News Release

Rolls-Royce

Trusted to deliver excellence

14 February 2017

ROLLS-ROYCE HOLDINGS PLC
2016 FULL YEAR RESULTS

Commenting on the results, Warren East, Chief Executive, said: *"2016 has been an important year as we accelerated the transformation of Rolls-Royce. Despite the significant market and aerospace product transition challenges identified in 2015, we have made operational progress and performed ahead of our expectations for the year as a whole. At the same time we have delivered major changes to our management and processes and, while we have made good progress in our cost cutting and efficiency programmes, more needs to be done to ensure we drive sustainable margin improvements within the business."*

	Reported			Underlying		
Year to 31 December	**2016**	2015	Change	**2016**	2015	Change*
Revenue (£m)	**14,955**	13,725	+9%	**13,783**	13,354	-2%
Profit before tax (£m)	**(4,636)**	160	N/A	**813**	1,432	-49%
Earnings per share	**(220.1)p**	4.5p	N/A	**30.1p**	58.7p	-54%

	2016	2015	Change**
Net debt (£m)	**(225)**	(111)	(114)
Free cash flow (£m)* **	**100**	179	(79)

Underlying: for definition see note 2 on page 35; * translated at constant exchange rates; ** translated at actual exchange rates; *** free cash flow defined as operating cash after capital expenditure, pensions and taxes, before payments to shareholders, foreign exchange and acquisitions & disposals. The derivation of free cash flow from the cash flow statement is shown on page 27.

Highlights

- Reported revenue up 9%
- Reported loss reflects a non-cash impact of £4.4bn period-end mark-to-market revaluation of our derivatives and a £0.7bn charge for financial penalties from agreements with investigating bodies
- Underlying revenue down 2% at constant exchange rates, reflecting weakness in Marine
- Underlying profit before tax down 49% at constant exchange rates
- Good free cash flow performance; led by working capital improvements
- Final payment to shareholders maintained at 7.1 pence per share in line with changes announced in February 2015 giving a full year dividend of 11.7 pence (2015 full year: 16.4 pence)

Transformation programme

- Well underway; over £60m incremental in-year savings in 2016; £80-110m further in-year benefit expected in 2017
- On track for ~£200m annualised run rate by end 2017

Looking forward

- Outlook for 2017: modest performance improvements, targeting free cash flow to be similar to 2016
- Completion of ITP acquisition expected mid-2017

Warren East added: *"As I set out in November last year, it is now time to look further ahead. With my new team in place, our focus is turning towards the Group's long-term goals. Over the next few months we will conclude our review of our strengths and investment opportunities and set out an appropriate vision for the business and the best way we can deliver sustainable shareholder value."*

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"In the meantime, we will continue to focus on our key milestones. In Civil Aerospace, we need to introduce our new Trent engines and successfully deliver the ramp up in engine production. At the same time we must ensure our wide ranging business transformation programme delivers the full benefits expected, not only in terms of cost savings but also the cultural and behavioural changes necessary to ensure the transformation is sustained and high standards of business conduct are maintained. These are essential if we are to become a more trusted, resilient company."

This announcement has been determined to contain inside information.

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Photographs and broadcast-standard video are available at www.rolls-royce.com.
A PDF copy of this report can be downloaded from www.rolls-royce.com/investors.

This Full Year Results Announcement contains forward-looking statements. Any statements that express forecasts, expectations and projections are not guarantees of future performance and will not be updated. By their nature, these statements involve risk and uncertainty, and a number of factors could cause material differences to the actual results or developments. This report is intended to provide information to shareholders, is not designed to be relied upon by any other party, or for any other purpose and the Company and its directors accept no liability to any other person other than under English law.

Results Presentation

A presentation will be held at 09:00 (GMT) today. Details of how to join the event online are provided below. Downloadable materials will be available on the Rolls-Royce website from the start of the event.

Online webcast registration details for 14 February presentation
To register for the live webcast (including Q&A participation) please visit this link:

http://edge.media-server.com/m/p/bn5bprbe

Please use this same link to access the webcast replay after the event.

2016 Business Highlights

Percentage or absolute change figures in this document are on a constant translational currency ('constant currency') basis unless otherwise stated

2016 results	% of Group revenues*	Closing order book £bn	Underlying revenue £m	Underlying revenue % change	Underlying profit before financing £m	Underlying profit before financing % change
Civil Aerospace	*51%*	71.4	7,067	*0%*	367	*-60%*
Defence Aerospace	*16%*	3.9	2,209	*1%*	384	*-8%*
Power Systems	*19%*	1.8	2,655	*-1%*	191	*-14%*
Marine	*8%*	0.9	1,114	*-24%*	(27)	*-280%*
Nuclear	*6%*	1.8	777	*11%*	45	*-37%*
Other		-	37	*-64%*	(1)	
Eliminations/central			(76)	*-36%*	(44)	
Total Group		**79.8**	**13,783**	***-2%***	**915**	***-45%***

* *Based on gross revenues prior to intra-group eliminations*

Civil Aerospace

- Underlying revenue unchanged; gross margins lower:
  - Original equipment (OE): increased deliveries of newer Trent engines but lower link-accounted Trent 700 and business aviation sales reduced achieved margins
  - Services: growth from in-production large engine fleet, but declining regional and older large engine fleet aftermarket revenues; increase in technical costs for large engines, including the Trent 700 and Trent 900, largely mitigated by foreign exchange benefits
- £4.4bn order book growth; includes £2.1bn benefit from long-term US dollar planning rate change
- New programmes: Trent 1000 TEN received EASA certification in July; first test run of new Ultrafan™ gearbox; first flight of the Airbus A350-1000 powered by the Trent XWB-97
- Supply chain modernisation reducing costs and increasing capacity for Trent XWB ramp up
- 2017 outlook: modest growth in revenue and profit; cost improvements offsetting OE and aftermarket mix effects

Defence Aerospace

- Underlying revenue up slightly; modest growth in OE
- Underlying profit before financing down 8%; reflecting adverse product mix and costs related to the TP400 programme, partially offset by through-life cost-savings on a major EJ200 contract
- Investing to enhance manufacturing, aftermarket service and closer proximity to core customers
- 2017 outlook: revenue steady; margin and profit expected to soften from recent levels

Power Systems

- Underlying revenue 1% lower; growth in power generation and industrial markets offset by reduction in commodity and oil price driven sales
- Underlying profit before financing 14% lower; volume reduction and adverse product mix
- Good start to transformation with new leadership in place to drive further performance improvement
- 2017 outlook: steady; healthy order book in key segments offsetting some challenging markets

Marine

- Underlying revenue down 24%; weak offshore markets impacting both OE and service revenues
- Underlying profit before financing negative; lower volumes and reduced overhead absorption
- Net restructuring benefits from current and legacy programmes starting to improve performance
- £200m impairment of goodwill reflecting a more cautious outlook; further weakness in offshore oil and gas markets offset by ongoing cost improvements as we refocus the business

Nuclear

- Underlying revenue 11% higher; strong revenues led by increased submarine work
- Underlying profit before financing 37% lower; adverse margin mix in submarine projects, lower R&D credit than 2015 and R&D spend on small modular reactor concept development
- 2017 outlook: focus on further delivery improvements and investing to address future opportunities

Chief Executive's Review

Introduction

2016 has been an important year as we accelerated the transformation of Rolls-Royce. Overall, we have performed ahead of our expectations for the year as a whole while delivering significant changes to our management and processes. We increased our large engine output by over 15%, supported the needs of our customers, and made good technical progress in the final stages of the development of the three new large engines, due to enter service over the next twelve months. At the same time we have improved manufacturing lead times for our key civil aerospace programmes, an important goal as we ramp up production over the next few years. Progress with our transformation programme was also better than expected, delivering over £60m of in-year benefits compared to our initial target of between £30-50m. Overall, the performance improvements have helped offset a number of changing trading conditions and higher R&D spend.

Performance in 2016

In 2015 we identified a number of significant headwinds that would hold back performance in 2016, including mixed market conditions and the revenue and cost impacts of some key product transitions.

Looking first at our markets, demand for our large civil aerospace products and services remained robust, despite some specific weaknesses for service demand in respect of older engines. At the same time, demand for new corporate jets softened, as did the aftermarket for the regional jets powered by our AE3007 engines. Defence Aerospace markets held up well with a steady demand for our aftermarket services in particular. Offshore oil and gas markets for our Marine business continued to suffer from the consequences of low oil prices. Alongside weaker industrial demand this also impacted Power Systems.

Other known headwinds transpired broadly as expected, led by lower Trent 700 volumes and prices, legacy civil large engine aftermarket reductions and weakness in Marine markets. At the same time we have continued to invest in products and services to support our customers and reinforce the long-term strength of our order book, valued at the end of the year at around £80bn.

Against this backdrop, group underlying **revenue** reduced 2% on a constant currency basis with reductions in both original equipment and aftermarket revenues, led by the Marine businesses where revenues were down 24%. More details are included in the group trading summary and the individual business reviews.

Compared to 2015, underlying profit before finance charges and tax was 45% lower at £915m. On this basis, Civil Aerospace delivered £367m (2015: £812m); Defence Aerospace delivered £384m (2015: £393m); Power Systems delivered £191m (2015: £194m); Marine generated a loss of £27m (2015: £15m profit) and Nuclear delivered £45m (2015: £51m excluding the £19m R&D credit benefits highlighted in 2015). More detail on each business is included in the Operational Review.

After underlying financing costs of £102m (2015: £60m including a £34m gain from hedging overseas dividends), underlying profit before tax was £813m (2015: £1,432m).

Since the EU referendum vote at the end of June, the value of sterling relative to the US dollar has fallen significantly. As a result, we have recognised a £4.4bn in-year non-cash mark-to-market valuation adjustment for our currency hedge book as part of our reported financing costs of £(4,677)m (2015: £(1,341)m). While reported revenue of £14,955m (2015: £13,725m) was unaffected by this adjustment, it impacted reported profit. In addition, our reported results also included a £671m charge for financial penalties from agreements with investigating authorities in connection with historic bribery and corruption involving intermediaries in a number of overseas markets. Our reported loss before tax was £(4,636)m (2015: £160m profit).

After an underlying tax charge of £261m (2015: £351m), underlying profit after tax for the year was £552m (2015: £1,081m). With an average 1,832m shares in issue, underlying earnings per share were 30.1p (2015: 58.7p).

After a reported tax credit of £604m (2015: £76m charge), the reported loss for the year was £(4,032)m (2015: £84m profit). Reported earnings per share were (220.1)p (2015: +4.5p).

A full reconciliation of underlying to reported profit can be found in note 2 on page 35.

Free cash inflow in the year was £100m (2015: inflow of £179m), better than expected, reflecting strong cash collections from a number of key customers at the very end of the period and an improvement in

underlying working capital performance. While some of this positive variance is a timing impact and likely to reverse early in 2017, improved efficiencies should drive a level of sustainable benefit. For more details see the section on technical guidance.

A more detailed review of financial performance is included in the Group Trading Summary and the Financial Review.

Agreement reached with various investigating authorities

In mid-January 2017 we announced that we had entered into Deferred Prosecution Agreements (DPAs) with the UK's Serious Fraud Office (SFO) and the US Department of Justice (DoJ) and completed a Leniency Agreement with Brazil's Ministério Público Federal (MPF). These agreements relate to bribery and corruption involving intermediaries in a number of overseas markets, concerns about which we passed to the SFO from 2012 onwards following a request from the SFO.

The agreements are voluntary and result in the suspension of prosecution provided that the company fulfils certain requirements, including the payment of a financial penalty. The agreements will result in the total payment of around £671m. This is recognised within our 2016 accounts.

Under the terms of the DPA with the SFO, we agreed to pay £497m plus interest under a schedule lasting up to five years, plus a £13m payment in respect of the SFO's costs. We also agreed to make payments to the DoJ totalling around US$170m and to the MPF totalling around US$26m. As a result, the total payment in 2017 is expected to be £293m (at prevailing exchange rates) with some elements having already been paid.

Payment schedule	SFO	DoJ	MPF	Total
2017	£119m* +£13m	US$170m	US$26m	£293m*
2019	£100m*			£100m*
2020	£130m*			£130m*
2021	£148m*			£148m*

* plus interest

It is our intention that these financial penalties will be paid from existing facilities and an improved underlying cash flow performance in the longer-term.

Our focus on clear priorities for 2016 has helped deliver positive outcomes

Our 2016 priorities were threefold: to strengthen our focus on engineering, operational and aftermarket excellence to drive long-term profitable growth; to deliver a strong start to our transformation programme; and to start rebuilding trust and confidence in our long-term growth prospects.

Increased our focus on engineering, operational and aftermarket excellence

Over the last few years we have invested significantly in new product development and manufacturing capabilities. In **engineering**, in 2016 we invested over £1.3bn in gross R&D. The net investment of £937m was higher than 2015 and our expectations for 2016. A large proportion of this was focused on Civil Aerospace to support delivery of three new engine programmes which will enter service over the next twelve months; the Trent 1000 TEN, the Trent XWB-97 and the Trent 7000. Supporting these investments was a group-wide engineering efficiency programme, known internally as E^3, which has formed part of our overarching transformation programme. Within the engineering team, this change programme has focused on delivering a lean, resilient, lower cost engineering function through reducing complexity, improving work prioritisation and simplifying management structures.

In **operations**, over £1.4bn has been invested in new capital equipment since 2011 (£225m in 2016) in transforming our manufacturing footprint across the business. In Civil Aerospace, these investments in state-of-the-art manufacturing facilities will enable us to meet the significant growth in engine deliveries required to match customer demand for our new Trent engines, particularly the Trent 1000, Trent XWB and Trent 7000. At the same time, the investments lower unit costs and reduce the net cash outflows related to engine production. In Defence, the investments have focused on modernisation of facilities such as in Indianapolis to reduce costs and improve delivery performance of both original equipment and spares to support higher standards of customer service. In Marine, new facilities will contribute to a more efficient and

scalable manufacturing capability that will address the demands of our customers today, while markets are weak, and tomorrow, when they have recovered.

The benefits of these investments is starting to be seen in improved delivery performance, lower assembly lead times, lower unit costs and increased capacity. For example, in Civil Aerospace, large engine deliveries increased by over 15% to over 355 and capacity is now in place to deliver around 500 engines in 2017; an increase of over a third.

The focus on improving **aftermarket** excellence has been driven business by business by customer needs as well as through the broader transformation activities. In Civil Aerospace for example, this has resulted in a progressive change to the structure of our engine overhaul services, our commercial TotalCare® and time and materials product offerings and management structures. These have enabled us to respond to a changing market and maturing installed engine portfolio by adapting our resources to focus on areas of greatest value to the company and our customers – such as supporting airframe transitions and rolling out SelectCare™ and TotalCare® Flex offerings and preparing for the launch of LessorCare™. In Defence Aerospace, the focus has been driven by the customer need for more embedded support. This has included increasing our service presence at key customer facilities in the UK and overseas, improving response time and resolving a greater proportion of issues on-wing.

Transformation programme ahead of expectations

In November 2015, we announced a major transformation programme focused on simplifying the organisation, streamlining senior management, reducing fixed costs and adding greater pace and accountability to decision making. The initial target was to deliver incremental gross cost savings of between £150m and £200m per annum, with the full benefits accruing from the end of 2017 onwards.

Against these initial objectives, which included a target of delivering in-year savings of £30-50m in 2016, we have made a better than expected start. 2016 in-year savings were above target, at over £60m. During the year we also identified significant opportunities to drive good sustainable cost savings from the business. As a result, we expect the in-year savings that can be delivered in 2017 to be between £80-£110m and we are on track to achieve the top end of the target for the programme as a whole, targeting a run rate of over £200m by end 2017.

At the same time other restructuring initiatives have delivered their expected benefits. These included programmes to improve operational efficiency in Civil and Defence Aerospace (announced in 2014) and Marine (announced in May 2015), as well as a back office cost saving programme in Marine (announced in October 2015). In December 2016, an additional reorganisation of the Marine business was announced to further rationalise manufacturing activities in Scandinavia, targeting incremental annualised savings of £50m from mid-2017. Reflecting our cautious near-term outlook for the Marine business, we have also taken an exceptional charge of around £200m for impairment of goodwill, principally associated with the acquisition of Vickers in 1999.

In summary, expected ongoing benefits of all current restructuring programmes initiated since 2014 will reduce costs by around £400m by the end of 2018, compared to a 2014 baseline

In aggregate, ongoing divisional restructuring programmes together with the new programme announced in November 2015 are expected to reduce costs by around £400m by the end of 2018, including the full benefit of the Marine restructuring announced in December 2016. The cost reduction breaks down into incremental legacy Civil and Defence Aerospace restructuring savings of £80m, Marine savings of now around £110m and the transformation programme savings of around £200m.

Rebuilding trust and confidence; steady year with few major surprises

2016 out-turned ahead of expectations with only a few unexpected developments from an operational perspective, despite the challenges presented by a changing macro-environment and some known weaknesses in the business. The expected headwinds in Civil Aerospace and Marine transpired largely as forecast. In addition, the benefits of outperformance on transformation savings and foreign exchange hedging more than offset some additional programme costs in Civil Aerospace and a range of other smaller one-off items. As a result, external expectations remained largely unchanged throughout the year.

The introduction of the new revenue reporting standard, IFRS15 *Revenue from Contracts with Customers*, will have a significant impact on how we present our revenues and profits, particularly for Civil Aerospace. As a result, a combination of significant in-house analysis and appropriate progressive communication was undertaken, culminating in a Capital Markets Day in November. This set out in some detail how we now

expect the new standard to change the presentation of our financial results, illustrated through a re-presentation of 2015 performance. All the materials from this investor event were shared at the time and are available on the company's website at www.rolls-royce.com.

Priorities for 2017 broadly unchanged; additional focus on developing our long-term vision and strategy

Overall, the priorities for 2017 are largely unchanged from those set out in 2016. We will continue to invest in strengthening our focus on engineering, operational and aftermarket excellence to drive long-term profitable growth. At the same time, 2017 will be an important year to drive incremental savings from our transformation programme.

At our Capital Markets Day in November 2016 we set out how our focus is turning towards the Group's long-term goals. Over the next few months the senior leadership team will be concluding the review of our strengths and investment opportunities, to define an appropriate vision for the business and the best way we can deliver sustainable shareholder value. Conclusions of this work will be shared during 2017.

