Financial review

Reported results

The changes in 2017 resulting from underlying trading are described on page 9.

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. In particular, the USD:GBP hedge book has had a significant impact on the reported results in 2017 as the USD:GBP rate has risen from 1.23 to 1.35 and the EUR:GBP has fallen from 1.17 to 1.13. 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.

Reconciliation between underlying and reported results

Year to 31 December	**Revenue**		**Profit before financing**		**Financing**		**Profit/(loss) before tax**	
£m	**2017**	2016	**2017**	2016	**2017**	2016	**2017**	2016
Underlying	**15,090**	13,783	**1,175**	915	**(104)**	(102)	**1,071**	813
Revenue recognised at exchange rate on date of transaction [1]	**1,217**	1,172	**–**	–	**–**	**–**	**–**	–
Mark-to-market adjustments on derivatives [8]	**–**	–	**24**	–	**2,648**	**(4,420)**	**2,672**	(4,420)
Related foreign exchange adjustments	**–**	–	**345**	570	**257**	**(151)**	**602**	419
Movements on other financial instruments	**–**	–	**–**	–	**11**	**(8)**	**11**	(8)
Effects of acquisition accounting [2]	**–**	–	**(129)**	(115)	**–**	**–**	**(129)**	(115)
Impairments [3]	**–**	–	**(24)**	(219)	**–**	**–**	**(24)**	(219)
Exceptional restructuring [4]	**–**	–	**(104)**	(129)	**–**	**–**	**(104)**	(129)
Acquisitions and disposals [5]	**–**	–	**798**	(3)	**–**	**–**	**798**	(3)
Financial penalties [6]	**–**	–	**–**	(671)	**–**	**–**	**–**	(671)
Post-retirement schemes	**–**	–	**–**	(306)	**1**	**3**	**1**	(303)
Other	**–**	–	**–**	(1)	**(1)**	**1**	**(1)**	–
Reported	**16,307**	14,955	**2,085**	41	**2,812**	**(4,677)**	**4,897**	(4,636)

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

Profit before financing

[1] The impact of measuring revenues and costs at spot rates rather than rates achieved on hedging transactions increased revenues by £1,217m (2016: £1,172m) and increased profit before financing by £345m (2016: increased £570m).

[2] The effects of acquisition accounting £129m (2016: £115m) principally relate to the amortisation of intangible assets arising on the acquisition of Power Systems in 2013.

[3] The impairment of goodwill, investments, PPE and inventory of £24m (2016: £219m). In 2017, this includes £12m as a result of consolidating a previously unconsolidated subsidiary and £12m relating to the Marine business. The impairments in 2016 largely related to the Marine business as a result of the weakness in the oil and gas market.

[4] Exceptional restructuring costs of £104m (2016: £129m). These are costs associated with the substantial closure or exit of a site, facility or activity related to the significant transformation project that the business is currently undertaking. A number of the projects within the transformation programme are spread over several years.

[5] The acquisition of ITP Aero resulted in a gain of £553m from the revaluation of the previous joint venture investment and recognition of a bargain purchase of £245m.

[6] In 2016, £671m of penalties from agreements with investigating bodies were recognised.

[7] In 2016, the UK pension schemes were restructured resulting in costs of £306m, principally a settlement charge on the transfer of the Vickers Group Pension Scheme to an insurance company.

Financing and taxation

[8] The mark to market gain on the Group's hedge book of £2,648m (2016: loss of £4,420m). These reflect: the large hedge book held by the Group (circa USD $38.5bn); and the strengthening of sterling, particularly against the US dollar offset by the weakening of sterling against 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 charge of £361m (2016: credit £865m), largely as a result of the mark to market adjustments £(463)m and £792m in 2017 and 2016 respectively). In addition, £163m of advance corporation tax credits has been recognised as a result of changes to UK tax laws in 2017.

