## Financial review

| Underlying income statement<br>Year to 31 December<br>£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<br>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**<br>**Year to 31 December**<br>£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**<br>**£m** | 2015<br>£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**<br>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.<br>• Investing in innovation and new technologies.<br>• Focusing on enhancing our skills and capabilities to maintain our technology leadership.<br>• Forming strategic partnerships and conducting joint research programmes.<br>• Establishing our digital business. |
| **Product failure**<br>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.<br>• Applying our engineering design and validation process from initial design, through production and into service.<br>• Reviewing the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards.<br>• 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.<br>• Product safety training is an integral part of our SMS.<br>• Improving our supply chain quality. |
| **Business continuity**<br>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.<br>• Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and the skills of our people.<br>• Selecting stronger suppliers, developing dual sources or dual capability.<br>• Developing and testing site-level incident management and business recovery plans.<br>• Providing improved response to supply chain disruption through customer excellence centres.<br>• 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**<br>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.<br>• Running security and network operations centres.<br>• Actively sharing IT security information through industry, government and security forums. |
| **Competitive position**<br>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.<br>• Focusing on being responsive to our customers and improving the quality, delivery and reliability of our products and services.<br>• Partnering with others effectively.<br>• Driving down cost and improving margins.<br>• Protecting credit lines.<br>• Investing in innovation, manufacturing and production, and continuing governance of technology programmes.<br>• Maintaining a healthy balance sheet to enable access to cost-effective sources of third-party funding.<br>• Understanding our competitors.<br>• Understanding the potential implications on our competitiveness resulting from Brexit and change to the US administration. |
| **Political risk**<br>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.<br>• Diversifying global operations to avoid excessive concentration of risks in particular areas.<br>• The Group's international network and its businesses proactively monitoring local situations.<br>• Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base.<br>• Proactively influencing regulation where it affects us.<br>• Steering committee, chaired by Group President, to co-ordinate activities across the Group and minimise the impact of Brexit.<br>• 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**<br>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.<br>• 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.<br>• Conducting technical audits at pre-defined points which are performed by a team that is independent from the programme.<br>• Requiring programmes to address the actions arising from reviews, and audits and then monitoring and controlling progress through to closure.<br>• Applying knowledge management principles to provide benefit to current and future programmes. |
| **Compliance**<br>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.<br>• 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.<br>• Strengthening of the ethics, anti-bribery and corruption, compliance and export control teams.<br>• A legal team is in place to manage regulatory investigations.<br>• Engaging with external regulatory authorities.<br>• 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**<br>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.<br><br>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.<br>• Providing financial flexibility by maintaining high levels of liquidity and an investment grade credit rating.<br>• 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.<br>• 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.<br>• 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**<br>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.<br>• Developing and enhancing organisational, leadership, technical and functional capability to deliver global programmes and transformational change.<br>• Continuing a strong focus on individual development and succession planning.<br>• 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.<br>• Embedding a lean, agile high performance culture that tightly aligns Group strategy with individual and team objectives.<br>• 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.<br>• Tracking engagement through our annual employee opinion survey and a commitment to drive year-on-year improvement to the employee experience and communications.<br>• 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
*Chief Executive*
13 February 2017

David Smith
*Chief Financial Officer*
13 February 2017