Rebuilding trust and confidence in the Group and its long-term prospects remains a key priority for the management team at Rolls-Royce. The focus remains on progressive, effective communication combined with strong operational delivery. While we have made a steady start, more remains to be done. The addition of new management and a renewed focus within the business leadership teams, with clear goals and stronger accountabilities, should provide a strong platform for further progress in 2017.

Acquisition of outstanding 53.1% stake in Industria de Turbo Propulsores SA (ITP)

We were notified in early July that SENER Grupo de Ingeniería SA ("SENER") had decided to exercise the put option in respect of its 53.1% stake in Industria de Turbo Propulsores SA ("ITP"). This decision provides us with the opportunity to effectively consolidate several key large engine risk and revenue sharing arrangements (RRSAs) into the business, strengthens our position on a number of important defence engine platforms and will enable us to enjoy greater benefits from future aftermarket growth.

Under the shareholder agreement, the consideration of €720m will be settled over a two year period following completion in eight equal, evenly spaced instalments. The agreement allows flexibility to settle up to 100% of the consideration in the form of Rolls-Royce shares. Final consideration as to whether the payments will be settled in cash, shares or cash and shares will be determined by Rolls-Royce during the payment period. Completion remains subject to regulatory clearances and is expected in mid-2017.

The acquisition of ITP strengthens Rolls-Royce's position on its Civil Aerospace large engine growth programmes by capturing significant additional value from its long-term aftermarket revenues, including the high volume Trent 1000 and XWB engines, where ITP has played a key role as a participant in RRSAs. It also enhances the group's own manufacturing and services capabilities and adds value to the Defence Aerospace business, particularly on the TP400 and EJ200 programmes.

Further details of its impact on the Group will be made available on completion of the acquisition.

Board update

During the year there have been a number of important changes to the Board. In March we appointed Brad Singer, a partner of ValueAct Capital, to the Board, at which time he also joined the Science & Technology Committee. In May, following the AGM, Dame Helen Alexander stepped down from the Board and was succeeded as Chairman of the Remuneration Committee by Ruth Cairnie. At the same time, alongside chairing the Science & Technology Committee, Sir Kevin Smith took over the role of Senior Independent Director from Lewis Booth, who continues as Chairman of the Audit Committee. Finally, Alan Davies stepped down from the Board in November 2016.

In respect of Executive Directors, we announced in September that Stephen Daintith will join the Board in 2017 as Chief Financial Officer. He succeeds David Smith who leaves Rolls-Royce to join QinetiQ Group plc on 1 March 2017.

Commenting on David Smith's contribution to Rolls-Royce, Warren East said: *"I would like to thank David for his valuable support over the past three years. He has made an important contribution to restoring confidence in the business, improving financial reporting and delivering the early stages of our transformation. I and the rest of the Rolls-Royce team wish him every success in the future."*

In addition, Colin Smith will be leaving the company after 43 years with Rolls-Royce, including 12 years as a main Board Director. He will be stepping down from the Board after this year's AGM. During his time with Rolls-Royce Colin has held a variety of key positions within Engineering, including Director – Research and Technology and, from 2005 to 2015, Director, Engineering and Technology and most recently as Group President.

Commenting on Colin Smith, Warren East added: *"Colin has devoted his entire career to Roll-Royce having joined the company as an undergraduate apprentice in 1974. He has made a tremendous contribution to the company and the industry having been instrumental in developing much of today's portfolio of power systems and helping shape our technology plans for the future. His advice and insights will be greatly missed but he leaves behind a strong legacy. On behalf of all of everyone at Rolls-Royce I would like to thank Colin for his exceptional service and wish him well in his next endeavours."*

Shareholder payments

Our stated objective in the long term is to progressively rebuild our payment to shareholders to an appropriate level, subject to the short-term cash needs of the business. This reflects the Board's long-standing confidence in the strong future cash generation of Rolls-Royce.

At this stage the investment needs of the business remain high, reflected in the low level of free cash flow in 2016 and this is expected again in 2017. In addition, the Board sees the need to retain a degree of balance sheet flexibility.

As a result, it is proposed that the final payment for 2016 is unchanged from 2015 at 7.1 pence per share. Taken together with the interim payment, this brings the full year payment to 11.7 pence per share. As in past payments, the distribution will be in the form of C Shares.

Further details are included at the end of this statement on page 48.

Outlook for 2017

After a better than expected 2016, year-on-year incremental progress will be modest. Our medium-term trajectory for revenue, profit and free cash flow remains unchanged. On a constant currency basis, Group revenue for 2017 should be marginally higher than that achieved in 2016, despite expected further weakening in offshore oil and gas markets in Marine. Underlying improvements in performance should be driven largely by transformation savings and free cash flow should benefit from increased aftermarket cash revenues in Civil Aerospace, further improvements in working capital efficiency and cost savings. As a result, we expect a modest performance improvement overall and we are targeting free cash flow to be similar to that achieved in 2016.

Individual outlooks are provided for each business in the operating review.

Looking further ahead - long-term outlook remains strong

We continue to see value in the underlying strengths of our business: the underlying growth of our long-term markets, the quality of our mission-critical technology and services, and the strength of customer demand for these which is reflected in our strong order book. While we have near-term challenges and some core execution priorities, these constants provide us with confidence in a strong, profitable and cash-generative future.

The successful roll-out of new engines, led in particular by the Trent XWB, 1000 and 7000, together with a growing aftermarket, is expected to drive significant revenue growth over the coming ten years as we build toward a 50% plus share of the installed widebody passenger market. As a result, we remain confident that the important investments we are making to modernise our production will create a strong platform to drive customer service and strong cash flows, together with the current investments in new products and the streamlining of our existing product portfolios to ensure we are providing high value, cost competitive products into our target end markets.

Group Trading Summary

The commentary in this section relates to the Group's operating segments and so, consistent with the requirements of accounting standards, is provided on an underlying basis which is the measurement basis used by the Group in its segmental reporting.

£m	2015*	Underlying Change**	Foreign Exchange***	2016
Order book	**76,399**	**3,329**	**82**	**79,810**
Underlying revenue	**13,354**	**(296)**	**725**	**13,783**
Change		*-2%*	*+5%*	*+3%*
Underlying OE revenue	6,724	(112)	415	7,027
Change		*-2%*	*+6%*	*+5%*
Underlying services revenue	6,630	(184)	310	6,756
Change		*-3%*	*+5%*	*+2%*
Underlying gross margin	**3,203**	**(577)**	**197**	**2,823**
Gross Margin %	*24.0%*	-390 bps		*20.5%*
Commercial and administrative costs	(1,025)	(71)	(67)	(1,163)
Restructuring costs	(39)	41	(2)	-
Research and development costs	(765)	(47)	(50)	(862)
Joint ventures and associates	118	(11)	10	117
Underlying profit before financing	**1,492**	**(665)**	**88**	**915**
Change		*-45%*	*+6%*	*-39%*
Underlying operating margin	**11.2%**	**-480 bps**		**6.6%**

Underlying: for definition see note 2 on page 35; *2015 figures have been restated as a result of £21m of costs previously reported in 'cost of sales', being reclassified as 'other commercial and administrative costs' to ensure consistent treatment with 2016; ** Order book underlying change includes £2.1bn increase from a change to our long term US dollar planning rate; *** Translational foreign exchange impact

Order book and order intake

During the year our order book increased by £3.3bn to £79.8bn, led by Civil Aerospace, which, alongside strong order intake, also benefitted from a £2.1bn uplift from a 5 cent decrease to our long term US dollar planning rate. Order intake in our Marine business was poor, largely as a result of the continuing weak offshore market. Overall orders were also lower in Defence Aerospace, Power Systems and Nuclear, although we view the prospects for these businesses as unchanged, reflecting long-term orders won in previous years.

Underlying trading

Underlying group revenue declined 2% in 2016 compared to 2015 on a constant currency basis, reflecting declines in both original equipment revenue (down 2%) and services (down 3%) and driven almost entirely by Marine. By business on a constant currency basis, Civil Aerospace revenue was unchanged, Defence Aerospace revenue increased 1%, Power Systems revenue decreased 1%, Marine revenue decreased 24% and Nuclear revenue increased 11%.

Underlying profit before financing of £915m (2015: £1,492m) was 45% lower on a constant currency basis, led by a significant reduction in Civil Aerospace profit. This reflected the previously communicated volume and margin reductions on link accounted Trent 700 engines, reduced business jet original equipment volumes, reduced large engine utilisation and increased technical costs for large engines. In addition, reported 2015 numbers included one-off benefits from a methodology change in respect of risk assessment and reversal of impairments and provisions in respect of a Trent 1000 launch customer, totalling £189m and £65m respectively. These were partially offset by strong life-cycle cost improvements on installed engines and some provision releases. Profit in Defence Aerospace at £384m was 8% lower on a constant currency basis largely reflecting additional costs related to the TP400 programme. Power Systems was down 14% year-on-year principally due to volume reduction and adverse changes to product mix. Marine profit was sharply lower led by continuing weakness in the off-shore markets. Nuclear profit was 37% lower than 2015 due to a lower margin mix in submarine projects.

Underlying gross margin was £2,823m, down 390 bps to 20.5% largely reflecting the lower margins in Civil Aerospace, Defence and Marine. Commercial and administrative costs include accruals for employee incentive schemes in line with our current policies. Given the good performance relative to original plan, these are higher than in the prior year. This contributed to commercial and administrative costs being £71m higher on a constant currency basis year-on-year.

The R&D charge increased by 6% over 2015 on a constant currency basis, reflecting increased charges in Civil Aerospace and the adverse year-on-year effect of the favourable R&D credit adjustment taken in 2015 in Nuclear.

Underlying restructuring charges reduced by £41m reflecting the lower level of underlying restructuring as most costs in 2016 were taken as exceptional due to the nature of the restructuring activities within the group. The exceptional charge in relation to these programmes was £129m in 2016. This included £92m for the transformation programme launched in November 2015, which delivered in year benefits of over £60m in 2016. The underlying tax rate for 2016 increased to 32.1% (2015: 24.5%). The primary reasons for the increase are the non-recognition of deferred tax assets on losses in Norway, which reflects the current uncertainty in the oil and gas markets, and a different profit mix with more profits arising in countries with higher tax rates.

Reported results

Reported results are impacted by the mark-to-market adjustments driven by movements in USD:GBP and EUR:GBP exchange rates over the year. In addition, we recognised the £671m charge related to the agreements reached in respect of regulatory investigations, a goodwill impairment charge of £219m largely reflecting a more cautious outlook for our marine business and £129m of exceptional restructuring cost. As a result, the reported loss before tax was £(4,636)m (2015: a profit of £160m).

Free cash flow

Free cash inflow in the year was £100m (2015: inflow of £179m), better than expected, reflecting strong cash collections from a number of key customers at the very end of the period and an improvement in underlying working capital performance. This helped offset the lower profit before tax and higher expenditure on PPE and intangibles. The latter reflects the increased capital investment in new manufacturing capacity, higher capitalised R&D, mainly related to the Trent 1000 TEN and higher certification costs on the Trent XWB-97. More details on the movement in trading and free cash are included in the Funds Flow section of the Financial Review.

While some of this positive variance is a timing impact and likely to reverse early in 2017, improved efficiencies should drive a level of sustainable benefit. For more details see the section on technical guidance.

Net debt and foreign currency

The Group is committed to maintaining a robust balance sheet with a healthy, investment-grade credit rating. We believe this is important when selling high-performance products and support packages which will be in operation for decades. Standard & Poor’s updated its rating in January 2017 to BBB+ from A-/negative outlook and Moody’s maintained a rating of A3/stable.

During 2016, the Group’s net debt position increased from £111m to £225m, reflecting the £100m free cash inflow, shareholder payments of £301m and £154m for the increased investment in our approved maintenance centre joint ventures following receipt of regulatory approval for the changes to the joint venture agreements in June 2016. In April, we increased our revolving credit facilities by £500m to £2bn to provide additional liquidity.

The Group hedges the transactional foreign exchange exposures to reduce volatility to revenues, costs and resulting margins. The hedging policy sets maximum and minimum cover ratios of hedging for net transactional foreign exchange exposure. It allows us to take advantage of attractive FX rates, whilst remaining within the cover ratios. A level of flexibility is built into the hedging instruments to manage

changes in exposure from one period to the next and to reduce volatility by smoothing the achieved rates over time.

The most significant exposure is the net US dollar income which is converted into GBP (currently approximately $5bn per year and forecast to increase significantly by 2021). Following the fall in the value of sterling which resulted from the outcome of the UK referendum on membership of the European Union, additional cover has been taken out to benefit from the favourable rates. This has resulted in an increase in the nominal value of the hedge book to approximately $38bn at the end of 2016 (end 2015: $29bn) together with a reduction in the average rate in the hedge book to £/$1.55 (end 2015: £/$1.59). The movement in the average achieved rate year-on-year was around two and a half cents, providing a net underlying group benefit, after balance sheet effects (the movement in achieved rate also affects creditor and debtor balances of hedged cash flows), of around £20m.

Group technical factors for 2017

All figures are at constant translational currencies unless otherwise stated.

Should **foreign exchange** rates for the full year remain unchanged from those at the end of 2016, the movements from average 2016 rates would improve full year underlying revenues by around £400m and improve underlying profit before tax by around £50m.

In the second half of 2016 we took advantage of weak sterling to increase our US dollar hedge book and averaged down the overall rate to around £/$1.55. With this higher level of cover, we do not expect to make any material net additions to the hedge book in 2017. As a result, we expect the average achieved rate in 2017 to be broadly unchanged from that achieved in 2016.

Net R&D spend is expected to be in the region of £950m in 2017 (2016: £937m), principally reflecting expenses related to the completion of important new product launches in Civil Aerospace. Largely reflecting an increase in R&D capitalisations associated with new engine programmes, the net R&D charge is expected to be between £60-100m lower than that in 2016 (2016: £862m).

Incremental **restructuring cost savings** in 2017, from the transformation programme announced in November 2015, are expected to be between £80-110m (2016: over £60m).

Overall underlying **finance charges** in 2017 are expected to be in the region of £100-110m, partly reflecting the higher average level of gross and net debt.

Given the sensitivity of the underlying tax rate to a number of factors, including the impact of weak marine offshore markets, we expect our **effective tax rate** for 2017 to be between 25-30%, reflecting the continued high proportion of taxable profit expected to be generated in higher tax rate regions.

Capital expenditure for 2017 is expected to be around £600m (2016: £626m).

We are targeting **free cash flow** to be similar to that achieved in 2016. Free cash flow excludes the payments in respect of agreements reached with investigating authorities.

Operational Review: Civil Aerospace

£m	2015	Underlying Change*	Foreign Exchange**	2016
Order book	**67,029**	**4,395**	**2**	**71,426**
Engine deliveries	**712**	**(63)**		**649**
Underlying revenue	**6,933**	**(27)**	**161**	**7,067**
Change		-	*+2%*	*+2%*
Underlying OE revenue	3,258	14	85	3,357
Change		-	*+3%*	*+3%*
Underlying services revenue	3,675	(41)	76	3,710
Change		*-1%*	*+2%*	*+1%*
Underlying gross margin	**1,526**	**(397)**	**56**	**1,185**
Gross Margin %	*22.0%*	-570 bps		*16.8%*
Commercial and administrative costs	(296)	(43)	(3)	(342)
Restructuring costs	(7)	(4)	-	(11)
Research and development costs	(515)	(34)	(19)	(568)
Joint ventures and associates	104	(8)	7	103
Underlying profit before financing	**812**	**(486)**	**41**	**367**
Change		*-60%*	*+5%*	*-55%*
Underlying operating margin	**11.7%**	**-700 bps**		**5.2%**

Underlying: for definition see note 2 on page 35; * Order book underlying change includes £2.1bn increase from a change to our long term US dollar planning rate; ** Translational foreign exchange impact

Financial overview

Overall, **underlying revenue** for Civil Aerospace was unchanged (up 2% at actual exchange rates). Original equipment revenue (OE) was unchanged, with increases from higher volumes of large engines being offset by the decline in business jet engines and V2500 modules. Aftermarket revenue was down 1% despite strong growth from our in-production engines.

£m	2015	% of whole	Underlying Change	Underlying Change %	Foreign Exchange	% of Whole	2016
Original Equipment	**3,258**	**48%**	**14**	**-**	**85**	**48%**	**3,357**
Large engine: linked and other	1,570	23%	32	+2%	2	23%	1,604
Large engine: unlinked installed	504	7%	237	+47%	1	10%	742
Business aviation	903	14%	(228)	-25%	82	11%	757
V2500	281	4%	(27)	-10%	-	4%	254
Service	**3,675**	**52%**	**(41)**	**-1%**	**76**	**52%**	**3,710**
Large engine	2,371	34%	(84)	-4%	2	32%	2,289
Business aviation	425	6%	(13)	-3%	40	6%	452
Regional	360	5%	(52)	-14%	34	5%	342
V2500	519	7%	108	+21%	-	9%	627

Original equipment revenue from *Large engine: linked and other* was up 2% reflecting increased volumes of Trent 900s and a higher number of spare Trent XWB engines, partly offset by Trent 700 volume and price reductions, ahead of the introduction of the Trent 7000 for the Airbus A330neo. Sales of spare engines to joint ventures, included in *Large engine: linked and other*, generated revenue of £288m (2015: £189m).

Original equipment revenue from *Large engine: unlinked installed* increased 47%, led by higher volumes of Trent XWBs.

Large engine service revenue reflected double digit growth from our in-production engines which more than offset the reduction from older engines, including the expected lower year-on-year utilisation of Trent 500 and Trent 800 engines. Time and material revenue reduced, as a result of fewer overhauls of engines across the out-of-production fleet. Contract accounting effects within service revenue in 2016 were

significantly lower than prior year. As a result, while there was a small foreign exchange improvement in 2016, underlying service revenue from large engines were down 4%. Adjusting for contract accounting effects, service revenue from large engines would have been up 2%.

Revenue from *business aviation* OE engine sales was, as expected, lower, particularly for the BR710 engines, reflecting general market weakness and a transition to newer non-Rolls-Royce powered platforms. Volumes of our newer BR725 engine, which powers the Gulfstream G650 and G650ER, were stable. Overall, business aviation OE revenues declined 25% while aftermarket revenue was slightly down.