Funds flow

Summary funds flow statement [1] £m	2017 Excl ITP Aero	2017 ITP Aero	2017 Total	2016	Change excl ITP Aero
Opening net (debt)	**(225)**	**–**	**(225)**	(111)	**–**
Closing net (debt)/funds	**(520)**	**215**	**(305)**	(225)	**–**
Change in net (debt)/funds	**(295)**	**215**	**(80)**	(114)	**–**
Underlying profit before tax	**1,071**	**–**	**1,071**	813	+258
Depreciation and amortisation	**741**	**–**	**741**	720	+21
Movement in net working capital	**546**	**(14)**	**532**	(55)	+601
Expenditure on property, plant and equipment and intangible assets	**(1,732)**	**–**	**(1,732)**	(1,201)	-531
Other	**(164)**	**–**	**(164)**	47	-211
Trading cash flow	**462**	**(14)**	**448**	324	+138
Contributions to defined benefit pensions in excess of underlying PBT charge	**(9)**	**–**	**(9)**	(67)	+58
Taxation paid	**(180)**	**–**	**(180)**	(157)	-23
Free cash flow	**273**	**(14)**	**259**	100	+173
Shareholder payments	**(214)**	**–**	**(214)**	(301)	+87
Net funds acquired/acquisitions	**(17)**	**229**	**212**	(153)	+136
Payment of financial penalties	**(286)**	**–**	**(286)**	–	-286
Other	**8**	**–**	**8**	–	+8
Foreign exchange	**(59)**	**–**	**(59)**	240	-299
Change in net funds	**(295)**	**215**	**(80)**	(114)	

[1] The derivation of the summary funds flow statement above from the reported cash flow statement is included on page 52.

Movement in working capital – the main drivers of the £546m cash inflow from a fall in working capital were increased receipts from airframers in advance of discounts payable to the operator (£460m) in Civil Aerospace together with an increase in payables (£120m) but partly offset by increased inventory (£330m), all linked with the ramp-up of our newer programmes. Other significant contributors to the working capital reduction were improved receivables and deposits (£90m) in Power Systems and the Aviall distribution agreement in Defence Aerospace (£120m) and associated reduced inventory.

Expenditure on property, plant and equipment and intangibles – the major increases are due to: investment in Civil operations and manufacturing assembly and test facilities as well as increases to the aero engine fleet to support the growing installed fleet; and increased capitalisation of development costs in the Civil business, reflecting the stage of the new programmes.

Pensions – cash contributions reduced by £22m to £249m, split evenly between the UK and overseas. The UK contributions are net of a refund of £5m from a wound-up scheme. The UK pension cost increased by £21m in 2017, largely due to changes in discount rates which determine the accounting charge.

Shareholder payments – the change in shareholder payments reflects the difference between the 2016 and 2017 payments, which are paid in the following year.

Acquisitions and disposals – the consideration for ITP Aero is payable in eight quarterly instalments from January 2018, no payments were made in 2017. The deferred consideration can be settled in cash or Rolls-Royce Holdings plc shares, at the discretion of Rolls-Royce with a 3% premium to be applied if the consideration is in shares. The net funds of ITP Aero on acquisition were £229m. From the date of acquisition to 31 December 2017, the net funds outflow in ITP Aero was £14m; excluding the impact of ITP Aero, free cash flow would have been £273m.

In addition, the consolidation of MTU Brazil for the first time resulted in the recognition of net debt of £17m.

Payment of financial penalties – following the agreements reached with investigating authorities in January 2017, £286m of penalties were paid in the UK, US and Brazil. Further UK payments of £378m (plus interest) will be made in 2019-2021.

Balance sheet

Summary balance sheet At 31 December £m	Excluding the impact of ITP Aero	Impact of ITP Aero	**2017**	2016
Intangible assets	5,646	1,417	**7,063**	5,080
Property, plant and equipment	4,356	268	**4,624**	4,114
Joint ventures and associates	892	(204)	**688**	844
Net working capital[1]	(1,874)	(444)	**(2,318)**	(1,553)
Net funds[2]	(520)	215	**(305)**	(225)
Provisions	(815)	(68)	**(883)**	(759)
Net post-retirement scheme surpluses/(deficits)	738	–	**738**	(29)
Net financial assets and liabilities[2]	(2,449)	(148)	**(2,597)**	(5,751)
Other net assets and liabilities[3]	(602)	(238)	**(840)**	143
Net assets	5,372	798	**6,170**	1,864
Other items				
US$ hedge book (US$bn)			**38.5**	37.8
TotalCare assets			**3,536**	3,348
TotalCare liabilities			**(1,033)**	(907)
Net TotalCare assets			**2,503**	2,441

[1] Net working capital includes inventories, trade and other receivables, trade and other payables and current tax assets and liabilities.
[2] Net funds includes £227m (2016: £358m) 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.

The acquisition of ITP Aero has had a significant impact on the shape of our balance sheet which is described below. Other key changes are as follows:

Intangible assets (page 47) increased by £566m. Additions of £973m (including £160m of certification and participation fees, £342m of development costs, £286m of contractual aftermarket rights and software of £135m) were offset by amortisation of £430m.

