver our strategic priorities, plans and projects whilst implementing the Group's major programme to transform its business, to be resilient and to act with pace and simplicity. • Tracking engagement through our annual employee opinion survey and a commitment to drive year-on-year improvement to the employee experience and communications (see Sustainability on page 50). **This principal risk is subject to review by the Nominations & Governance Committee.**	1 2 3

1 Engineering excellence 2 Operational excellence 3 Capturing aftermarket value