Service revenue from our *regional* jet engines declined 14%, reflecting retirements and reduced utilisation of relevant fleets by North American operators in particular.

On the *V2500* programme, which powers aircraft including the Airbus A320, revenue from OE modules declined 10% reflecting the production slow-down as Airbus transitions to the A320neo, powered by another engine provider. However, V2500 service revenues were 21% higher, reflecting price escalation on flying hour payments together with increased overhaul activity.

Overall **gross margins** for Civil Aerospace were 16.8% (2015: 22.0%), declining £397m from 2015 on a constant currency basis. The main headwinds were as forecast at the start of the year; OE reductions to the Trent 700 programme, business aviation engines and V2500 modules, reduced utilisation and fewer overhauls of our out-of-production Trent 500 and 800 and RB211 engines and the declining regional aftermarket. In addition, we also incurred programme charges of around £30m for engines still in development. These were partially offset by the release, after accounting and legal review, of accruals related to the termination in prior years of intermediary services, totalling £53m (2015: £nil). Gross margin from spare engine sales to joint ventures contributed £97m (2015: £67m).

The in-year net benefit from long-term contract accounting adjustments totalled £90m (2015: total benefit of £222m, which included a £189m one-off benefit associated with the refinement of our methodology for risk assessment of future revenue). The £90m included a £217m benefit from life-cycle cost improvements (2015: benefit of £140m). We also recognised in this period a £35m benefit from a 5 cent change (2015: £nil) to our estimated long-term US dollar to sterling exchange rate to bring our own planning rate within updated external benchmark long-term forecast data. These benefits were offset by technical costs of £98m (2015: £24m) for large engines, including the Trent 900, relating to the need for increased shop visits in the short-term, and the Trent 700, where we are upgrading the engine management system, together with a charge of £64m (2015: £83m), reflecting other operational changes.

The year-on-year change was also impacted by a one-off £65m write-back in 2015 of a previously recognised impairment of Contractual Aftermarket Rights (CARs) for sales to a launch customer and the release of a related provision; in 2016 these sales were capitalised as CARs.

Costs below gross margin were £89m higher than the previous year at £818m on an underlying basis. Within this, R&D charges of £568m were £34m higher, reflecting higher spend on key programmes, particularly in respect of the Trent 7000 which are being expensed ahead of capitalisation and lower development cost contributions from risk and revenue sharing partners, partly offset by increased R&D capitalisation on the Trent 1000 TEN.

Underlying commercial and administrative costs were £43m higher than 2015 reflecting increased employee incentive charges. Underlying restructuring costs of £11m were £4m higher than 2015 and profits from joint ventures and associates were down £8m.

As a result, **profit before financing and tax** was 55% down, reflecting a combination of lower overall gross margins, higher commercial and administrative, R&D and restructuring costs and reduced joint venture and associate profits. Taking account of foreign exchange effects, underlying profit before financing and tax was £367m (2015: £812m).

Trading cash flow

Trading cash flow before working capital movements of £22m declined year-on-year by £462m, driven by a reduction in underlying profit before financing of £445m and increased property, plant and equipment

additions. There were also increased certification costs driven by the Trent XWB-97 and higher R&D capitalisation of the Trent 1000 TEN development costs, offset in part by other timing differences including provision movements.

£m	2016	2015	Var
Underlying profit before financing	**367**	**812**	**(445)**
Depreciation and amortisation	491	410	81
Sub-total	**858**	**1,222**	**(364)**
CARs additions	(208)	(161)	(47)
Property, plant, equipment and other intangibles	(739)	(502)	(237)
Other timing differences*	111	(75)	186
Trading cash flow pre-working capital movements	**22**	**484**	**(462)**
Net long-term contract debtor movements	(246)	(406)	160
Other working capital movements	267	(78)	345
Trading cash flow**	**43**	**-**	**43**

* Includes timing differences between underlying profit before financing and cash associated with: joint venture profits less dividends received; provision charges higher /(lower) than cash payments; non-underlying cash and profit timing differences (including restructuring); and, financial assets and liabilities movements including the effect of foreign exchange movements on non-cash balances. ** Trading cash flow is cash flow before: deficit contributions to the pension fund; taxes; payments to shareholders; foreign exchange on cash balances; and, acquisitions and disposals.

The overall trading cash flow improvement of £43m resulted largely from a significant year-on-year improvement in working capital, due mainly to differences in the timing of payments to suppliers and increased deposits, offset in part by an increase in inventory. In addition, reflecting the lower profits recorded on our linked engines such as the Trent 700, net long term contract debtor additions were also lower.

TotalCare net assets and Contractual Aftermarket Rights

TotalCare net assets increased in 2016 by £230m (2015: £406m) to £2.44bn reflecting accounting for new "linked" engines of £432m (2015: £521m), contract accounting adjustments taken in the year of £90m (2015: £222m) offset by the cash inflows and net other items of £(292)m (2015: £(337)m). It should be noted that the £230m net asset increase is different from the £246m used in the trading cash flow above because of foreign exchange effects on evaluating TotalCare net debtor balance movements.

The CARs balance increased by £169m (2015: increase of £156m) to £574m reflecting higher sales of unlinked Trent XWB engines partly offset by engine cost improvements.

Investment and business development

Order intake of £14.1bn in 2016 for Civil Aerospace was £1.3bn higher than the previous year. The order book closed at £71.4bn, up £4.4bn or 7% from 2015, which included a £2.1bn benefit from the change in the long term planning foreign exchange rate discussed previously. Excluding this the order book was up 3%.

Significant orders in 2016 included a $2.7bn order from Norwegian for Trent 1000 engines, an order from Garuda Indonesia worth $1.2bn for Trent 7000 engines and a $900m order from Virgin Atlantic for Trent XWB. All of these include the provision of long term TotalCare® engine services.

Foundations for future growth are built from our investment in engineering excellence

During the year we committed resources in order to ensure we made significant progress across all key engineering programmes in 2016. The Trent 1000 TEN (Thrust, Efficiency and New Technology) engine undertook its first test flight in March and received its European Aviation Safety Agency (EASA) certification on 11 July. The Trent 1000 TEN will power all variants of the Boeing 787 Dreamliner family and will power the first flight of the 787-10 in 2017.

In November the latest version of the Trent XWB, the higher thrust -97 engine, successfully powered the first flight of the Airbus A350-1000 in Toulouse. The Trent 7000 engine, which will exclusively power the

Airbus A330neo, undertook ground testing for the first time and we started assembly of the first flight test engines.

In respect of future technologies, the Advance3 large engine demonstrator is proceeding well. The engine will test the new core architecture for future engine families and other key technologies such as Lean Burn combustion, Ceramic Matrix Composites, CastBond™ (specialist turbine manufacturing) plus additive layer manufacturing or 3D printing. It is currently in development at our Bristol facility with all core modules advancing well.

In September, we successfully ran the world's most powerful aerospace gearbox for the first time under the joint venture Aerospace Transmission Technologies (ATT). The gearbox is designed to reach up to 100,000 horsepower and is a significant step in the development of the new UltraFan™ engine technology.

Supporting our commitment to research and development, we also announced a $30m expansion into a new facility in Cypress, California, that will be dedicated to research and development of ceramic matrix composite (CMC) materials and processes for use in next generation aircraft engine components.

Investing in new aerospace supply chain capabilities to help drive operational excellence

In January, we announced plans to invest more than £30m at our site in Washington, Tyne & Wear, UK, creating a new facility to manufacture a range of aerospace discs for in-service engines. The new facility is expected to be fully operational in 2018 and will have the capacity to manufacture well over 1,500 fan and turbine discs a year for use in a wide-range of existing engines.

The construction of a £50m extension to our Wide Chord Fan Blade facility in Barnoldswick, UK, started in December. The expanded facility will be able to manufacture 6,000 large Trent fan blades a year, almost twice its current capacity. We also announced the creation of a Centre of Excellence (CoE) in Structures & Transmissions at the same site. The new centre, supported by £20m of investment, will manufacture many of the complex structures that feature in all Rolls-Royce aero engines.

Good progress strengthening our aerospace aftermarket service offering

We have continued to invest in our service capabilities to support our customers with state-of-the-art facilities and relevant products and services, particularly within our portfolio of TotalCare offerings.

During the year we completed changes to three Approved Maintenance Centre (AMC) joint ventures. This included investing £154m to increase our stake in both Hong Kong Aero Engine Aero Services Limited (HAESL) and Singapore Aero Engine Services Pte Ltd (SAESL) to 50%. These AMCs support our strategy to offer a competitive, capable and flexible Trent service network to meet the changing needs of customers across the lifecycle of engines and to support the growing Trent engine fleet.

Additionally, we announced further details of a new AMC in Abu Dhabi with Mubadala Development Company, the emirate-based investment and development organisation. This purpose built facility will carry out work on the Trent XWB.

We also announced that we are further expanding our global network of Authorised Service Centres (ASC) for business aviation aircraft under our CorporateCare® service provision for customers. Rolls-Royce now has 62 ASCs in place with key maintenance providers worldwide.

Following the launch of SelectCare™ in 2016 we secured our first agreement for Trent 800 engines as part of a wide-ranging deal with Delta Airlines.

Civil Aerospace outlook

On a constant currency basis our Civil Aerospace business should deliver modest growth in revenue and profit in 2017, supported by large engine aftermarket growth, further life-cycle cost reductions and a higher level of R&D capitalisation. Business jet demand is expected to weaken further, as will the demand for aftermarket services to support Rolls-Royce powered regional aircraft. After a better year for trading cash flow in 2016, we now expect this to be broadly unchanged year-on-year reflecting higher volumes of cash-loss making engines offsetting the positive effects of higher aftermarket cash revenues.

We expect the TotalCare net asset to peak in the next twelve months at between £2.5bn and £2.7bn, reflecting further targeted life cycle cost improvements and other timing differences between cost and cash.

Positive market developments continue to drive long-term growth in Civil Aerospace

The long-term positive market trends for our leading power and propulsion systems remain unchanged despite some near-term uncertainties in Civil Aerospace that continue to impact business jet engine production volumes and service activity on older large engines. The long-term trends driving demand for growth in large passenger aircraft, business jets, power systems and maritime activity remain strong; in particular a growing aspirational and mobile middle-class, particularly in Asia, and globalisation in business, trade and tourism.

While recent political and economic developments have added some uncertainty to near-term utilisation, we continue to expect that strong widebody airframe demand - driven by the need for newer, more fuel efficient aircraft - should provide resilience to manufacturing schedules over the next few years as the industry undergoes a strong replacement cycle.

New airframe growth and transitions are in line with expectations

Preparations for the transition of the Airbus A330ceo to A330neo models are also progressing well and once the transition is completed, we will benefit from an exclusive position with the new Trent 7000 on the A330neo.

The roll-out of new engines, including the Trent XWB for the highly successful Airbus A350 family, will significantly grow our market share and the installed base of new engines that will deliver strong aftermarket revenues for decades to come.

Operational Review: Defence Aerospace

£m	2015	Underlying Change	Foreign Exchange*	2016
Order book	**4,316**	**(391)**	**1**	**3,926**
Engine deliveries	649	12	-	661
Underlying revenue	**2,035**	**17**	**157**	**2,209**
Change		*+1%*	*+8%*	*+9%*
Underlying OE revenue	801	22	67	890
Change		*+3%*	*+8%*	*+11%*
Underlying services revenue	1,234	(5)	90	1,319
Change		-	*+7%*	*+7%*
Underlying gross margin	**579**	**(49)**	**34**	**564**
Gross margin %	*28.5%*	-260 bps		*25.5%*
Commercial and administrative costs	(124)	(3)	(7)	(134)
Restructuring	(8)	18	-	10
Research and development costs	(73)	5	(3)	(71)
Joint ventures and associates	19	(4)	-	15
Underlying profit before financing	**393**	**(33)**	**24**	**384**
Change		*-8%*	*+6%*	*-2%*
Underlying operating margin	**19.3%**	**-180 bps**		**17.4%**

Underlying: for definition see note 2 on page 35; * Translational foreign exchange impact

Financial Overview

Underlying revenue of £2,209m was up slightly on the prior year. Higher volumes for TP400 production, together with increased Adour engine deliveries, helped original equipment (OE) revenues increase 3%. Service revenues were stable, with lower demand for spare parts offset by increased revenues from long-term Eurofighter Typhoon and C-130J service contracts.

Gross margin declined by £49m, reflecting lower sales of spare parts, an adverse change in OE product mix, additional expenditure of £31m on the TP400 programme and higher payroll costs. Retrospective contract margin improvements totalled £82m, £5m lower than prior year, but ahead of early

expectations. Of this, around half relates to delivering significant cost savings benefits on the largest Eurofighter Typhoon contract, which triggered a cost-saving incentive award.

While overall R&D costs were slightly lower than the prior year; the business continued to invest in future programme development and the Indianapolis transformation.

Restructuring costs were lower due to reduced level of severance costs and reversal of a provision for the closure of the defence facility at Ansty through better cost recovery than expected. Underlying commercial and administrative costs and other costs were similar to prior year.

Profit before financing of £384m was 8% lower than the prior period, driven by the lower gross margin.

Investment and business development

Order intake for 2016 was £1.5bn (2015: £1.7bn), reflecting significant follow-on export orders being delayed to 2017.

Significant activities in 2016 included winning orders for the F-35B LiftSystem, increased MRTT engines for A330 aircraft and contract renewals for services. Deliveries of engines were slightly higher in 2016, driven by increased units for TP400 and Adour export. Services revenues were steady, reflecting higher flying hours from newer EJ200, F405 Adour and AE2100 powered aircraft in the UK, North America and the Middle-East.

The first T56 3.5 technology insertion kits delivered to the USAF for its legacy Hercules C-130 fleet have validated the expected fuel saving and performance benefits, prompting growing interest in the upgrade.

The UK and French Governments also committed to the €2bn FCAS unmanned combat air system programme in December, enabling progress through to the demonstrator phase of the programme in 2017. Our LibertyWorks™ development unit was selected to provide the vertical lift propulsion for the new DARPA VTOL X-Plane. The unit also launched an infrared footprint suppression module, reflecting our diverse and cutting edge technology capability.

Within the Services portfolio, the support contract for the US's C-130J transport fleet was renewed and we signed a memorandum of understanding with Pratt & Whitney to extend support for the UK's new F-35B Lightning fleet beyond the Rolls-Royce LiftSystem®.

This strategy of strengthening our service offerings closer to our major customers saw the opening of new on-base Service Delivery Centres in the UK (at RAF Brize Norton) and in the US (at Kingsville Texas), as well as a new joint engine support facility for the USAF's Global Hawk fleet.

As part of the TP400 consortium, the focus was on delivering solutions to improve the on-wing reliability of the GE-Avio gearbox. This included an on-wing exchange procedure which has greatly helped to reduce the service time and backlog.

Transformation milestones were achieved as planned, including completion of the first production cell as part of the investment activity in Indianapolis. Further manufacturing changes are due to come on stream in the first half of 2017.

Defence Aerospace outlook

While revenues should remain steady, margins are expected to come under pressure from the essential investments in efficiency and long-term growth. These reflect important product development and manufacturing transformation initiatives as the business looks capitalise on its strong positions, particularly in Combat and Transport & Patrol, and the absence of significant incentive arrangements under remaining long-term service agreements. As a result, margins and profits are expected to soften from the recent levels.

Operational Review: Power Systems

£m	2015*	Underlying change	Foreign Exchange**	2016
Order book	**1,928**	**(113)**	**-**	**1,815**
Underlying revenue	**2,385**	**(25)**	**295**	**2,655**
Change		*-1%*	*+12%*	*+11%*
Underlying OE revenue	1,618	(9)	201	1,810
Change		*-1%*	*+12%*	*+12%*
Underlying services revenue	767	(16)	94	845
Change		*-2%*	*+12%*	*+10%*
Underlying gross margin	**656**	**(28)**	**79**	**707**
Gross margin %	*27.5%*	-90 bps		*26.6%*
Commercial and administrative costs	(296)	(9)	(35)	(340)
Restructuring	(4)	4	-	-
Research and development costs	(162)	5	(20)	(177)
Joint ventures and associates	-	1	-	1
Underlying profit before financing	**194**	**(27)**	**24**	**191**
Change		*-14%*	*+12%*	*-2%*
Underlying operating margin	**8.1%**	**-110 bps**		**7.2%**

Underlying: for definition see note 2 on page 35; * 2015 figures have been restated as a result of costs previously reported in 'cost of sales', being reclassified as 'other commercial and administrative costs' to ensure consistent treatment with 2016; ** Translational foreign exchange impact

Financial overview

Underlying revenue of £2,655m was 1% lower at constant currency (11% higher including the impact of translational foreign exchange). Overall original equipment revenue declined 1%. Growth in sales of diesel and gas products to power generation and industrial customers offset reductions within markets where demand is linked to low oil and commodity prices, and reduced activity in naval markets.

Service revenues reduced 2%, largely reflecting weaker marine medium speed markets, once again reflecting low oil prices.

Gross margin reduced by £28m in absolute terms and by 90 basis points, to 26.6% (2015: 27.5%) with good progress on cost reduction generated from transformation activity offsetting some of the impact of volume reduction, adverse changes in product mix and a reduction in the discount rate applied to the warranty provision.

Overall, underlying profit declined £27m or 14%, led by the reduction in gross margin. Costs below gross margin remained broadly unchanged on an underlying basis. The £9m increase in commercial and administrative costs was offset by a £5m reduction in R&D reflecting a more focused approach to future product development activity together with reduced underlying restructuring costs. An exceptional charge of £45m has been taken for restructuring activity.

Investment and business development

Power Systems' customers span a range of markets from power generation and defence to marine, industrial and construction markets. This end-market diversity has enabled the business to mitigate some of the weak market environments and as a result, the order book ended the year at £1.8bn (2015: £1.9bn).

2016 order intake of £2.4bn (2015: £2.5bn) was 2% down at constant currency, with the year-on-year reduction being mainly in oil and gas and commodity-related markets including marine, together with lower government project orders. This was offset by improvements within power generation, agricultural and industrial markets.