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 (page 48) increased by £242m. Additions of £764m were offset by depreciation of £444m. Additions included an increase to the size of the Civil Aerospace engine pool (£136m) driven by fleet support for new programmes, investment in industrial footprint consolidation (£109m) and in manufacturing assembly and test (£68m).

Investments in joint ventures and associates increased by £48m. The main movements were: additions of £48m, including £28m of investment in joint ventures that finance some of the Civil Aerospace spare engine pool; the Group's share of retained profit of £52m; offset by £44m of exchange differences.

Movements in **net funds** are shown on page 32.

Net working capital reduced by £321m. As well as the cash impact of £546m described above, the movement reflects the payment of penalties of £286m. The remaining movements are primarily driven by movements in foreign exchange rates.

Provisions largely relate to warranties and guarantees provided to secure the sale of OE and services. The increase of £56m includes a provision for tax interest and penalties that was previously included in current tax liabilities but reclassified due to guidance issued by the International Financial Reporting Interpretations Committee (IFRIC).

Net post-retirement scheme surpluses (page 50) have increased by £767m.

In the UK (increase in surplus of £772m), changes in actuarial estimates reduced the value of the obligations £515m, principally due to: (i) inclusion of the latest mortality tables; and (ii) the reflection of actual experience as part of the 2017 funding valuation. In addition, there were returns (in excess of those assumed) on the scheme assets of £265m.

The position overseas has remained broadly stable, with in the impact of reduced discount rates in Germany and the US being offset by other actuarial gains in the US.

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 £2.3bn, a reduction of £3.2bn in the year, mainly a result of the strengthening of sterling against the US dollar.

The **US$ hedge book** increased by 2% to US$38.5bn. This represents around six 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.

Impact of the acquisition of ITP Aero:

The acquired net assets of ITP Aero are shown on page 51. The most significant intangible assets acquired relate to customer relationships, to technology, patents and licences and to in-process development. In addition, working capital includes an accrual of £648m for the deferred consideration to be paid in 2018 and 2019. The deferred consideration can be settled in cash or Rolls-Royce Holdings plc shares, at the discretion of Rolls-Royce with a 3% premium to be applied if the consideration is in shares.

Condensed consolidated financial statements

Condensed consolidated income statement

For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Revenue	2	**16,307**	14,955
Cost of sales		**(13,134)**	(11,907)
Gross profit		**3,173**	3,048
Commercial and administrative costs [1]		**(1,222)**	(2,203)
Research and development costs	3	**(795)**	(918)
Share of results of joint ventures and associates		**131**	117
Operating profit *	2	**1,287**	44
Gains arising on the acquisition of ITP Aero	14	**798**	–
Loss on disposal of business		**–**	(3)
Profit before financing and taxation	2	**2,085**	41
Financing income	4	**2,973**	96
Financing costs	4	**(161)**	(4,773)
Net financing		**2,812**	(4,677)
Profit/(loss) before taxation		**4,897**	(4,636)
Taxation	5	**(689)**	604
Profit/(loss) for the year		**4,208**	(4,032)
Attributable to:			
Ordinary shareholders		**4,207**	(4,032)
Non-controlling interests		**1**	–
Profit/(loss) for the year		**4,208**	(4,032)
Earnings per ordinary share attributable to shareholders	6		
Basic		**229.40p**	(220.08)p
Diluted		**228.64p**	(220.08)p
Underlying earnings per ordinary share are shown in note 6.			
Payments to ordinary shareholders in respect of the year	7		
Per share		**11.7p**	11.70p
Total		**216**	215
* Underlying operating profit	2	**1,175**	915

[1] 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.

All activities comprise continuing operations.

Condensed consolidated statement of comprehensive income

For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Profit/(loss) for the period		**4,208**	(4,032)
Other comprehensive income (OCI)			
Movements in post-retirement schemes	11	**735**	495
Share of OCI of joint ventures and associates		**(1)**	(2)
Related tax movements		**(307)**	(179)
Items that will not be reclassified to profit or loss		**427**	314
Foreign exchange translation differences on foreign operations		**(142)**	861
Share of OCI of joint ventures and associates		**(5)**	(7)
Related tax movements		**1**	4
Items that may be reclassified to profit or loss		**(146)**	858
Total comprehensive income for the year		**4,489**	(2,860)
Attributable to:			
Ordinary shareholders		**4,488**	(2,860)
Non-controlling interests		**1**	–
Total comprehensive expense for the year		**4,489**	(2,860)

Condensed consolidated balance sheet

At 31 December 2017

	Notes	2017 £m	2016 £m
ASSETS			
Non-current assets			
Intangible assets	8	**7,063**	5,080
Property, plant and equipment	9	**4,624**	4,114
Investments – joint ventures and associates		**688**	844
Investments – other		**26**	38
Other financial assets	10	**610**	382
Deferred tax assets		**271**	876
Post-retirement scheme surpluses	11	**2,125**	1,346
		15,407	12,680
Current assets			
Inventories		**3,660**	3,086
Trade and other receivables		**7,919**	6,956
Taxation recoverable		**17**	32
Other financial assets	10	**36**	5
Short-term investments		**3**	3
Cash and cash equivalents		**2,953**	2,771
Assets held for sale		**7**	5
		14,595	12,858
Total assets		**30,002**	25,538
LIABILITIES			
Current liabilities			
Borrowings		**(82)**	(172)
Other financial liabilities	10	**(581)**	(651)
Trade and other payables		**(9,527)**	(7,957)
Current tax liabilities		**(209)**	(211)
Provisions for liabilities and charges		**(526)**	(543)
		(10,925)	(9,534)
Non-current liabilities			
Borrowings		**(3,406)**	(3,185)
Other financial liabilities	10	**(2,435)**	(5,129)
Trade and other payables		**(4,178)**	(3,459)
Deferred tax liabilities		**(1,144)**	(776)
Provisions for liabilities and charges		**(357)**	(216)
Post-retirement scheme deficits	11	**(1,387)**	(1,375)
		(12,907)	(14,140)
Total liabilities		**(23,832)**	(23,674)
Net assets		**6,170**	1,864
EQUITY			
Attributable to ordinary shareholders			
Called-up share capital		**368**	367
Share premium account		**195**	181
Capital redemption reserve		**162**	162
Cash flow hedging reserve		**(112)**	(107)
Other reserves		**673**	814
Retained earnings		**4,881**	445
		6,167	1,862
Non-controlling interests		**3**	2
Total equity		**6,170**	1,864

Condensed consolidated cash flow statement

For the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Reconciliation of cash flows from operating activities			
Operating profit		**1,287**	44
Loss on disposal of property, plant and equipment		**11**	5
Share of results of joint ventures and associates		**(131)**	(117)
Dividends received from joint ventures and associates		**79**	74
Amortisation and impairment of intangible assets	8	**430**	628
Depreciation and impairment of property, plant and equipment	9	**450**	426
Impairment of investments		**14**	–
Increase in provisions		**58**	44
Increase in inventories		**(235)**	(161)
(Increase)/decrease in trade and other receivables		**(462)**	54
(Decrease)/increase in amounts payable for financial penalties from agreements with investigating bodies		**(286)**	671
Other increase in trade and other payables		**1,411**	234
Cash flows on other financial assets and liabilities held for operating purposes		**(661)**	(608)
Net defined benefit post-retirement cost recognised in profit before financing	11	**240**	510
Cash funding of defined benefit post-retirement schemes	11	**(249)**	(271)
Share-based payments		**34**	35
Net cash inflow from operating activities before taxation		**1,990**	1,568
Taxation paid		**(180)**	(157)
Net cash inflow from operating activities		**1,810**	1,411
Cash flows from investing activities			
Additions of unlisted investments		**(4)**	–
Additions of intangible assets	8	**(973)**	(631)
Disposals of intangible assets	8	**7**	8
Purchases of property, plant and equipment		**(773)**	(585)
Government grants received		**14**	15
Disposals of property, plant and equipment		**4**	8
Acquisitions of business	14	**263**	(6)
Consolidation of previously unconsolidated subsidiary		**1**	–
Disposals of other businesses		**–**	7
Increase in share in joint ventures		**–**	(154)
Other investments in joint ventures and associates		**(48)**	(30)
Cash and cash equivalents in joint ventures reclassified as joint operations		**–**	5
Net cash outflow from investing activities		**(1,509)**	(1,363)
Cash flows from financing activities			
Repayment of loans		**(160)**	(434)
Proceeds from increase in loans and finance leases		**366**	93
Capital element of finance lease payments		**(6)**	(4)
Net cash flow from increase/(decrease) in borrowings and finance leases		**200**	(345)
Interest received		**14**	14
Interest paid		**(64)**	(84)
Interest element of finance lease payments		**(3)**	(2)
Increase in short-term investments		**–**	(1)
Issue of ordinary shares (net of expenses)		**21**	1
Purchase of ordinary shares – other		**(24)**	(21)
Redemption of C Shares		**(214)**	(301)
Net cash outflow from financing activities		**(70)**	(739)
Change in cash and cash equivalents		**231**	(691)
Cash and cash equivalents at 1 January		**2,771**	3,176
Exchange (losses)/gains on cash and cash equivalents		**(69)**	286
Cash and cash equivalents at 31 December		**2,933**	2,771