Within power generation markets, we delivered 200 gensets (a package of engine and generator) to the Asian VPower Group, one of our strategic partners in the region. We have continued to strengthen our

position in the growing market for backup power for larger mission critical applications. Order intake later in the year was healthy for solutions to support data systems in both Europe and the US and also for independent power customers. We have also agreed to establish a 50/50 joint venture with Yuchai Machinery Company Ltd for the production under licence of MTU Series 4000 diesel engines in China, targeting the Chinese off-highway market.

Demand for our marine products remained good. Naval orders included gensets for the UK Royal Navy's Type 26 Global Combat Ship and a supply contract for the Italian Navy relating to a new multi-purpose ocean-going patrol vessel. Within the land defence markets there was a follow-up order for use in a German armoured vehicle.

In other areas we continued to attract new customers in new regional markets including Japanese high-tech crane producer Kato. We also made progress within the rail market in both Europe and Asia. This included a notable order from Hitachi Rail Europe for over 100 MTU power packs for use in the UK and an order to remanufacture (an in-house process, known as Reman, to refurbish and extend the life of existing systems) around 400 MTU power packs for Transdev Group in Germany.

Innovation was again strong with some notable new products coming to market in the year. We launched new advanced diesel and gas propulsion systems which meet new IMO and EPA emissions standards. At the same time, we launched advanced propulsion systems for the construction and industrial markets which satisfy new emission standards in those industries. Finally, we launched a hybrid power pack and energy pack battery system for the rail market.

Power Systems also made progress with the transformation programme, targeting reductions in product costs as well as strengthening sales and service resources and leveraging digital capabilities to develop value adding services.

Power Systems outlook

The outlook for Power Systems remains steady. The business finished the year with a strong order book for several of its key markets. Whilst some markets, particularly those impacted by oil and commodity prices remain difficult, we expect the business to deliver modest growth in revenue and profit in 2017.

Operational Review: Marine

£m	2015	Underlying change	Foreign Exchange*	2016
Order book	**1,164**	**(337)**	**78**	**905**
Underlying revenue	**1,324**	**(312)**	**102**	**1,114**
Change		*-24%*	*+8%*	*-16%*
Underlying OE revenue	773	(198)	56	631
Change		*-26%*	*+7%*	*-18%*
Underlying services revenue	551	(114)	46	483
Change		*-21%*	*+8%*	*-12%*
Underlying gross margin	**260**	**(44)**	**20**	**236**
Gross margin %	*19.6%*	+170 bps		*21.2%*
Commercial and administrative costs	(201)	(6)	(17)	(224)
Restructuring	(16)	19	(1)	2
Research and development costs	(28)	(11)	(2)	(41)
Joint ventures and associates	-	-	-	(0)
Underlying profit before financing	**15**	**(42)**	**-**	**(27)**
Change		*-280%*		*-280%*
Underlying operating margin	**1.1%**	**-380 bps**		**-2.4%**

Underlying: for definition see note 2 on page 35; * Translational foreign exchange impact

Financial overview

Underlying revenue of £1,114m was 24% lower on a constant currency basis. Within this, original equipment and services revenues were 26% and 21% lower respectively. This reflected continued weakness in offshore and merchant, as ship owners deferred overhaul and maintenance on the back of reduced utilisation of their vessels.

Gross margin was £236m, an improvement of 170 basis points versus 2015, but £(44)m lower in absolute terms, as a result of the lower volume. The improved gross margin percentage partly resulted from cost reduction actions. Overall this resulted in a net loss of £(27)m.

The announcement in December 2016 of further organisational changes and headcount reduction in 2017 has led to an exceptional £(5)m restructuring charge. In addition, £200m of the group impairment of goodwill was in marine and mainly related to the acquisition of Vickers in 1999.

Investment and business development

Overall, the Marine order book declined 29% during the year at constant currency, reflecting adjustments for a number of postponed or cancelled orders and very weak offshore markets. Orders for new vessels, projects and services were all sharply lower than 2015 and as a result order intake was only £715m, 29% down on the previous year at constant currency.

The offshore market was extremely challenging, driven by a low oil price and reduced capital expenditure within the upstream oil exploration and related services sectors. Several merchant segments were also subdued, reflecting generally weak conditions in the global marine industry. The business focussed on using its strengths as a system integrator to leverage across adjacencies including designing and equipping the UK's new polar research ship RSS Sir David Attenborough. It also landed a major deal to design and equip Hurtigruten's new explorer cruise ships, along with battery solutions to make full electric propulsion possible.

The business announced a contract to supply the world's first automatic crossing system to ferry operator, Fjord 1, and also launched our new Azipull Carbon thruster with yacht builder Benetti, reflecting the increasing importance of newer technologies. The fishing segment remained strong, with contracts won for a range of vessels. The naval business was focused on further development work and supporting customers across Asia, Europe and US. These included supporting successful sea-trials for US Navy's most advanced warship the USS Zumwalt, further MT-30 orders for new Italian helicopter landing craft and selection by New Zealand Navy for ship design of its MSC programme.

The Marine business continues to lower its cost base and build flexibility into the organisation particularly across back office and operational activities. The restructuring programmes announced in 2015 have led to a reduction of around 1,100 headcount with £65m of annual savings recognised from 2017.

Reflecting the ongoing subdued and increasingly cost-conscious market environment, in December further restructuring to take place in early 2017 was announced, targeting annualised savings of around £50m. This included a further headcount reduction of around 800 across operations and back-office functions as the business continues to shrink footprint, reduce indirect headcount, and consolidate manufacturing activity.

At the same time, investments were made in the strategic enablers of the future, including upgrading our azimuth thruster production facility in Rauma, Finland. The £44m project will create a state-of-the-art production facility for one of our most important product groups.

The pace of technology change in the sector is accelerating, and we continue to invest in pioneering research into Ship Intelligence technologies focused on data-driven value-added services that facilitate full ship automation in the long term.

Marine outlook

Overall the outlook for Marine remains cautious. We expect that the market will continue to feel the impact of low oil prices, and the general overcapacity in several segments will take time to reach equilibrium. This

will impact the demand for our products and services. We will sustain our active cost reduction programmes, focusing on manufacturing, supply chain and overhead costs, in order to drive a more competitive business adapted to the current market conditions.

Operational Review: Nuclear

£m	2015	Underlying change	Foreign Exchange*	2016
Order book	**2,168**	**(379)**	**1**	**1,790**
Underlying revenue	**687**	**74**	**16**	**777**
Change		*+11%*	*+2%*	*+13%*
Underlying OE revenue	251	95	8	354
Change		*+38%*	*+3%*	*+41%*
Underlying services revenue	436	(21)	8	423
Change		*-5%*	*+2%*	*-3%*
Underlying gross margin	**111**	**6**	**4**	**121**
Gross margin %	*16.2%*	-80 bps		*15.6%*
Commercial and administrative costs	(53)	(14)	(3)	(70)
Restructuring	(2)	2	-	-
Research and development costs	14	(20)	-	(6)
Joint ventures and associates	0	-	-	-
Underlying profit before financing	**70**	**(26)**	**1**	**45**
Change		*-37%*	*+1%*	*-36%*
Underlying operating margin	**10.2%**	**-440 bps**		**5.8%**

Underlying: for definition see note 2 on page 35; * Translational foreign exchange impact

Financial overview

Underlying revenue increased by 11% to £777m, led by growth in several key programmes in the submarines business, including support for the next generation Dreadnought class submarines (the successor to the Vanguard class), various refuelling projects and decommissioning activities. Volumes on key civil instrumentation and control programmes in both France and Finland were also good.

Gross margin was lower at 15.6%, reflecting the revenue mix favouring lower margin government-led submarine projects. Below gross margin, the change in treatment of R&D credits, which significantly impacted the full year in 2015, produced an R&D credit of £7m in 2016. This was offset by additional costs to support the higher volumes and to improve delivery performance. In addition, there were extra payroll costs, as well as additional R&D to support the initial design phase for small modular reactors.

As a result, underlying profit before financing excluding the R&D credit was £37m at constant currency, 27% below the prior year (2015: £51m adjusted for the R&D credit). After the R&D credit and including a £1m foreign exchange benefit, underlying profit was £45m.

Investment and business developments

Order intake of £385m was 8% higher than 2015. Notwithstanding, the closing order book of £1.8bn was 17% below 2015, reflecting the business working through the large multi-year orders, particularly in submarines, received in prior years.

Submarine activities focused on continuing our support to the Royal Navy's current operational fleet of nuclear powered submarines, as well as delivery of propulsion systems for the remaining Astute Class submarines and for the Dreadnought programme. As well as implementing a range of performance improvement initiatives during the year, we also completed delivery of the nuclear propulsion system for the 4th (of 7) Astute class submarine and have made good progress both in the preparation for the refuelling programme of HMS Vanguard and for decommissioning the Naval Reactor Test Establishment in Scotland. In conjunction with the UK's Ministry of Defence and BAE Systems, we have also advanced discussions around a long-term alliance framework for the Dreadnought programme. Once concluded, this new

framework should ensure that the delivery structure and commercial benefits are clarified for all key partners in this £31bn investment programme.

The civil nuclear business successfully concluded the first phase of its major instrumentation and control modernisation programme at Fortum's Loviisa plant in Finland, using our Spinline™ technology. It also continued with its upgrade programme across the French nuclear fleet as part of a multi-year contract.

The UK Government announced final approval for the Hinkley Point C nuclear power station in September, where our Nuclear business was awarded preferred bidder status for contracts covering waste treatment systems, heat exchangers and diesel generators.

The business also announced the strengthening of the strategic collaboration, started in 2014, with the China National Nuclear Corporation, including engineering and training services. The Chinese market is expected to sustain strong growth and we are well positioned with relevant technology.

During the year we started an R&D programme, together with a number of partners, to scope out the initial design phase for small modular reactors (known as SMRs). These smaller, more flexible nuclear power generation units offer the potential for a more flexible power generation in future decades and directly build on the knowledge and specialist skills of our Nuclear business. Any significant further development work will be dependent on government support for this technology.

Nuclear outlook

The long-term outlook for Nuclear remains positive, supported by confirmation from the UK Government of the ongoing investment in the Dreadnought class submarines. Together with renewed activities in the civil market, particularly in the UK and China, these provide encouraging growth opportunities.

Performance in 2017 will be impacted by the loss of R&D credits on investments and further modest increases in the investment in SMR technology. As a result, profit is expected to be around half that achieved in 2016.

Financial review

Underlying income statement Year to 31 December £m	2016	2015	Change
Revenue – 2015 exchange rates	**13,058**	13,354	-296
Translation to 2016 exchange rates	**725**		
Revenue	**13,783**	13,354	+429
Gross profit	**2,626**	3,203	-577
Commercial and administrative costs	**(1,096)**	(1,025)	-71
Restructuring	**2**	(39)	+41
Research and development costs	**(812)**	(765)	-47
Share of results of joint ventures and associates	**107**	118	-11
Profit before financing at 2015 exchange rates	**827**	1,492	-665
Translation to 2016 exchange rates	**88**		
Profit before financing	**915**	1,492	-577
Net financing	**(102)**	(60)	-42
Profit before tax	**813**	1,432	-619
Tax	**(261)**	(351)	+90
Profit for the year	**552**	1,081	-529
Earnings per share (EPS)	**30.13p**	58.73p	-28.60p
Payments to shareholders	**11.70p**	16.37p	-4.67p
Gross R&D expenditure	**(1,331)**	(1,240)	-91
Net R&D charge	**(862)**	(765)	-97

Segmental analysis Year to 31 December	Revenue			Gross profit			Profit before financing		
£m	2016	2015	Change	2016	2015	Change	2016	2015	Change
Civil	**6,906**	6,933	-27	**1,129**	1,526	-397	**326**	812	-486
Defence	**2,052**	2,035	+17	**530**	579	-49	**360**	393	-33
Power Systems	**2,360**	2,385	-25	**628**	656	-28	**167**	194	-27
Marine	**1,012**	1,324	-312	**216**	260	-44	**(27)**	15	-42
Nuclear	**761**	687	+74	**117**	111	+6	**44**	70	-26
Other	**35**	96	-61	**6**	64	-58	**1**	52	-51
Intra-segment	**(68)**	(106)	+38	**–**	7	-7	**–**	7	-7
Central costs							**(44)**	(51)	+7
Group at 2015 exchange rates	**13,058**	13,354	-296	**2,626**	3,203	-577	**827**	1,492	-665
Translation to 2016 exchange rates	**725**			**422**			**88**		
Group	**13,783**	13,354	+429	**3,048**	3,203	-155	**915**	1,492	-577

Underlying revenue and **underlying profit before financing** are discussed in the Review of 2016 (page 4), the Group Trading Summary (page 9) and the Operational Reviews (from page 12).

Underlying financing costs increased by £42m to £102m. Net interest payable increased by £4m to £63m. Other underlying financing costs increased by £38m to £39m, principally due to the non-recurrence of an underlying foreign exchange gain recognised in 2015, which arose from the realised gains on foreign exchange contracts settled to translate overseas dividends in to sterling.

Underlying taxation was £261m (2015: £351m), an underlying rate of 32.1% compared with 24.5% in 2015. The primary reasons for the increase are the non-recognition of deferred tax assets on losses in Norway, which reflects the current uncertainty in the oil & gas market, and a different profit mix with more profits arising in countries with higher tax rates.

Underlying EPS decreased 49% to 30.13p, reflecting the reduction in profit for the year.

At the Annual General Meeting on 4 May 2017, the directors will recommend an issue of 71 C Shares with a total nominal value of 7.1 pence for each ordinary share. Together with the interim issue on 4 January 2017 of 46 C Shares for each ordinary share with a total nominal value of 4.6 pence, this is the equivalent of a total annual **payment to ordinary shareholders** of 11.7 pence for each ordinary share. Further details are included on pages 8 and 48.

Reported income statement **Year to 31 December** £m	**2016**	2015[1]
Revenue	**14,955**	13,725
Gross profit	**3,048**	3,277
Other operating income	**5**	10
Commercial and administrative costs[2]	**(2,208)**	(1,070)
Research and development costs	**(918)**	(818)
Share of results of joint ventures and associates	**117**	100
Operating profit	**44**	1,499
(Loss)/profit on disposal of businesses	**(3)**	2
Profit before financing	**41**	1,501
Net financing	**(4,677)**	(1,341)
(Loss)/profit before tax	**(4,636)**	160
Tax	**604**	(76)
(Loss)/profit for the year	**(4,032)**	84
Earnings per share (EPS)	**(220.08)p**	4.51p

[1] 2015 figures have been restated as a result of £11m costs previously reported in 'cost of sales', being reclassified as 'commercial and administrative costs' to ensure consistent treatment with 2016.
[2] In 2016, 'commercial and administrative costs' include £671m for financial penalties from agreements with investigating bodies and £306m for the restructuring of the UK pension schemes.

The changes in 2016 resulting from underlying trading are described in the previous sections.

Consistent with past practice and IFRS, we provide both reported and underlying figures. As the Group does not hedge account in accordance with IAS 39 *Financial Instruments*, we believe underlying figures are more representative of the trading performance, by excluding the impact of year-end mark-to-market adjustments, principally the USD:GBP hedge book, which has had a significant impact on the reported results in 2016 as the USD:GBP rate has fallen from 1.48 to 1.23 and the EUR:GBP has fallen from 1.36 to 1.17. The adjustments between the underlying income statement and the reported income statement are set out in note 2 to the condensed consolidated financial statements. This basis of presentation has been applied consistently.

The most significant items included in the reported income statement, but not in underlying are summarised below.

Profit before financing

The impact of measuring revenues and costs at spot rates rather than rates achieved on hedging transactions. This increased revenues by £1,172m (2015: £371m) and increased profit before financing by £570m (2015: £265m).

The effects of acquisition accounting £115m (2015: £124m), principally relating to the amortisation of intangible assets arising on the acquisition of Power Systems in 2013.

The impairment of goodwill of £219m (2015: £75m), principally relating to the Marine business as a result of the continued weakness in the oil & gas market (see note 8).

Exceptional restructuring costs of £129m (2015: £49m). These are costs associated with the substantial closure or exit of a site, facility or activity and increased as a result on the ongoing transformation programme.

Financial penalties of £671m from agreements with investigating bodies (page 5).

Costs of restructuring the UK pension schemes in 2016 of £306m, principally a settlement charge on the transfer of the Vickers Group Pension Scheme to an insurance company (see note 11).

Financing and taxation

The mark to market adjustments on the Group's hedge book of £4,420m (2015: £1,306m). These reflect: the large hedge book held by the Group (eg. USD $38bn); and the weakening of

sterling, particularly against the US dollar and the euro, as noted above. At each year end, our foreign exchange hedge book is included in the balance sheet at fair value ('mark to market') and the movement in the year included in reported financing costs.

Appropriate tax rates are applied to these additional items included in the reported results, leading to an additional tax credit of £865m (2015: £275m), largely as a result of the mark to market adjustments.

Reconciliation between underlying and reported results								
Year to 31 December	**Revenue**		**Profit before financing**		**Financing**		**Profit/(loss) before tax**	
£m	**2016**	2015	**2016**	2015	**2016**	2015	**2016**	2015
Underlying	**13,783**	13,354	**915**	1,492	**(102)**	(60)	**813**	1,432
Revenue recognised at exchange rate on date of transaction	**1,172**	371	**–**	–	**–**	–	**–**	–
Mark-to-market adjustments on derivatives	**–**	–	**–**	(9)	**(4,420)**	(1,306)	**(4,420)**	(1,315)
Related foreign exchange adjustments	**–**	–	**570**	265	**(151)**	(15)	**419**	250
Movements on other financial instruments	**–**	–	**–**	–	**(8)**	8	**(8)**	8
Effects of acquisition accounting	**–**	–	**(115)**	(124)	**–**	–	**(115)**	(124)
Impairment of goodwill	**–**	–	**(219)**	(75)	**–**	–	**(219)**	(75)
Exceptional restructuring	**–**	–	**(129)**	(49)	**–**	–	**(129)**	(49)
Acquisitions and disposals	**–**	–	**(3)**	2	**–**	–	**(3)**	2
Financial penalties	**–**	–	**(671)**	–	**–**	–	**(671)**	–
Post-retirement schemes	**–**	–	**(306)**	–	**3**	32	**(303)**	32
Other	**–**	–	**(1)**	(1)	**1**	–	**–**	(1)
Reported	**14,955**	13,725	**41**	1,501	**(4,677)**	(1,341)	**(4,636)**	160

Summary balance sheet **At 31 December**		
£m	**2016**	2015
Intangible assets	**5,080**	4,645
Property, plant and equipment	**4,114**	3,490
Joint ventures and associates	**844**	576
Net working capital[1]	**(1,553)**	(501)
Net funds[2]	**(225)**	(111)
Provisions	**(759)**	(640)
Net post-retirement scheme deficits	**(29)**	(77)
Net financial assets and liabilities[2]	**(5,751)**	(1,883)
Other net assets and liabilities[3]	**143**	(483)
Net assets	**1,864**	5,016
Other items		
US$ hedge book (US$bn)	**37.8**	28.8
TotalCare assets	**3,348**	2,994
TotalCare liabilities	**(907)**	(783)
Net TotalCare assets	**2,441**	2,211
Gross customer finance commitments	**238**	269
Net customer finance commitments	**61**	54

1 Net working capital includes inventories, trade and other receivables, trade and other payables and current tax assets and liabilities.
2 Net funds includes £358m (2015 £13m) of the fair value of financial instruments which are held to hedge the fair value of borrowings.
3 Other includes other investments and deferred tax assets and liabilities.

Intangible assets (note 8) increased by £435m mainly due to exchange differences of £438m. Additions of £631m (including £154m of certification and participation fees, £100m of development costs and £208m of contractual aftermarket rights) were largely offset by amortisation of £406m and impairment of £222m (including £200m on Marine goodwill).

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain:

reductions in assumed market share; programme timings; increases in unit cost assumptions; and adverse movements in discount rates.

Property, plant and equipment (note 9) increased by £624m, around half of which was caused by exchange differences of £330m. Additions of £701m (including £75m of TotalCare® Flex® engines) were offset by depreciation of £424m and £41m was added from the reclassification of joint ventures to joint operations.

Investments in joint ventures and associates increased by £268m, including an increase of £154m in the Group's share of authorised maintenance centre joint ventures. The other main movements were: exchange gains of £109m; and the Group's share of retained profit of £43m; offset by a £57m reclassification of certain joint ventures to joint operations.

Movements in **net funds** are shown overleaf.

Net working capital reduced by £1,052m, including a £671m accrual for financial penalties, £134m increased deposits and £265m of foreign exchange movements. This was partially offset by higher inventory of £194m.

Provisions largely relate to warranties and guarantees provided to secure the sale of OE and services. The increase of £119m includes reclassifications from accruals of £92m, following a review of accounting consistency during the period. The remaining increase of £27m includes net additional charges of £271m (including £147m for warranties and), and foreign exchange movements of £75m, offset by utilisation of £227m.

Net post-retirement scheme deficits (note 11) have reduced by £48m.

In the UK (increase in surplus of £293m), changes in actuarial estimates increased the value of the obligations £1.8bn, largely due to the discount rate reducing from 3.6% to 2.7%. This was more than offset by returns (in excess of those assumed) on the scheme assets of £2.3bn. This return is largely due to the liability driven investment policy of the assets being invested to match changes in value of the obligations (on a proxy solvency basis, which is more onerous than the accounting valuation). The net increase in surplus was reduced by the recognition of a settlement charge of £301m on the insurance buy-out of the Vickers Group Pension Scheme.

The principal movements in overseas schemes (increase in deficit of £245m) were exchange differences of £208m.

Net financial assets and liabilities principally relate to the fair value of foreign exchange, commodity and interest rate contracts, set out in detail in note 10. All contracts continue to be held for hedging purposes. The fair value of foreign exchange derivatives is a net financial liability of £5.6bn, an increase of £3.9bn in the period, mainly a result of the weakening of sterling against the US dollar and euro.

The **US$ hedge book** increased by 31% to US$37.8bn. This represents around 5½ years of net exposure and has an average book rate of £1 to US$1.55.

Net TotalCare assets relate to Long-Term Service Agreement (LTSA) contracts in the Civil Aerospace business, including the flagship services product TotalCare. These assets represent the timing difference between the recognition of income and costs in the income statement and cash receipts and payments.

Customer financing facilitates the sale of OE and services by providing financing support to certain customers. Where such support is provided by the Group, it is generally to customers of the Civil Aerospace business and takes the form of various types of credit and asset value guarantees. These exposures produce contingent liabilities that are outlined in note 12. The contingent liabilities represent the maximum aggregate discounted gross and net exposure in respect of delivered aircraft, regardless of the point in time at which such exposures may arise. The reduction in gross exposures is a result of guarantees expiring.

Summary funds flow statement[1] **Year to 31 December** £m	**2016**	2015	Change
Opening net (debt)/funds	**(111)**	666	
Closing net debt	**(225)**	(111)	
Change in net funds	**(114)**	(777)	
Underlying profit before tax	**813**	1,432	-619
Depreciation and amortisation	**720**	613	+107
Movement in net working capital	**(55)**	(544)	+489
Expenditure on property, plant and equipment and intangible assets	**(1,201)**	(887)	-314
Other	**47**	(229)	+276
Trading cash flow	**324**	385	-61
Contributions to defined benefit pensions in excess of underlying PBT charge	**(67)**	(46)	-21
Taxation paid	**(157)**	(160)	+3
Free cash flow	**100**	179	-79
Shareholder payments	**(301)**	(421)	+120
Share buyback	**–**	(414)	+414
Acquisitions and disposals	**(153)**	(3)	-150
Discontinued operations	**–**	(121)	+121
Foreign exchange	**240**	3	+237
Change in net funds	**(114)**	(777)	

[1] The derivation of the summary funds flow statement above from the reported cash flow statement is included in note 14 of the condensed consolidated financial statements.

Movement in working capital – the £55m increase in working capital includes an increase in inventory, partially offset by a net reduction in financial working capital. These movements are largely driven by the increased sales volumes during 2016.

Expenditure on property, plant and equipment and intangibles – the major increases are: £98m higher property plant and equipment expenditure as we build the supply chain; £37m software costs relating to systems development; £81m certification costs driven by the Trent XWB-97 programme; £45m capitalised development costs largely relating to the Trent 1000 TEN; and £46m higher contractual aftermarket rights, mainly on Trent XWB sales.

Pensions – the increase in pension contributions in excess of the underlying income statement largely reflects changes in net past service costs £13m.

Shareholder payments – the change in shareholder payments reflects the difference between the 2014 and 2015 payments, which are paid in the following year.

Acquisitions and disposals include the £154m increase in stake in joint ventures described above.

Condensed consolidated financial statements

Condensed consolidated income statement

For the year ended 31 December 2016

	Notes	2016 £m	2015[1] £m
Revenue	2	**14,955**	13,725
Cost of sales		**(11,907)**	(10,448)
Gross profit		**3,048**	3,277
Other operating income		**5**	10
Commercial and administrative costs[2]		**(2,208)**	(1,070)
Research and development costs	3	**(918)**	(818)
Share of results of joint ventures and associates		**117**	100
Operating profit		**44**	1,499
(Loss)/profit on disposal of businesses		**(3)**	2
Profit before financing and taxation		**41**	1,501
Financing income	4	**96**	115
Financing costs	4	**(4,773)**	(1,456)
Net financing		**(4,677)**	(1,341)
(Loss)/profit before taxation*		**(4,636)**	160
Taxation	5	**604**	(76)
(Loss)/profit for the year		**(4,032)**	84
Attributable to:			
Ordinary shareholders		**(4,032)**	83
Non-controlling interests		**–**	1
(Loss)/profit for the year		**(4,032)**	84
Earnings per ordinary share attributable to shareholders	6		
Basic		**(220.08)p**	4.51p
Diluted		**(220.08)p**	4.48p
Underlying earnings per ordinary share are shown in note 6.			
Payments to ordinary shareholders in respect of the year	7		
Pence per share		**11.70p**	16.37p
Total		**215**	301
* Underlying profit before taxation	2	**813**	1,432

[1] 2015 figures have been restated as a result of £11m of Power Systems costs previously reported in cost of sales, being reclassified as commercial and administrative costs to ensure consistent treatment with 2016. The applicable notes have been restated.

[2] In 2016, commercial and administrative costs include £671m for financial penalties from agreements with investigating bodies (see note 12) and £306m for the restructuring of the UK pension schemes (see note 11).

All activities comprise continuing operations.

Condensed consolidated statement of comprehensive income

For the year ended 31 December 2016

	Notes	2016 £m	2015 £m
(Loss)/profit for the period		**(4,032)**	84
Other comprehensive income (OCI)			
Items that will not be reclassified to profit or loss			
Movements in post-retirement schemes	11	**495**	(722)
Share of OCI of joint ventures and associates		**(2)**	–
Related tax movements		**(179)**	257
		314	(465)
Items that may be reclassified to profit or loss			
Foreign exchange translation differences on foreign operations		**861**	(129)
Reclassification to income statement on disposal of businesses		**–**	1
Share of OCI of joint ventures and associates		**(7)**	(19)
Related tax movements		**4**	(2)
		858	(149)
Total comprehensive income for the year		**(2,860)**	(530)
Attributable to:			
Ordinary shareholders		**(2,860)**	(530)
Non-controlling interests		**–**	–
Total comprehensive expense for the year		**(2,860)**	(530)

Condensed consolidated balance sheet

At 31 December 2016

	Notes	2016 £m	2015 £m
ASSETS			
Non-current assets			
Intangible assets	8	**5,080**	4,645
Property, plant and equipment	9	**4,114**	3,490
Investments – joint ventures and associates		**844**	576
Investments – other		**38**	33
Other financial assets	10	**382**	83
Deferred tax assets		**876**	318
Post-retirement scheme surpluses	11	**1,346**	1,063
		12,680	10,208
Current assets			
Inventories		**3,086**	2,637
Trade and other receivables		**6,956**	6,244
Taxation recoverable		**32**	23
Other financial assets	10	**5**	29
Short-term investments		**3**	2
Cash and cash equivalents		**2,771**	3,176
Assets held for sale		**5**	5
		12,858	12,116
Total assets		**25,538**	22,324
LIABILITIES			
Current liabilities			
Borrowings		**(172)**	(419)
Other financial liabilities	10	**(651)**	(331)
Trade and other payables		**(7,957)**	(6,923)
Tax liabilities		**(211)**	(164)
Provisions for liabilities and charges		**(543)**	(336)
		(9,534)	(8,173)
Non-current liabilities			
Borrowings		**(3,185)**	(2,883)
Other financial liabilities	10	**(5,129)**	(1,651)
Trade and other payables		**(3,459)**	(2,317)
Tax liabilities		**–**	(1)
Deferred tax liabilities		**(776)**	(839)
Provisions for liabilities and charges		**(216)**	(304)
Post-retirement scheme deficits	11	**(1,375)**	(1,140)
		(14,140)	(9,135)
Total liabilities		**(23,674)**	(17,308)
Net assets		**1,864**	5,016
EQUITY			
Attributable to ordinary shareholders			
Called-up share capital		**367**	367
Share premium account		**181**	180
Capital redemption reserve		**162**	161
Cash flow hedging reserve		**(107)**	(100)
Other reserves		**814**	(51)
Retained earnings		**445**	4,457
		1,862	5,014
Non-controlling interests		**2**	2
Total equity		**1,864**	5,016

Condensed consolidated cash flow statement

For the year ended 31 December 2016

	Notes	**2016 £m**	2015 £m
Reconciliation of cash flows from operating activities			
Operating profit		**44**	1,499
Loss on disposal of property, plant and equipment		**5**	8
Share of results of joint ventures and associates		**(117)**	(100)
Dividends received from joint ventures and associates		**74**	63
Amortisation and impairment of intangible assets	8	**628**	432
Depreciation and impairment of property, plant and equipment	9	**426**	378
Impairment of investments		**–**	2
Increase/(decrease) in provisions		**44**	(151)
(Increase)/decrease in inventories		**(161)**	63
Decrease/(increase) in trade and other receivables		**54**	(836)
Accruals for financial penalties from agreements with investigating bodies		**671**	–
Other increase in trade and other payables		**234**	242
Cash flows on other financial assets and liabilities held for operating purposes		**(608)**	(305)
Net defined benefit post-retirement cost recognised in profit before financing	11	**510**	213
Cash funding of defined benefit post-retirement schemes	11	**(271)**	(259)
Share-based payments		**35**	5
Net cash inflow from operating activities before taxation		**1,568**	1,254
Taxation paid		**(157)**	(160)
Net cash inflow from operating activities		**1,411**	1,094
Cash flows from investing activities			
Additions of unlisted investments		**–**	(6)
Additions of intangible assets	8	**(631)**	(408)
Disposals of intangible assets		**8**	4
Purchases of property, plant and equipment		**(585)**	(487)
Government grants received		**15**	8
Disposals of property, plant and equipment		**8**	33
Acquisitions of businesses		**(6)**	(5)
Disposal of discontinued operations		**–**	(121)
Disposals of other businesses		**7**	2
Increase in share in joint ventures		**(154)**	–
Other investments in joint ventures and associates		**(30)**	(15)
Cash and cash equivalents in joint ventures reclassified as joint operations		**5**	–
Net cash outflow from investing activities		**(1,363)**	(995)
Cash flows from financing activities			
Repayment of loans	10	**(434)**	(54)
Proceeds from increase in loans and finance leases		**93**	1,150
Capital element of finance lease payments		**(4)**	(1)
Net cash flow from (decrease)/increase in borrowings and finance leases		**(345)**	1,095
Interest received		**14**	5
Interest paid		**(84)**	(58)
Interest element of finance lease payments		**(2)**	(2)
(Increase)/decrease in short-term investments		**(1)**	5
Issue of ordinary shares (net of expenses)		**1**	32
Purchase of ordinary shares – share buyback		**–**	(433)
Purchase of ordinary shares – other		**(21)**	(2)
Redemption of C Shares		**(301)**	(421)
Net cash (outflow)/inflow from financing activities		**(739)**	221
Change in cash and cash equivalents		**(691)**	320
Cash and cash equivalents at 1 January		**3,176**	2,862
Exchange gains/(losses) on cash and cash equivalents		**286**	(6)
Cash and cash equivalents at 31 December		**2,771**	3,176

	2016 £m	2015 £m
Reconciliation of movements in cash and cash equivalents to movements in net debt		
Change in cash and cash equivalents	**(691)**	320
Cash flow from decrease/(increase) in borrowings and finance leases	**345**	(1,095)
Cash flow from (decrease)/increase in short-term investments	**1**	(5)
Change in net debt resulting from cash flows	**(345)**	(780)
Net debt (excluding cash and cash equivalents) of joint ventures reclassified to joint operations	**(9)**	–
Exchange gains on net debt	**240**	3
Fair value adjustments	**(345)**	45
Movement in net debt	**(459)**	(732)
Net debt at 1 January excluding the fair value of swaps	**(124)**	608
Net debt at 31 December excluding the fair value of swaps	**(583)**	(124)
Fair value of swaps hedging fixed rate borrowings	**358**	13
Net debt at 31 December	**(225)**	(111)

The movement in net funds (defined by the Group as including the items shown below) is as follows:

	At 1 January 2016 £m	Funds flow £m	Reclassification of joint ventures to joint operations £m	Exchange differences £m	Fair value adjustments £m	Reclassifications £m	At 31 December 2016 £m
Cash at bank and in hand	**662**	**96**	**5**	**109**	**–**	**–**	**872**
Money market funds	**783**	**(260)**	**–**	**29**	**–**	**–**	**552**
Short-term deposits	**1,731**	**(532)**	**–**	**148**	**–**	**–**	**1,347**
Cash and cash equivalents	**3,176**	**(696)**	**5**	**286**	**–**	**–**	**2,771**
Short-term investments	**2**	**1**	**–**	**–**	**–**	**–**	**3**
Current borrowings	**(417)**	**350**	**(9)**	**(24)**	**–**	**(69)**	**(169)**
Non-current borrowings	**(2,833)**	**(1)**	**–**	**(11)**	**(345)**	**69**	**(3,121)**
Finance leases	**(52)**	**(4)**	**–**	**(11)**	**–**	**–**	**(67)**
Net debt excluding the fair value of swaps	**(124)**	**(350)**	**(4)**	**240**	**(345)**	**–**	**(583)**
Fair value of swaps hedging fixed rate borrowings	**13**				**345**		**358**
Net debt	**(111)**	**(350)**	**(4)**	**240**	**–**	**–**	**(225)**

Condensed consolidated statement of changes in equity

For the year ended 31 December 2016

	Attributable to ordinary shareholders								
	Share capital	Share premium	Capital redemption reserve	Cash flow hedging reserve	Other reserves [1]	Retained earnings [2]	**Total**	Non-controlling interests (NCI)	**Total equity**
	£m	£m	£m	£m	£m	£m	**£m**	£m	**£m**
At 1 January 2015	**376**	**179**	**159**	**(81)**	**78**	**5,671**	**6,382**	**5**	**6,387**
Profit for the year	–	–	–	–	–	83	83	1	84
Foreign exchange translation differences on foreign operations	–	–	–	–	(128)	–	(128)	(1)	(129)
Reclassified to income statement on disposal of business	–	–	–	–	1	–	1	–	1
Movements on post-retirement schemes	–	–	–	–	–	(722)	(722)	–	(722)
Share of comprehensive income of joint ventures and associates	–	–	–	(19)	–	–	(19)	–	(19)
Related tax movements	–	–	–	–	(2)	257	255	–	255
Total comprehensive income for the year	**–**	**–**	**–**	**(19)**	**(129)**	**(382)**	**(530)**	**–**	**(530)**
Arising on issues of ordinary shares	–	1	–	–	–	–	1	–	1
Issue of C Shares[4]	–	–	(430)	–	–	2	(428)	–	(428)
Redemption of C Shares	–	–	423	–	–	(423)	–	–	–
Ordinary shares purchased – buyback[5]	–	–	–	–	–	(433)	(433)	–	(433)
Ordinary shares cancelled[5]	(9)	–	9	–	–	–	–	–	–
Ordinary shares purchased – other	–	–	–	–	–	(2)	(2)	–	(2)
Share-based payments – direct to equity[3]	–	–	–	–	–	30	30	–	30
Transactions with NCI	–	–	–	–	–	–	–	(3)	(3)
Related tax movements	–	–	–	–	–	(6)	(6)	–	(6)
Other changes in equity in the year	**(9)**	**1**	**2**	**–**	**–**	**(832)**	**(838)**	**(3)**	**(841)**
At 1 January 2016	**367**	**180**	**161**	**(100)**	**(51)**	**4,457**	**5,014**	**2**	**5,016**
Loss for the year	–	–	–	–	–	(4,032)	(4,032)	–	(4,032)
Foreign exchange translation differences on foreign operations	–	–	–	–	861	–	861	–	861
Movements on post-retirement schemes	–	–	–	–	–	495	495	–	495
Share of comprehensive income of joint ventures and associates	–	–	–	(7)	–	(2)	(9)	–	(9)
Related tax movements	–	–	–	–	4	(179)	(175)	–	(175)
Total comprehensive income for the year	**–**	**–**	**–**	**(7)**	**865**	**(3,718)**	**(2,860)**	**–**	**(2,860)**
Arising on issues of ordinary shares	–	1	–	–	–	–	1	–	1
Issue of C Shares[4]	–	–	(301)	–	–	1	(300)	–	(300)
Redemption of C Shares	–	–	302	–	–	(302)	–	–	–
Ordinary shares purchased	–	–	–	–	–	(21)	(21)	–	(21)
Share-based payments – direct to equity[3]	–	–	–	–	–	30	30	–	30
Related tax movements	–	–	–	–	–	(2)	(2)	–	(2)
Other changes in equity in the year	**–**	**1**	**1**	**–**	**–**	**(294)**	**(292)**	**–**	**(292)**
At 31 December 2016	**367**	**181**	**162**	**(107)**	**814**	**445**	**1,862**	**2**	**1,864**

[1] Other reserves include a merger reserve of £3m and a translation reserve of £811m.