	2017 £m	2016 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Change in cash and cash equivalents	**231**	(691)
Cash flow from (increase)/decrease in borrowings and finance leases	**(200)**	345
Cash flow from increase in short-term investments	**–**	1
Change in net funds resulting from cash flows	**31**	(345)
Net funds (excluding cash and cash equivalents) on acquisition of ITP Aero	**(34)**	–
Net funds (excluding cash and cash equivalents) of previously unconsolidated subsidiary	**(18)**	–
Net funds (excluding cash and cash equivalents) of joint ventures reclassified as joint operations	**–**	(9)
Exchange (losses)/gains on net funds	**(59)**	240
Fair value adjustments	**131**	(345)
Movement in net funds	**51**	(459)
Net funds at 1 January excluding the fair value of swaps	**(583)**	(124)
Net funds at 31 December excluding the fair value of swaps	**(532)**	(583)
Fair value of swaps hedging fixed rate borrowings	**227**	358
Net funds at 31 December	**(305)**	(225)

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

	At 1 January 2017 £m	Funds flow £m	Net funds on acquisition of business £m	Net funds on consolidation of previously unconsolidated subsidiary £m	Exchange differences £m	Fair value adjustments £m	Reclassifications £m	At 31 December 2017 £m
Cash at bank and in hand	**872**	(5)	–	–	(29)	–	–	**838**
Money market funds	**552**	44	–	–	(7)	–	–	**589**
Short-term deposits	**1,347**	212	–	–	(33)	–	–	**1,526**
Overdrafts	**–**	(20)	–	–	–	–	–	**(20)**
Cash and cash equivalents	**2,771**	231	–	–	(69)	–	–	**2,933**
Short-term investments	**3**	–	–	–	–	–	–	**3**
Other current borrowings	**(169)**	159	(6)	(18)	3	–	(8)	**(39)**
Non-current borrowings	**(3,121)**	(280)	(28)	–	(2)	131	8	**(3,292)**
Finance leases	**(67)**	(79)	–	–	9	–	–	**(137)**
Financial liabilities	**(3,357)**	(200)	(34)	(18)	10	131	–	**(3,468)**
Net funds excluding the fair value of swaps	**(583)**	31	(34)	(18)	(59)	131	–	**(532)**
Fair value of swaps hedging fixed rate borrowings	**358**					(131)		**227**
Net funds	**(225)**	31	(34)	(18)	(59)	–	–	**(305)**

Condensed consolidated statement of changes in equity

For the year ended 31 December 2017

	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 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 [3]	–	–	(301)	–	–	1	(300)	–	(300)
Redemption of C Shares	–	–	302	–	–	(302)	–	–	–
Ordinary shares purchased	–	–	–	–	–	(21)	(21)	–	(21)
Share-based payments – direct to equity [4]	–	–	–	–	–	30	30	–	30
Related tax movements	–	–	–	–	–	(2)	(2)	–	(2)
Other changes in equity in the year	–	1	1	–	–	(294)	(292)	–	(292)
At 1 January 2017	**367**	**181**	**162**	**(107)**	**814**	**445**	**1,862**	**2**	**1,864**
Profit for the year	–	–	–	–	–	4,207	4,207	1	4,208
Foreign exchange translation differences on foreign operations	–	–	–	–	(142)	–	(142)	–	(142)
Movements on post-retirement schemes	–	–	–	–	–	735	735	–	735
Share of comprehensive income of joint ventures and associates	–	–	–	(5)	–	(1)	(6)	–	(6)
Related tax movements	–	–	–	–	1	(307)	(306)	–	(306)
Total comprehensive income for the year	**–**	**–**	**–**	**(5)**	**(141)**	**4,634**	**4,488**	**1**	**4,489**
Arising on issues of ordinary shares	1	14	–	–	–	(14)	1	–	1
Issue of C Shares [3]	–	–	(215)	–	–	1	(214)	–	(214)
Redemption of C Shares	–	–	215	–	–	(215)	–	–	–
Ordinary shares purchased	–	–	–	–	–	(24)	(24)	–	(24)
Share-based payments – direct to equity [4]	–	–	–	–	–	51	51	–	51
Related tax movements	–	–	–	–	–	3	3	–	3
Other changes in equity in the year	**1**	**14**	**–**	**–**	**–**	**(198)**	**(183)**	**–**	**(183)**
At 31 December 2017	**368**	**195**	**162**	**(112)**	**673**	**4,881**	**6,167**	**3**	**6,170**

[1] Other reserves include a merger reserve of £3m and a translation reserve of £670m.

[2] At 31 December 2017, **6,466,153** ordinary shares with a net book value of **£52m** (2016: 6,854,216, 2015: 5,894,064 ordinary shares with net book values of £56m and £52m respectively) were held for the purpose of share-based payment plans and included in retained earnings. During the year, **4,992,304** ordinary shares with a net book value of **£42m** (2016: 1,955,390 shares with a net book value of £17m) vested in share-based payment plans. During the year the Company acquired **92,537** (2016: 165,542) of its ordinary shares via reinvestment of dividends received on its own shares and purchased **2,711,349** (2016: 2,750,000) of its ordinary shares through purchases on the London Stock Exchange. During the year, the Company issued **1,740,355** new ordinary shares (2016: nil) with a book value of **£14m** (2016: nil) to the Group's share trust for its employee share based payment plans.

[3] 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.

[4] Share-based payments - direct to equity is the share based payment charge for the year less the actual cost of vesting and cash received on share based schemes vesting.

1 Basis of preparation and accounting policies

Reporting entity

Rolls-Royce Holdings plc (the 'Company') is a company domiciled in the UK. These condensed consolidated financial statements of the Company as at and for the year ended 31 December 2017 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 2016 (2016 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 2017 Annual Report.

The comparative figures for the financial year 31 December 2016 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 6 March 2018.

Significant accounting policies

No new accounting policies had a significant impact in 2017.

Revisions to IFRS not applicable in 2017

Standards and interpretations issues by the IASB are only applicable if endorsed by the EU.

IFRS 9 *Financial Instruments*

IFRS 9 (effective for the year beginning 1 January 2018) relates to the accounting for financial instruments and covers: classification and measurement; impairment; and hedge accounting. Except for hedge accounting, retrospective application is required with any adjustment being made to reserves on 1 January 2018. The Group is not required to restate 2017 comparative information and is analysing the impact on adoption on its financial statements.

- The Group can sell trade receivables of certain customers before the due date. The trade receivables of these customers that are not sold will be classified and disclosed at fair value through other comprehensive income from 2018. This will not have a significant impact on the income statement.
- The Group will adopt the simplified approach to provide for losses on receivables and contract assets resulting from transactions within the scope of IFRS 15. The Group performed a preliminary assessment of the adoption of the standard on the basis of average default risk of customers and will continue to work during 2018 to analyse the impact. This will not have a significant impact on the income statement.
- The Group determined that all existing effective hedging relationship will continue to qualify for hedge accounting under IFRS 9. We will continue not to hedge account for forecast foreign exchange transactions. This will not have a significant impact on the financial statements.

IFRS 15 *Revenue from Contracts with Customers*

IFRS 15 provides a single, principles based five-step model to be applied to all sales contracts. It is based on the transfer of control of goods and services to customers and replaces the separate models for goods, services and construction contracts currently included in IAS 11 Construction Contracts and IAS 18 Revenue. There are three broad implications:

- Linked accounting will cease to exist so all OE sales will be treated on the same basis;
- OE engine cash deficits will no longer be capitalised and recorded as contractual aftermarket rights, they will instead be recognised on delivery;
- Revenue and profits for aftermarket services will be recognised on an activity basis as costs are incurred.

The Group will adopt IFRS 15 on 1 January 2018 using the 'full' retrospective approach. The Group has undertaken significant analysis on the impact of IFRS 15 and the most significant accounting judgements, estimates and policies are set out below. Work will continue during 2018 to review and refine policies and procedures required to implement IFRS 15. As a result it is possible that there may be some changes to the impact reported.