[2] At 31 December 2016, 6,854,216 ordinary shares with a net book value of £56m (2015: 5,894,064, 2014: 14,561,097 ordinary shares with net book values of £52m and £129m respectively) were held for the purpose of share-based payment plans and included in retained earnings. During the year, 1,955,390 ordinary shares with a net book value of £17m (2015: 10,892,026 shares with a net book value of £98m) vested in share-based payment plans. During the year the Company acquired 165,542 (2015: 224,993) of its ordinary shares via reinvestment of dividends received on its own shares and purchased 2,750,000 (2015: 2,000,000) of its ordinary shares through purchases on the London Stock Exchange.

[3] Share-based payments- direct to equity is the net of the credit to equity in respect of the share-based charge to the income statement and the actual cost of shares vesting in the period, excluding those vesting from shares already held.

[4] In Rolls-Royce Holdings plc's own financial statements, C Shares are issued from the merger reserve. As this reserve is eliminated on consolidation, in the consolidated financial statements, the C Shares are shown as being issued from the capital redemption reserve.

[5] Following the completion of the sale of the Energy business to Siemens on 1 December 2014 and further to the announcement on 19 June 2014 of a £1bn share buyback, the Company put in place a programme to enable the purchase of its ordinary shares. The aim of the buyback was to reduce the issued share capital of the Company, helping enhance returns for shareholders. In the year to 31 December 2015, 46,016,303 shares were purchased at an average price of 937p. 44,016,303 of these shares were cancelled and 2,000,000 were retained for use in share-based payment plans.

1 Basis of preparation and accounting policies

Reporting entity

Rolls-Royce Holdings plc is a company domiciled in the UK. These condensed consolidated year financial statements of the Company as at and for the year ended 31 December 2016 comprise the Company and its subsidiaries (together referred to as the "Group") and the Group's interests in joint arrangements and associates.

The consolidated financial statements of the Group as at and for the year ended 31 December 2015 (2015 Annual Report) are available upon request from the Company Secretary, Rolls-Royce Holdings plc, 62 Buckingham Gate, London SW1E 6AT.

Statement of compliance

These condensed consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) adopted for use in the EU. They do not include all of the information required for full annual statements, and should be read in conjunction with the 2016 Annual Report.

The comparative figures for the financial year 31 December 2015 are not the Group's statutory accounts for that financial year. Those accounts have been reported on by the Group's auditors and delivered to the registrar of companies. The report of the auditors was (i) unqualified, (ii) did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report, and (iii) did not contain a statement under section 498(2) or (3) of the Companies Act 2006.

The Board of directors approved the condensed consolidated year financial statements on 13 February 2017.

Significant accounting policies

No new accounting policies had a significant impact in 2016.

During the year, the Group has reassessed the categorisation of joint arrangements. As a result of this review, certain entities, previously classified as joint ventures, have been reclassified as joint operations from 1 January 2016. This reclassification does not affect profit before tax or net assets, but the Group's share of the individual income statement and balance sheet categories are included on a proportional basis, rather than as a single figure. The adjustment to the opening balance was to reclassify £57m of investments in joint ventures to: property, plant and equipment (£41m), inventory (£19m), receivables (£18m), cash (£5m), payables (£17m) and borrowings (£9m). Prior figures have not been restated. In addition, following a review of consistency, £92m of accruals have been reclassified as provisions.

Forthcoming accounting standards

IFRS 15 *Revenue from Contracts with Customers* (effective for the year beginning 1 January 2018), provides a single, principles-based five-step model to be applied to all sales contracts, based on the transfer of control of goods and services to customers. It replaces the separate models for goods, services and construction contracts currently included in IAS 11 Construction Contracts and IAS 18 Revenue.

The Group has undertaken significant analysis of how IFRS 15 should be implemented and has taken tentative accounting policy decisions. Based on this analysis, we expect that adoption of IFRS 15 will have a significant impact on the timing of recognition of revenue on individual long-term contracts, most particularly in the Civil Aerospace business. The most significant changes are:

- IFRS 15 contains more specific requirements on the combination of contracts. Contracts can only be combined if they are with the same counterparty or related counterparties. The existing standards require contracts with different counterparties to be combined where that reflects the overall substance of a transaction. As a result, it will no longer be possible to link contracts entered into at the same time (with an airframer) for installed original equipment (OE) with long-term contracts (with the aircraft operator) for aftermarket services (LTSAs) relating to that OE.

- For similar reasons, it will no longer be possible to recognise an intangible asset in respect of contractual aftermarket rights (relating to future aftermarket business with an operator) when OE is sold to an airframer.

- For each performance obligation identified, IFRS 15 requires revenue to be recognised based on the transfer of control of the relevant goods or services. In contrast, under the existing standards, revenue is recognised based on when risk and reward is transferred. As a result it will no longer be possible to use flying hours (or equivalent) as a basis for measuring the stage of completion of LTSAs.

- Compared to IAS 11, IFRS 15 includes only limited guidance on accounting for costs incurred to fulfil a performance obligation and in general these will be recognised as incurred. It is no longer possible to defer or accrue costs to report a consistent margin percentage over the term of the LTSAs.

In summary, the impact of these changes will be that upon adoption of IFRS 15:

- Revenues and costs relating to deliveries of engines will be recognised when they are delivered. The revenue recognised will comprise that included in the contract with the airframer reduced (if applicable) by any OE concession agreed with the operator (which IFRS 15 describes as a payment to "a customer's customer"). Consequently, the revenues and costs recognised on OE deliveries will more closely match the related cash flows. No contractual aftermarket revenue will be allocated to the OE delivery (where contracts are currently combined – 'linked accounting') and no intangible asset will be recognised (where contracts are

not currently combined – 'unlinked accounting'). This will result in a loss being recognised on engine deliveries when the direct costs exceed the direct revenues.

- Revenues on LTSAs will be recognised as services are performed rather than as the equipment is used (engine flying hours) as is the case under the current accounting policy. The stage of completion will be measured using the actual costs incurred to date compared to the estimated costs to complete the performance obligation. In practice the bulk of the revenue and costs will relate to overhaul activity which occurs at distinct points of time during the period of the LTSA. As the first major overhaul typically occurs some years after delivery, this change will generally defer the recognition of revenue on LTSAs, as compared to the current accounting policy.

Taken together, had IFRS 15 been applicable with effect from 1 January 2015, the Group currently estimates the results for the year ended 31 December 2015 would have been as follows:

	IAS 11 and IAS 18		IFRS 15	
	Reported £bn	*Underlying £bn*	Reported £bn	*Underlying £bn*
Revenue				
Civil Aerospace original equipment		*3.3*		*2.6*
Civil Aerospace aftermarket services		*3.7*		*3.5*
Other		*6.4*		*6.4*
Total revenue	13.7	*13.4*	12.8	*12.5*
Gross profit				
Civil Aerospace		*1.5*		*0.6*
Other		*1.7*		*1.7*
Total gross profit	3.3	*3.2*	2.4	*2.3*
Profit before financing and taxation	1.5	*1.5*	0.6	*0.6*
Net financing	(1.3)	*(0.1)*	(1.3)	*(0.1)*
Taxation	(0.1)	*(0.3)*	0.1	*(0.1)*
Profit for the year	0.1	*1.1*	(0.6)	*0.4*
Net assets	**5.0**		**2.0**	

The Group plans to adopt IFRS 15 in 2018 using the 'full' retrospective approach. The comparative 2017 results included in the 2018 financial statements will be restated, with an adjustment to equity as at 1 January 2017.

The Group will continue to work during 2017 to design, implement and refine procedures to apply the new requirements of IFRS 15 and to finalise accounting policy choices. As a result of this ongoing work, it is possible that some changes to the impact above may result.

2 Analysis by business segment

The analysis by Divisions (business segment) is presented in accordance with IFRS 8 *Operating segments*, on the basis of those segments whose operating results are regularly reviewed by the Board (the Chief Operating Decision Maker as defined by IFRS 8).

Civil	development, manufacture, marketing and sales of commercial aero engines and aftermarket services.
Defence	development, manufacture, marketing and sales of military aero engines and aftermarket services.
Power Systems	development, manufacture, marketing and sales of reciprocating engines and power systems.
Marine	development, manufacture, marketing and sales of marine-power propulsion systems and aftermarket services.
Nuclear	development, manufacture, marketing and sales of nuclear systems for civil power generation and naval propulsion systems.

The operating results are prepared on an underlying basis, which the Board considers reflects better the economic substance of the Group's trading during the year and provides financial measures that, together with the results prepared in accordance with Adopted IFRS, allow better analysis of the factors affecting the year's results compared to the prior period. The principles adopted to determine the underlying results are:

Underlying revenues and costs – Where revenues and costs are denominated in a currency other than the functional currency of the Group undertaking and the Group hedges the net exposure, these reflect the achieved exchange rates arising on derivative contracts settled to cover the net exposure. These achieved exchange rates are applied to all relevant revenues and costs, including those for which there is a natural offsetting position, rather than translating the offsetting transactions at spot rates. The underlying profits would be the same under both approaches, but the Board considers that the approach taken provides a better indication of trends over time.

Underlying profit before financing – In addition to impact of exchange rates on revenues and costs above, adjustments have been made to exclude one-off past service credits on post-retirement schemes, exceptional restructuring costs (associated with the substantial closure or exit of a site, facility or line of business, or other major transformation activities), the effect of acquisition accounting, the effect of business disposals, the impairment of goodwill, and in 2016 financial penalties from agreements with investigating bodies.

Underlying profit before taxation – In addition to those adjustments in underlying profit before financing:

- includes amounts realised from settled derivative contracts and revaluation of relevant assets and liabilities to exchange rates forecast to be achieved from future settlement of derivative contracts; and
- excludes unrealised amounts arising from revaluations required by IAS 39 *Financial Instruments: Recognition and Measurement*, changes in value of financial RRSA contracts arising from changes in forecast payments, and the net impact of financing costs related to post-retirement scheme benefits.

Taxation – the tax effect of the adjustments above are excluded from the underlying tax charge. In addition changes in the amount of recoverable advance corporation tax recognised and the impact of changes in tax rates are also excluded.

This analysis also includes a reconciliation of the underlying results to those reported in the consolidated income statement.

The 2016 underlying results below are shown at 2015 exchange rates, with the adjustment to 2016 exchange rates shown separately.

	Civil £m	**Defence £m**	**Power Systems £m**	**Marine £m**	**Nuclear £m**	**Inter-segment £m**	**Total reportable segments £m**
For the year ended 31 December 2016							
Underlying revenue from original equipment	**3,272**	**823**	**1,609**	**575**	**346**	**(33)**	**6,592**
Underlying revenue from aftermarket services	**3,634**	**1,229**	**751**	**437**	**415**	**(35)**	**6,431**
Total underlying revenue at 2015 exchange rates	**6,906**	**2,052**	**2,360**	**1,012**	**761**	**(68)**	**13,023**
Translation to 2016 exchange rates	**161**	**157**	**295**	**102**	**16**	**(8)**	**723**
Total underlying revenue	**7,067**	**2,209**	**2,655**	**1,114**	**777**	**(76)**	**13,746**
Gross profit	**1,129**	**530**	**628**	**216**	**117**	**–**	**2,620**
Commercial and administrative costs	**(339)**	**(127)**	**(305)**	**(207)**	**(67)**	**–**	**(1,045)**
Restructuring	**(11)**	**10**	**–**	**3**	**–**	**–**	**2**
Research and development costs	**(549)**	**(68)**	**(157)**	**(39)**	**(6)**	**–**	**(819)**
Share of results of joint ventures and associates	**96**	**15**	**1**	**–**	**–**	**–**	**112**
Underlying profit before financing and taxation at 2015 exchange rates	**326**	**360**	**167**	**(27)**	**44**	**–**	**870**
Translation to 2016 exchange rates	**41**	**24**	**24**	**–**	**1**	**–**	**90**
Underlying profit before financing and taxation	**367**	**384**	**191**	**(27)**	**45**	**–**	**960**
For the year ended 31 December 2015							
Underlying revenue from original equipment	3,258	801	1,618	773	251	(53)	6,648
Underlying revenue from aftermarket services	3,675	1,234	767	551	436	(53)	6,610
Total underlying revenue	6,933	2,035	2,385	1,324	687	(106)	13,258
Gross profit	1,526	579	656	260	111	7	3,139
Commercial and administrative costs	(296)	(124)	(296)	(201)	(53)	–	(970)
Restructuring	(7)	(8)	(4)	(16)	(2)	–	(37)
Research and development costs	(515)	(73)	(162)	(28)	14	–	(764)
Share of results of joint ventures and associates	104	19	–	–	–	–	123
Underlying profit before financing and taxation	812	393	194	15	70	7	1,491

Reconciliation to reported results

	Total reportable segments £m	Other businesses* and corporate £m	Total underlying £m	Underlying adjustments £m	Reported results £m
For the year ended 31 December 2016					
Revenue from original equipment	6,592	20	6,612	976	7,588
Revenue from aftermarket services	6,431	15	6,446	921	7,367
Total underlying revenue at 2015 exchange rates	**13,023**	**35**	**13,058**	**1,897**	**14,955**
Translation to 2016 exchange rates	723	2	725	(725)	–
Total revenue	**13,746**	**37**	**13,783**	**1,172**	**14,955**
Gross profit	2,620	6	2,626	422	3,048
Other operating income	–	–	–	5	5
Commercial and administrative costs	(1,045)	(51)	(1,096)	(1,112)	(2,208)
Restructuring	2	–	2	(2)	–
Research and development costs	(819)	7	(812)	(106)	(918)
Share of results of joint ventures and associates	112	(5)	107	10	117
Profit before financing and taxation at 2015 exchange rates	870	(43)	827	(783)	44
Translation to 2016 exchange rates	90	(2)	88	(88)	–
Loss on disposal of businesses	–	–	–	(3)	(3)
Profit before financing and taxation	960	(45)	915	(874)	41
Net financing		(102)	(102)	(4,575)	(4,677)
Profit/(loss) before taxation		(147)	813	(5,449)	(4,636)
Taxation		(261)	(261)	865	604
Profit/(loss) for the period			552	(4,584)	(4,032)
Attributable to:					
Ordinary shareholders			552	(4,584)	(4,032)
Non-controlling interests			–	–	–
For the year ended 31 December 2015					
Revenue from original equipment	6,648	76	6,724	215	6,939
Revenue from aftermarket services	6,610	20	6,630	156	6,786
Total revenue	13,258	96	13,354	371	13,725
Gross profit	3,139	64	3,203	74	3,277
Other operating income	–	–	–	10	10
Commercial and administrative costs	(970)	(55)	(1,025)	(45)	(1,070)
Restructuring	(37)	(2)	(39)	39	–
Research and development costs	(764)	(1)	(765)	(53)	(818)
Share of results of joint ventures and associates	123	(5)	118	(18)	100
Profit on disposal of businesses	–	–	–	2	2
Profit before financing and taxation	1,491	1	1,492	9	1,501
Net financing		(60)	(60)	(1,281)	(1,341)
(Loss)/profit before taxation		(59)	1,432	(1,272)	160
Taxation		(351)	(351)	275	(76)
(Loss)/profit for the period		(410)	1,081	(997)	84
Attributable to:					
Ordinary shareholders			1,080	(997)	83
Non-controlling interests			1	–	1

* Other businesses comprise former Energy businesses not included in the disposal to Siemens in 2014.

	Total assets		Total liabilities		Net assets/(liabilities)	
	2016 £m	2015 £m	**2016 £m**	2015 £m	**2016 £m**	2015 £m
Civil	13,856	11,774	(14,510)	(8,709)	(654)	3,065
Defence	1,759	1,449	(1,996)	(1,698)	(237)	(249)
Power Systems	3,837	3,384	(1,151)	(1,017)	2,686	2,367
Marine	1,520	1,488	(903)	(783)	617	705
Nuclear	352	303	(435)	(324)	(83)	(21)
Inter-segment	(1,223)	(850)	1,223	850	–	–
Reportable segments	20,101	17,548	(17,772)	(11,681)	2,329	5,867
Other businesses and corporate	51	120	(183)	(120)	(132)	–
Net funds/(debt)	3,132	3,252	(3,357)	(3,363)	(225)	(111)
Tax assets/(liabilities)	908	341	(987)	(1,004)	(79)	(663)
Post-retirement scheme surpluses/(deficits)	1,346	1,063	(1,375)	(1,140)	(29)	(77)
	25,538	22,324	(23,674)	(17,308)	1,864	5,016

Group employees average during the year	2016	2015
Civil	**23,800**	23,100
Defence	**6,000**	6,300
Power Systems	**10,300**	10,600
Marine	**5,300**	6,000
Nuclear	**4,300**	4,100
Other businesses and corporate[1,2]	**200**	400
	49,900	50,500

[1] Other businesses and corporate includes the Energy businesses not sold to Siemens in 2014 and corporate employees who do not provide a shared service to the segments. Where corporate functions provide such a service, employees have been allocated to the segments on an appropriate basis. 2015 figures have been restated on this basis.