Key areas of judgement:

Determining the timing of satisfaction of performance obligations:

- Where the performance obligation is the supply of goods (principally original equipment and spare parts) which is satisfied at the point in time that those goods are transferred to the customer, the Group will recognise revenue at that point in time.
- The Group generates a significant proportion of its revenue and profit from aftermarket arrangements arising from the use of the installed original equipment (OE). These aftermarket contracts, such as TotalCare and CorporateCare agreements in Civil Aerospace, cover a range of services and often have contractual terms covering more than one year. Under these contracts, the Group's primary obligation is to maintain customers' equipment in an operational condition and this is achieved by undertaking various activities, such as repair, overhaul and engine monitoring over the period of the contract. Revenue on these contracts is recognised over the period of the contract and the measure of performance is a matter of judgement. In general, the Directors consider that the stage of performance of the contract is best measured by using the actual costs incurred to date compared to the estimated costs to complete the performance obligations.
- The assessment of stage of completion is generally measured for each contract. However, in certain cases, such as for CorporateCare agreements where there are many contracts covering aftermarket services, each for a small number of engines, the Group will apply the practical expedient offered by IFRS 15 to account for a portfolio of contracts together as it expects that

the effects on the financial statements would not differ materially from applying the standard to the individual contracts in the portfolio.

The Group has paid participation fees to airframe manufacturers, its customers for OE on certain programmes. Amounts paid are initially treated as contract assets and subsequently charged as a reduction to the OE revenue when it is transferred to the customer. The number of units over which the asset will be charged is a matter of judgement as the orders will grow over the course of the programme.

In assessing the accounting for the participation fee payments we make to our OE customers, we have also assessed the accounting for up-front payments we sometimes receive from the Group's suppliers under RRSAs to allow them to participate in an engine programme. We have concluded that, consistent with our accounting for participation fees noted above, these receipts should be deferred and recognised against cost of sales over the period of supply. This will also require judgement as to the number of units over which the receipts will be allocated.

The Group has elected to use the practical expedient to expense as incurred any incremental costs of obtaining or fulfilling a contract if the amortisation period of an asset created would have been one year or less.

Key sources of estimation uncertainty:
Assessment of long-term contractual arrangements:

- The estimated revenue and costs under such agreements are inherently imprecise and significant estimates are required to take into account uncertainties relating to: (i) the forecast utilisation of the engines by the operator and related pricing; (ii) the frequency of engine overhauls where the principal variables are the operating parameters of the engine and operational lives of components; and (iii) the forecast costs to maintain the engines in accordance with the contractual requirements where the cost of each overhaul is dependent on the required work-scope and the cost of parts and labour at the time.
- An allowance is made against the risk of non-recovery of resulting contract balances from reduced utilisation e.g. engine flying hours, based on historical forecasting experience, the risk of aircraft being parked by the customer and the customer's creditworthiness.
- A significant amount of revenue and cost is denominated in currencies other than that of the relevant Group undertaking. These are translated at estimated long-term exchange rates.

Significant accounting policies:
Revenue recognition comprises sales to outside customers after discounts and amounts payable to customers and excludes value added taxes. The Group has elected to use the practical expedient not to adjust revenue for the effect of financing components where the expectation is that the period between the transfer of goods and services to customers and the receipt of payment is less than a year.

Sales of services are recognised by reference to the progress towards complete satisfaction of the performance obligation provided the outcome of contracts can be assessed with reasonable certainty. Full provision is made for any estimated losses to completion of contracts, having regard to the overall substance of the arrangements.

TotalCare and similar long-term aftermarket service arrangements are accounted for on a stage of completion basis. A contract liability will be created where payment is received ahead of the costs incurred to meet performance obligations. In making the assessment of future revenue, costs and the level of profit recognised, the Group takes account of the inherent uncertainties and the risk of non-recovery of any resulting contract balances. To the extent that actual revenue and costs differ from forecast or that forecasts change, the cumulative impact is recognised in the period. When accounting for a portfolio of long-term service arrangements, such as CorporateCare agreements, the Group uses estimates and assumptions that reflect the size and composition of the portfolio. The new standard has no impact on the timing of the reported cash flows.

The comparative 2017 results to be included in the 2018 financial statements will be restated. Certain tables from note 2 have been prepared on the IFRS 15 basis set out above and are shown in note 16. Overall, the adoption of IFRS 15 is expected to result in a reduction in 2017 underlying revenue and operating profit of £1,408m and £854m respectively and a reduction of net assets of £5.2bn at 31 December 2017.

IFRS 16 *Leases*
IFRS 16 (effective for the year beginning 1 January 2019) will require all leases to be recognised on the balance sheet. Currently, IAS 17 *Leases* only requires leases categorised as finance leases to be recognised on the balance sheet.