[2] As described in Note 1, the Group has reclassified certain joint ventures to joint operations from 1 January 2016. This increased the reported Group employees by 800.

Underlying adjustments	2016				2015			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**13,783**	**915**	**(102)**	**(261)**	13,354	1,492	(60)	(351)
Recognise revenue at exchange rate on date of transaction	**1,172**	**–**	**–**	**–**	371	–	–	–
Realised losses/(gains) on settled derivative contracts[1]	**–**	**426**	**162**	**(107)**	–	287	(35)	(51)
Net unrealised fair value changes to derivative contracts[2]	**–**	**–**	**(4,420)**	**792**	–	(9)	(1,306)	270
Effect of currency on contract accounting	**–**	**77**	**–**	**(14)**	–	(9)	–	2
Revaluation of trading assets and liabilities	**–**	**67**	**(313)**	**56**	–	(13)	20	(6)
Financial risk and revenue sharing arrangements (RRSAs) – exchange differences and changes in forecast payments	**–**	**–**	**(8)**	**(1)**	–	–	8	(1)
Effect of acquisition accounting[3]	**–**	**(115)**	**–**	**35**	–	(124)	–	31
Impairment of goodwill	**–**	**(219)**	**–**	**–**	–	(75)	–	–
Pension restructuring[4]	**–**	**(306)**	**–**	**107**				
Net post-retirement scheme financing	**–**	**–**	**3**	**(2)**	–	–	32	(12)
Disposal of business	**–**	**(3)**	**–**	**–**	–	2	–	15
Exceptional restructuring	**–**	**(129)**	**–**	**34**	–	(49)	–	11
Financial penalties from agreements with investigating bodies	**–**	**(671)**	**–**	**–**	–	–	–	–
Other	**–**	**(1)**	**1**	**(5)**	–	(1)	–	(2)
Reduction in rate of UK corporation tax	**–**	**–**	**–**	**(30)**	–	–	–	18
Total underlying adjustments	**1,172**	**(874)**	**(4,575)**	**865**	371	9	(1,281)	275
Reported per consolidated income statement	**14,955**	**41**	**(4,677)**	**604**	13,725	1,501	(1,341)	(76)

[1] The adjustments for realised losses/(gains) on settled derivative contracts include adjustments to reflect the losses/(gains) in the same period as the related trading cash flows.
[2] The adjustments for unrealised fair value changes to derivative contracts include those of equity accounted joint ventures and exclude those for which the related trading contracts have been cancelled when the fair value changes are recognised immediately in underlying profit.
[3] The adjustment eliminates charges recognised as a result of recognising assets in acquired businesses at fair value.
[4] In the UK, tax is provided on pension surpluses at a rate of 35%, which is the relevant rate if the surpluses were to be return to the Group.

3 Research and development

	2016 £m	2015 £m
Expenditure in the year	**(937)**	(831)
Capitalised as intangible assets	**99**	51
Amortisation of capitalised costs	**(147)**	(136)
Impairment of capitalised costs	**(2)**	–
Net cost	**(987)**	(916)
Entry fees received	**73**	83
Entry fees deferred in respect of charges in future periods	**(40)**	(28)
Recognition of previously deferred entry fees	**36**	43
Net cost recognised in the income statement	**(918)**	(818)
Underlying adjustments relating to the effects of acquisition accounting and foreign exchange	**56**	53
Net underlying cost recognised in the income statement	**(862)**	(765)
Translation to 2015 exchange rates	**50**	–
Net underlying cost at 2015 exchange rates	**(812)**	(765)

4 Net financing

	2016 **Per consolidated income statement** **£m**	***Underlying financing*** ***£m***	2015 Per consolidated income statement £m	*Underlying financing* *£m*
Financing income				
Interest receivable	**14**	***14***	12	*12*
Net fair value gains on foreign currency contracts	**1**	**–**	–	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	**23**	**–**	21	–
Net fair value gains on commodity contracts	**16**	**–**	–	–
Financing on post-retirement scheme surpluses	**42**	**–**	65	–
Net foreign exchange gains	**–**	**–**	17	*32*
	96	***14***	115	*44*
Financing costs				
Interest payable	**(77)**	***(77)***	(71)	*(71)*
Net fair value losses on foreign currency contracts	**(4,437)**	**–**	(1,217)	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	**(31)**	**–**	(13)	–
Financial charge relating to financial RRSAs	**(6)**	***(6)***	(8)	*(8)*
Net fair value losses on commodity contracts	**–**	**–**	(89)	–
Financing on post-retirement scheme deficits	**(39)**	**–**	(33)	–
Net foreign exchange losses	**(145)**	**–**	–	–
Other financing charges	**(38)**	***(33)***	(25)	*(25)*
	(4,773)	***(116)***	(1,456)	*(104)*
Net financing	**(4,677)**	***(102)***	(1,341)	*(60)*
Analysed as:				
Net interest payable	**(63)**	***(63)***	(59)	*(59)*
Net fair value losses on derivative contracts	**(4,420)**	**–**	(1,306)	–
Net post-retirement scheme financing	**3**	**–**	32	–
Net other financing	**(197)**	***(39)***	(8)	*(1)*
Net financing	**(4,677)**	***(102)***	(1,341)	*(60)*

5 Taxation

The effective reported tax rate for the year is 13.0% (2015 47.5%). The 2016 reported loss before tax largely relates to the mark to market adjustment on the foreign currency derivatives which arise mainly in the UK and the key driver of the reported rate is therefore the UK tax rate. The financial penalties and goodwill impairments on which no tax relief is available then have the effect of reducing the rate. The 2015 reported rate was high due to the low level of reported profit before tax and the higher proportion of those profits arising in higher tax countries such as the US and items that impact the tax charge having a more distortive effect.

Following announcements in the Summer Budget 2015 and the Budget 2016, the UK corporation tax rate will reduce to 19% from 1 April 2017 and 17% from 1 April 2020. The Summer Budget 2015 had originally announced that the rate would reduce to 18% from 1 April 2020. This reduction was substantively enacted on 26 October 2015 and so the prior year deferred tax assets and liabilities were calculated at this rate. The subsequent announcement in the Budget 2016 that the rate will reduce to 17% from 1 April 2020 was substantively enacted on 6 September 2016. As this reduction was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been calculated at this rate.

The resulting charges or credits have been recognised in the income statement except to the extent that they relate to items previously charged or credited to other comprehensive income or equity. Accordingly, in 2016, £30m has been charged to the income statement (2015: £18m credited) and £2m has been charged directly to equity (2015: £3m).

6 Earnings per ordinary share (EPS)

Basic EPS are calculated by dividing the profit attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the period, excluding ordinary shares held under trust, which have been treated as if they had been cancelled. Diluted EPS are calculated by adjusting the weighted average number of ordinary shares in issue during the period for the bonus element of share options.

	2016			2015		
	Basic	**Potentially dilutive share options[1]**	**Diluted**	Basic	Potentially dilutive share options	Diluted
(Loss)/profit attributable to ordinary shareholders (£m)	**(4,032)**	**–**	**(4,032)**	83	–	83
Weighted average number of ordinary shares (millions)	**1,832**	**–**	**1,832**	1,839	12	1,851
EPS (pence)	**(220.08)p**	**–**	**(220.08)p**	4.51p	(0.03)p	4.48p

[1] As there is a loss, the effect of potentially dilutive ordinary shares is anti-dilutive.

The reconciliation between underlying EPS and basic EPS is as follows:

	2016		2015	
	Pence	**£m**	Pence	£m
Underlying EPS / Underlying profit attributable to ordinary shareholders re-presented	**30.13**	**552**	58.73	1,080
Total underlying adjustments to profit before tax (note 2)	**(297.43)**	**(5,449)**	(69.17)	(1,272)
Related tax effects	**47.22**	**865**	14.95	275
EPS / (Loss)/profit attributable to ordinary shareholders	**(220.08)**	**(4,032)**	4.51	83
Diluted underlying EPS	**30.08**		58.35	

7 Payments to shareholders in respect of the year

Payments to shareholders in respect of the period represent the value of C Shares to be issued in respect of the results for the period. Issues of C Shares were declared as follows:

	2016		2015	
	Pence per share	**£m**	Pence per share	£m
Interim (issued in January)	**4.60**	**85**	9.27	170
Final (issued in July)	**7.10**	**130**	7.10	131
	11.70	**215**	16.37	301

8 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Contractual aftermarket rights £m	Customer relationships £m	Software £m	Other £m	Total £m
Cost:								
At 1 January 2016	**1,589**	**1,145**	**1,730**	**799**	**456**	**616**	**543**	**6,878**
Exchange differences	**284**	**26**	**116**	**–**	**84**	**16**	**66**	**592**
Additions	**–**	**154**	**100**	**208**	**–**	**116**	**53**	**631**
Acquisitions of businesses	**1**	**–**	**–**	**–**	**–**	**–**	**1**	**2**
Disposals	**–**	**–**	**(2)**	**–**	**–**	**(6)**	**–**	**(8)**
At 31 December 2016	**1,874**	**1,325**	**1,944**	**1,007**	**540**	**742**	**663**	**8,095**
Accumulated amortisation:								
At 1 January 2016	**86**	**373**	**691**	**394**	**139**	**325**	**225**	**2,233**
Exchange differences	**32**	**3**	**48**	**–**	**28**	**8**	**35**	**154**
Charge for the year	**–**	**64**	**147**	**39**	**42**	**81**	**33**	**406**
Impairment	**219**	**–**	**2**	**–**	**–**	**–**	**1**	**222**
At 31 December 2016	**337**	**440**	**888**	**433**	**209**	**414**	**294**	**3,015**
Net book value at:								
31 December 2016	**1,537**	**885**	**1,056**	**574**	**331**	**328**	**369**	**5,080**
31 December 2015	1,503	772	1,039	405	317	291	318	4,645

Goodwill has been tested for impairment during 2016 on the following basis:

- The carrying values of goodwill have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long-term and established nature of many of the Group's products (product lives are often measured in decades), these forecasts generally cover the next five-ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates (2.0-3.5%) that reflect the products, industries and countries in which the relevant cash generating unit (CGU) or group of CGUs operate.
- The key assumptions for the impairment tests are the discount rate and, in the cash flow projections, the programme assumptions, the growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs. Impairment tests are performed using prevailing exchange rates.

Prior to 2016, goodwill in the Marine business was considered as separate CGUs, based on the original acquisitions (comprising ODIM ASA, Scandinavian Electric Holdings and Vinters Limited (formerly Vickers plc)). However, following re-organisations, including those resulting from the current transformation programme, we now consider that the Marine business (excluding the UK marine defence business) is a single CGU.

The Marine business has continued to be impacted by the low crude oil price and over supply of vessels to its offshore support customers. The downturn has been deeper and more prolonged than forecast a year ago and, as a consequence, the Group has recognised an impairment loss of £200m to the carrying value of goodwill of the CGU. This is included in cost of sales in the income statement, but excluded from the underlying results. The impairment loss is based on a value in use calculation using cash flows forecast over a ten-year period (which are considered to take account of the cyclicality of the market). The impairment test indicated a recoverable amount of £473m (including allowance for identified risks of £18m) compared with a pre-impairment carrying value of £673m.

The Group has also recognised other impairments to goodwill of £19m, including £14m in relation to its North American civil nuclear business. This reflects the current weakness in the services market, although the Directors expect these to recover in the medium term.

Certification costs and participation fees, development expenditure and contractual aftermarket rights have been reviewed for impairment in accordance with the requirements of IAS 36 *Impairment of Assets*. Where an impairment test was considered necessary, it has been performed on the following basis:

- The carrying values have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions over the lives of the respective programmes.
- The key assumptions underlying cash flow projections are assumed market share, programme timings, unit cost assumptions, discount rates, and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at 9-13% (2015: 9-13%), based on the Group's weighted average cost of capital, adjusted for the estimated programme risk, for example taking account of whether or not the forecast cash flows arise from contracted business.

No impairment is required on this basis. However, a combination of adverse changes in assumptions (eg. market size and share, unit costs and programme delays) and other variables (eg. discount rate and foreign exchange rates), could result in impairment in future years.

9 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At 1 January 2016	**1,375**	**3,894**	**339**	**708**	**6,316**
Exchange differences	**141**	**352**	**12**	**55**	**560**
Reclassification of joint ventures to joint operations	**7**	**87**	**–**	**–**	**94**
Additions – purchased	**25**	**124**	**51**	**426**	**626**
Additions arising from TotalCare Flex arrangements (non-cash)	**–**	**–**	**75**	**–**	**75**
Disposal of businesses	**(1)**	**(3)**	**–**	**–**	**(4)**
Reclassifications	**131**	**230**	**63**	**(424)**	**–**
Disposals/write-offs	**(11)**	**(85)**	**(49)**	**–**	**(145)**
At 31 December 2016	**1,667**	**4,599**	**491**	**765**	**7,522**
Accumulated amortisation:					
At 1 January 2016	**416**	**2,284**	**125**	**1**	**2,826**
Exchange differences	**44**	**182**	**4**	**–**	**230**
Reclassification of joint ventures to joint operations	**1**	**52**	**–**	**–**	**53**
Charge for the year	**63**	**333**	**28**	**–**	**424**
Impairment	**1**	**–**	**–**	**1**	**2**
Disposal of businesses	**–**	**(2)**	**–**	**–**	**(2)**
Reclassifications	**–**	**(9)**	**9**	**–**	**–**
Disposals/write-offs	**(10)**	**(75)**	**(40)**	**–**	**(125)**
At 31 December 2016	**515**	**2,765**	**126**	**2**	**3,408**
Net book value at:					
31 December 2016	**1,152**	**1,834**	**365**	**763**	**4,114**
31 December 2015	959	1,610	214	707	3,490

10 Financial assets and liabilities

Other financial assets and liabilities comprise:

	Derivatives							
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts[1] £m	Total £m	Financial RRSAs £m	TotalCare Flex £m	C Shares £m	Total £m
At 31 December 2016								
Non-current assets	**13**	**5**	**364**	**382**	**–**	**–**	**–**	**382**
Current assets	**4**	**1**	**–**	**5**	**–**	**–**	**–**	**5**
Current liabilities	**(566)**	**(24)**	**–**	**(590)**	**(33)**	**–**	**(28)**	**(651)**
Non-current liabilities	**(5,002)**	**(38)**	**(6)**	**(5,046)**	**(68)**	**(15)**	**–**	**(5,129)**
	(5,551)	**(56)**	**358**	**(5,249)**	**(101)**	**(15)**	**(28)**	**(5,393)**
At 31 December 2015								
Non-current assets	3	–	80	83	–	–	–	83
Current assets	29	–	–	29	–	–	–	29
Current liabilities	(244)	(39)	–	(283)	(19)	–	(29)	(331)
Non-current liabilities	(1,428)	(65)	(67)	(1,560)	(91)	–	–	(1,651)
	(1,640)	(104)	13	(1,731)	(110)	–	(29)	(1,870)

[1] Includes the foreign exchange impact of cross-currency interest rate swaps.

Derivative financial instruments	**2016**				2015
	Foreign exchange £m	**Commodity £m**	**Interest rate £m**	**Total £m**	Total £m
At 1 January	**(1,640)**	**(104)**	**13**	**(1,731)**	(630)
Currency options at inception[1]	**(33)**	**–**	**–**	**(33)**	(20)
Movements in fair value hedges	**–**	**–**	**345**	**345**	(35)
Movements in other derivative contracts	**(4,436)**	**16**	**–**	**(4,420)**	(1,306)
Contracts settled	**558**	**32**	**–**	**590**	260
At 31 December	**(5,551)**	**(56)**	**358**	**(5,249)**	(1,731)

1 The Group wrote currency options to sell USD and buy GBP as part of a commercial agreement. The fair value of this option on inception was treated as a discount to the customer.

Financial risk and revenue sharing arrangements (RRSAs) and other financial liabilities	**Financial RRSAs**		**TotalCare Flex**
	2016 £m	2015 £m	**2016 £m**
At 1 January	**(110)**	(145)	**–**
Exchange adjustments included in OCI	**5**	–	**–**
Additions	**–**	–	**(14)**
Financing charge[1]	**(6)**	(8)	**(1)**
Excluded from underlying profit			
Changes in forecast payments[1]	**5**	11	
Exchange adjustments[1]	**(13)**	(3)	**(3)**
Cash paid to partners	**18**	35	**–**
Other	**–**	–	**3**
At 31 December	**(101)**	(110)	**(15)**

1 Included in net financing.

Fair values of financial instruments equate to book values with the following exceptions:

	2016		2015	
	Book value £m	**Fair value £m**	Book value £m	Fair value £m
Borrowings	**(3,357)**	**(3,317)**	(3,302)	(3,312)
Financial RRSAs	**(101)**	**(109)**	(110)	(110)

Fair values

The fair value of a financial instrument is the price at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms-length transaction. Fair values have been determined with reference to available market information at the balance sheet date, using the methodologies described below.

- Unlisted non-current investments primarily comprise bank deposits where the fair value approximates to the book value.
- The fair values of trade receivables and payables, short-term investments and cash and cash equivalents are assumed to approximate to cost either due to the short-term maturity of the instruments or because the interest rate of the investments is reset after periods not exceeding six months.
- Fair values of derivative financial assets and liabilities are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. These financial instruments are included on the balance sheet at fair value, derived from observable market prices (Level 2 as defined by IFRS 13 *Fair Value Measurement*).
- Borrowing, financial RRSAs and TotalCare Flex liabilities are carried at amortised cost. Fair values are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. For financial RRSAs, the contractual cash flows are based on future trading activity, which is estimated based on latest forecasts.

Borrowings

During the year, the Group has repaid £434m of short-term borrowings, including the £200m $7^3/_8$% Notes, which matured in June.

11 Pensions and other post-retirement benefits

Movements in the net post-retirement position recognised in the balance sheet were as follows:

	UK schemes £m	Overseas schemes £m	Total £m
At 1 January 2016	**1,043**	**(1,120)**	**(77)**
Exchange adjustments	**–**	**(208)**	**(208)**
Current service cost and administrative expenses[1]	**(169)**	**(50)**	**(219)**
Past service credit/(cost)	**22**	**(1)**	**21**
Settlements[1]	**(302)**	**(10)**	**(312)**
Financing recognised in the income statement	**41**	**(38)**	**3**
Contributions by employer	**185**	**86**	**271**
Actuarial gains/(losses) recognised in OCI[2]	**(1,810)**	**(26)**	**(1,836)**
Returns on plan assets excluding financing recognised in OCI[2]	**2,326**	**5**	**2,331**
Other	**–**	**(3)**	**(3)**
At 31 December 2016	**1,336**	**(1,365)**	**(29)**
Analysed as:			
Post-retirement scheme surpluses - included in non-current assets	**1,336**	**10**	**1,346**
Post-retirement scheme deficits - included in non-current liabilities	**–**	**(1,375)**	**(1,375)**
	1,336	**(1,365)**	**(29)**

[1] £306m of costs have been excluded from the underlying results, comprising: £301m settlement cost on the buy-out of the Vickers Group Pension Scheme; £3m of administrative expenses on restructuring all the UK defined benefit plans; and £2m settlement cost in relation to winding-up lump sums on small pensions as a consequence of the restructuring.

[2] The net actuarial gains in the UK arose principally due to changes in the yield curves used to value the assets and the liabilities.

12 Contingent liabilities

On 6 December 2012, the Company announced that it had passed information to the Serious Fraud Office (SFO), following a request from the SFO for information about allegations of malpractice in overseas markets. On 23 December 2013, the Company announced that it had been informed by the SFO that it had commenced a formal investigation. Since the initial announcement, the Company continued its investigations and engaged with the SFO and other authorities in the UK, the US and elsewhere in relation to the matters of concern.

In January 2017, after full cooperation, the Company concluded deferred prosecution agreements with the SFO and the US Department of Justice and a leniency agreement with the MPF, the Brazilian federal prosecutors which are described on page 5. Prosecutions of individuals may follow and investigations may be commenced in other jurisdictions. In addition, we could still be affected by actions from customers and customers' financiers. The Directors are not currently aware of any matters that are likely to lead to a financial loss, but cannot anticipate all the possible actions that may be taken or their potential consequences.

In connection with the sale of its products the Group will, on some occasions, provide financing support for its customers - generally in respect of civil aircraft. The Group's commitments relating to these financing arrangements, which are spread over many years, relate to a number of customers and a broad product portfolio and are generally secured on the asset subject to the financing. These include commitments of US$3.2bn (31 December 2015: US$3.1bn) to provide borrowing facilities to enable customers to purchase aircraft (of which approximately US$421m could be called in 2017). These facilities may only be used if the customer is unable to obtain financing elsewhere and are priced at a premium to the market rate. Consequently the directors do not consider that there is a significant exposure arising from the provision of these facilities.

Commitments on delivered aircraft in excess of the amounts provided are shown in the table below. These are reported on a discounted basis at the Group's borrowing rate to reflect better the time span over which these exposures could arise. These amounts do not represent values that are expected to crystallise. The commitments are denominated in US dollars. As the Group does not generally adopt cash flow hedge accounting for future foreign exchange transactions, this amount is reported, together with the sterling equivalent at the reporting date spot rate. The values of aircraft providing security are based on advice from a specialist aircraft appraiser.

	31 December 2016		31 December 2015	
	£m	***$m***	£m	*$m*
Gross contingent liabilities	**238**	***293***	269	*399*
Value of security[1]	**(103)**	***(126)***	(136)	*(201)*
Indemnities	**(74)**	***(91)***	(79)	*(118)*
Net commitments	**61**	***76***	54	*80*
Net commitments with security reduced by 20%[2]	**86**	***106***	78	*115*
[1] Security includes unrestricted cash collateral of:	**38**	***47***	35	*52*

[2] Although sensitivity calculations are complex, the reduction of the relevant security by 20% illustrates the sensitivity of the contingent liability to changes in this assumption.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Group has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Group is no longer fully insured against known and

potential claims from employees who worked for certain of the Group's UK-based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group.

On 11 July 2016, the Group announced that it will purchase the outstanding 53.1% shareholding in ITP owned by SENER Grupo de Ingeniería SA ("SENER"). This follows a decision by SENER to exercise its put option. On 28 November 2016, and following due diligence, the Group confirmed the valuation of €720m. Under the agreement, consideration will be settled over a two-year period following completion in eight evenly spaced instalments of equal value. The updated agreement allows flexibility to settle the consideration either in cash, in the form of Rolls-Royce shares or any mixture of the two, as preferred by Rolls-Royce. A decision as to whether each payment will be settled in cash, shares or cash and shares will be determined by Rolls-Royce during the payment period.

Completion remains subject to regulatory clearances and is expected in 2017.

13 Related party transactions

Transactions with related parties are shown in note 24 of the 2016 Annual Report. Significant transactions in the current financial period are as follows:

	2016 **£m**	2015 £m
Sales of goods and services to joint ventures and associates	**2,022**	1,896
Purchases of goods and services from joint ventures and associates	**(1,881)**	(2,266)

Included in sales of goods and services to joint ventures and associates are sales of spare engines amounting to £356m (2015: £189m).

Profit recognised in the year on such sales amounted to £119m (2015: £71m), including profit on current year sales and recognition of profit deferred on similar sales in previous years. On an underlying basis (at actual achieved rates on settled derivative transactions), the amounts were £97m (2015: £67m).

14 Derivation of summary funds flow statement

The table below shows the derivation of the summary funds flow statement (lines marked *) on page 27 from the consolidated cash flow statement on page 30.

		2016		2015		
		£m	£m	£m	£m	Source
*	**Underlying profit before tax (PBT) – opposite**		**813**		1,432	
	Depreciation of property, plant and equipment	**426**		378		Cash flow statement
	Amortisation of intangible assets	**628**		432		Cash flow statement
	Impairment of goodwill	**(219)**		(75)		Reversal of underlying adjustment (above)
	Impairment of investments	**–**		2		Cash flow statement
	Acquisition accounting	**(115)**		(124)		Reversal of underlying adjustment (above)
*	**Depreciation and amortisation**		**720**		613	
	(Increase)/decrease in inventories	**(161)**		63		Cash flow statement
	Decrease/(increase) in trade and other receivables	**312**		(836)		Cash flow statement adjusted for non-underlying exchanges differences of £258m
	(Decrease)/increase in trade and other payables	**(273)**		242		Cash flow statement adjusted for non-underlying exchanges differences of £507m
	Revaluation of trading assets	**67**		(13)		Reversal of underlying adjustment (above)
*	**Movement on net working capital**		**(55)**		(544)	
	Additions of intangible assets	**(631)**		(408)		Cash flow statement
	Purchases of property, plant and equipment	**(585)**		(487)		Cash flow statement
	Government grants received	**15**		8		Cash flow statement
*	**Expenditure on property, plant and equipment and intangible assets**		**(1,201)**		(887)	
	Realised losses on hedging instruments	**426**		287		Reversal of underlying adjustment (above)
	Net unrealised fair value to changes to derivatives	**–**		(9)		Reversal of underlying adjustment (above)
	Foreign exchange on contract accounting	**77**		(9)		Reversal of underlying adjustment (above)
	Exceptional restructuring	**(129)**		(49)		Reversal of underlying adjustment (above)
	Other	**(1)**		(1)		Reversal of underlying adjustment (above)
	Underlying financing	**102**		60		Reversal of charge in underlying PBT (above)
	Non-underlying exchange differences on receivables	**(258)**		–		Reversal of adjustment above
	Non-underlying exchange differences on payables	**507**		–		Reversal of adjustment above
	Loss on disposal of property, plant and equipment	**5**		8		Cash flow statement
	Joint ventures	**(43)**		(37)		Joint venture dividends less share of results – cash flow statement
	Increase/(decrease) in provisions	**44**		(151)		Cash flow statement
	Cash flows on other financial assets and liabilities	**(608)**		(305)		Cash flow statement
	Share based payments	**35**		5		Cash flow statement
	Additions of unlisted investments	**–**		(6)		Cash flow statement
	Disposal of intangible assets	**8**		4		Cash flow statement
	Disposal of property, plant and equipment	**8**		33		Cash flow statement
	Investments in joint ventures and associates	**(30)**		(15)		Cash flow statement
	Net interest	**(72)**		(55)		Interest received and paid – cash flow statement
	Net funds of joint ventures reclassified to joint operations	**(4)**		–		Net cash and borrowings reclassified – cash flow statement
	Issue of ordinary shares	**1**		32		Cash flow statement
	Purchase of ordinary shares for share schemes	**(21)**		(21)		Cash flow statement, 2015 includes £19m from share buyback
*	**Other**		**47**		(229)	
*	**Trading cash flow**		**324**		385	
	Net defined benefit plans – underlying operating charge	**204**		213		Cash flow statement
	Cash funding of defined benefit plans	**(271)**		(259)		Cash flow statement
*	**Contributions to defined benefit schemes in excess of underlying PBT charge**		**(67)**		(46)	
*	**Tax**		**(157)**		(160)	Cash flow statement
*	**Free cash flow**		**100**		179	
*	**Shareholder payments**		**(301)**		(421)	Redemption of C Shares – cash flow statement
*	**Share buyback**		**–**		(414)	Cash flow statement, excluding £19m retained for share incentive schemes
*	**Increase in share in joint ventures**		**(154)**		–	Cash flow statement
*	**Discontinued operations**		**–**		(121)	Cash flow statement
*	**Other acquisitions and disposals**		**1**		(3)	Cash flow statement
*	**Foreign exchange**		**240**		3	Cash flow statement
*	**Change in net debt**		**(114)**		(777)	

Free cash flow is a measure of financial performance of the business's cash flow to see what is available for distribution among those stakeholders funding the business (including debt holders and shareholders). Free cash flow is calculated as trading cash flow less recurring tax and post-employment benefit expenses excluding capital expenditures and excludes payments made to shareholders, amounts spent (or received) on business acquisitions, exceptional restructuring costs and foreign exchange changes on net funds. The Board considers that free cash flow reflects cash generated from the Group's underlying trading.

	2016		2015		
	£m	**£m**	£m	£m	**Source**
Reported operating profit		**44**		1,499	
Realised losses on hedging instruments	**(426)**		(287)		Reported to underlying adjustment (note 2)
Net unrealised fair value to changes to derivatives	**–**		9		Reported to underlying adjustment (note 2)
Foreign exchange on contract accounting	**(77)**		9		Reported to underlying adjustment (note 2)
Revaluation of trading assets and liabilities	**(67)**		13		Reported to underlying adjustment (note 2)
Effect of acquisition accounting	**115**		124		Reported to underlying adjustment (note 2)
UK pension restructuring	**306**		–		Reported to underlying adjustment (note 2)
Impairment of goodwill	**219**		75		Reported to underlying adjustment (note 2)
Exceptional restructuring	**129**		49		Reported to underlying adjustment (note 2)
Financial penalties from agreements with investigating bodies	**671**		–		Reported to underlying adjustment (note 2)
Other	**1**		1		Reported to underlying adjustment (note 2)
Adjustments to reported operating profit		**871**		(7)	
Underlying profit before financing		**915**		1,492	
Underlying financing		**(102)**		(60)	Underlying income statement (note 2)
Underlying profit before tax		**813**		1,432	

The table below shows a reconciliation of free cash flow to the change in cash and cash equivalents presented in the consolidated cash flow statement on page 30.

	2016		2015	
	£m	**£m**	£m	£m
Change in cash and cash equivalents		**(691)**		320
Shareholder payments	**301**		421	
Share buy back	**–**		433	
Less amount retained for share incentive schemes	**–**		(19)	
Returns to shareholders		**301**		835
Net cash flow from changes in borrowings and finance leases		**345**		(1,095)
Increase/decrease in short-term investments		**1**		(5)
Increase in share in joint ventures	**154**		–	
Debt of joint ventures reclassified as joint operations	**(9)**		–	
Disposal of discontinued operations	**–**		121	
Acquisition of businesses	**6**		5	
Disposal of other businesses	**(7)**		(2)	
Changes in group structure		**144**		124
Free cash flow		**100**		179

Principal risks and uncertainties

The following table describes the principal risks facing the Group, notwithstanding that there are other risks that may occur and may impact the achievement of the Group's objectives:

Risk or uncertainty and potential impact	How we manage it
Disruptive technologies and business models Disruptive technologies, new entrants with alternative business models or disruptions to key markets or customers could reduce our ability to win sustainable future business, achieve operating results and realise future growth opportunities.	• Horizon and emerging technology scanning, and understanding our competitors, including patent searches. • Investing in innovation and new technologies. • Focusing on enhancing our skills and capabilities to maintain our technology leadership. • Forming strategic partnerships and conducting joint research programmes. • Establishing our digital business.
Product failure Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.	• Ensuring a culture that puts safety first. • Applying our engineering design and validation process from initial design, through production and into service. • Reviewing the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards. • 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. • Improving our supply chain quality.
Business continuity Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, financial 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.	• Continuing our 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 the skills of our people. • Selecting stronger suppliers, developing dual sources or dual capability. • Developing and testing site-level incident management and business recovery plans. • Providing improved response to supply chain disruption through customer excellence centres. • Understanding potential changes to supply chain responsiveness and resilience resulting from Brexit and change to the US administration (eg. due to logistics delays).
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. • Running security and network operations centres. • Actively sharing IT security information through industry, government and security forums.
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 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. • 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. • Protecting credit lines. • Investing in innovation, manufacturing and production, and continuing governance of technology programmes. • Maintaining a healthy balance sheet to enable access to cost-effective sources of third-party funding. • Understanding our competitors. • Understanding the potential implications on our competitiveness resulting from Brexit and change to the US administration.
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 Group's international network and its businesses proactively monitoring local situations. • Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base. • Proactively influencing regulation where it affects us. • Steering committee, chaired by Group President, to co-ordinate activities across the Group and minimise the impact of Brexit. • Monitoring the potential impact of changes following the change to the US administration, relating to tax policy, trade and relationships with the UK government.

Risk or uncertainty and potential impact	How we manage it
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. • 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 programmes lifecycles. • 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 then monitoring and controlling progress through to closure. • Applying knowledge management principles to provide benefit to current and future programmes.
Compliance Non-compliance by the Group with legislation or other regulatory requirements in the heavily regulated environment in which it operates (for example: export controls; use of controlled chemicals and substances; and anti-bribery and corruption legislation) compromising the 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 (including export credit financing), each 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. • Strengthening of the ethics, anti-bribery and corruption, compliance and export control teams. • A legal team is in place to manage regulatory investigations. • Engaging with external regulatory authorities. • Implementing a comprehensive Registration, Evaluation, Authorisation and restriction of CHemicals (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.
Market and financial shock The Group is exposed to a number of market risks, some of which are of a macro-economic nature (eg. oil price, exchange rates) and some of which are more specific to the Group (eg. liquidity and credit risks, credit rating, profitability post IFRS 15, 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 healthy balance sheet, through managing cash balances and debt levels and maturities. • 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. • 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. • Review debt financing and hedging in light of volatility in external financial markets caused by external events, such as Brexit and change of US administration.
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 and transformational change. • 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. • Reviewing employee mobility as part of Brexit steering group.

Annual General Meeting

All holders of ordinary shares may attend the Company's AGM at which the Chairman and Chief Executive present a review of the key business developments during the year. This year's AGM will be held at 11.00am on Thursday 4 May 2017 at the Pride Park Stadium, Pride Park, Derby, DE24 8XL. Shareholders can ask questions of the Board on the matters put to the meeting, including

the Annual Report and the running of the Company generally. All Directors are invited to attend each AGM. Unless unforeseen circumstances arise, all committee chairmen will be present to take questions at the AGM.

Payments to shareholders

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

Shareholders can choose to:

- redeem all C Shares for cash;
- redeem all C Shares for cash and reinvest the proceeds in the C Share Reinvestment Plan (CRIP); or
- keep the C Shares.

The CRIP is operated by Computershare Investor Services PLC (the Registrar). The Registrar will purchase ordinary shares in the market for shareholders electing to reinvest their C Share proceeds. Shareholders wishing to participate in the CRIP or redeem their C Shares in July 2017 must ensure that their instructions are lodged with the Registrar no later than 5pm BST on 1 June 2017 (CREST holders must submit their election in CREST before 3pm BST on 1 June 2017). Redemption will take place on 5 July 2017.

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

Directorate change

Further to the announcement on page 8 in respect of Colin Smith, the remuneration details required to be made available under section 430 (2B) of the Companies Act 2006 are available on the corporate governance section of our website www.rolls-royce.com

Annual report and financial statements

The statements below have been prepared in connection with the Company's full Annual Report for the year ended 31 December 2016. Certain parts thereof are not included in this announcement.

Going concern

The going concern assessment considers whether it is appropriate to prepare the financial statements on a going concern basis.

The Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds and notes. At 31 December 2016, the Group had borrowing facilities of £5.3bn and total liquidity of £5.1bn, including cash and cash equivalents of £2.8bn and undrawn facilities of £2.3bn. £170m of the facilities mature in 2017.

The Group's forecasts and projections, taking into account reasonably possible changes in trading performance, show that the Group has sufficient financial resources. The Directors have reasonable expectations that the Company and the Group are well placed to manage business risks and to continue in operational existence for the foreseeable future (which accounting standards require to be at least a year from the date of this report) and have not identified any material uncertainties to the Company's and the Group's ability to do so.

On the basis described above, the Directors consider it appropriate to adopt the going concern basis in preparing the consolidated financial statements (in accordance with the 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' published by the Financial Reporting Council in September 2014).

Responsibility statements under the Disclosure Guidance and Transparency Rules

Each of the persons who is a Director at the date of approval of this report confirms that to the best of his or her knowledge:

i. each of the Group and parent company financial statements, prepared in accordance with IFRS and UK Accounting Standards respectively, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole;

ii. the Strategic Report and Directors' Report include a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face; and

iii. the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy.

By order of the Board

Warren East	David Smith
Chief Executive	*Chief Financial Officer*
13 February 2017	13 February 2017