The Group is progressing well in its analysis of how IFRS 16 should be implemented and is developing the data-set, system and processes that will be required. The most significant leases, by value, relate to property and aircraft engines. The Group expects to apply the standard retrospectively with the cumulative effect of initially application recognised on 1 January 2019. Under this approach the Group will not restate comparative periods.

In broad-terms the impact of the standard will be to:

- Recognise an additional lease liability equivalent to the present value of the lease commitments at the date of transition. Further work is required to validate the contracts which will represent leases under IFRS 16, including ongoing consideration of some supply chain contracts. The Group is also considering whether there are any re-assessments of lease term required, and the discount rate to be applied. Under the expected transition option, payments will be discounted using incremental borrowing rates at 1 January 2019. The Group holds some leases in non-functional currencies where the value of the lease liability will be dependent on spot exchange rates on transition.
- Recognise a right-of-use asset measured either: as if the standard had applied since commencement of the lease; or at an amount equal to the lease liability on transition.

The Group does not consider that any other standards, amendments or interpretations issued by the IASB, but not yet applicable will have a significant impact on the financial statements.

2 Analysis by business segment

The analysis by 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 reviewed by the Board and 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 year. This approach has been applied consistently. The principles adopted to determine underlying results are:

Underlying revenues and cost of sales – 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. This reflects the economic hedging that the Group undertakes. 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 the impact of exchange rates on revenues and costs above, adjustments have been made to exclude one-off past service costs or 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 (including in 2017, the gains arising on the acquisition of ITP Aero) – so that all segments are measured on a consistent basis, the effect of business disposals, the impairment of goodwill and similar items, 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.
- 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.

The tables below and overleaf set out the results of the reportable segments on the basis described above and a reconciliation of these underlying results to those reported in the consolidated income statement. The 2017 underlying results below are shown at 2016 exchange rates, with the adjustment to 2017 exchange rates shown separately.

	Civil [1] £m	Defence £m	Power Systems £m	Marine £m	Nuclear £m	Inter-segment £m	Total reportable segments £m
Year ended 31 December 2017							
Underlying revenue from sale of original equipment	**3,775**	**928**	**1,828**	**534**	**377**	**(27)**	**7,415**
Underlying revenue from aftermarket services	**4,158**	**1,264**	**897**	**483**	**430**	**(37)**	**7,195**
Total underlying revenue at 2016 exchange rates	**7,933**	**2,192**	**2,725**	**1,017**	**807**	**(64)**	**14,610**
Translation to 2017 exchange rates	**90**	**83**	**198**	**60**	**11**	**(6)**	**436**
Total underlying revenue at 2017 exchange rates	**8,023**	**2,275**	**2,923**	**1,077**	**818**	**(70)**	**15,046**
Gross profit	**1,157**	**555**	**786**	**214**	**130**	**–**	**2,842**
Commercial and administrative costs	**(370)**	**(126)**	**(310)**	**(193)**	**(71)**	**–**	**(1,070)**
Research and development costs	**(403)**	**(77)**	**(166)**	**(44)**	**(22)**	**–**	**(712)**
Share of results of joint ventures and associates	**109**	**7**	**(3)**	**–**	**–**	**–**	**113**
Underlying operating profit/(loss) at 2016 exchange rates	**493**	**359**	**307**	**(23)**	**37**	**–**	**1,173**
Translation to 2017 exchange rates	**27**	**15**	**23**	**(2)**	**1**	**–**	**64**
Underlying operating profit/(loss) at 2017 exchange rates	**520**	**374**	**330**	**(25)**	**38**	**–**	**1,237**
Year ended 31 December 2016							
Underlying revenue from sale of original equipment	3,357	890	1,810	631	354	(36)	7,006
Underlying revenue from aftermarket services	3,710	1,319	845	483	423	(40)	6,740
Total underlying revenue	7,067	2,209	2,655	1,114	777	(76)	13,746
Gross profit	1,185	564	702	236	121	–	2,808
Commercial and administrative costs	(353)	(124)	(335)	(222)	(70)	–	(1,104)
Research and development costs	(568)	(71)	(177)	(41)	(6)	–	(863)
Share of results of joint ventures and associates	103	15	1	–	–	–	119
Underlying operating profit/(loss)	367	384	191	(27)	45	–	960

[1] Included within the results for the Civil Segment in 2017 is a charge of £227m (2016: £98m) related to in-service engine issues for the Trent 1000 and Trent 900.

Reconciliation to reported results	Total reportable segments £m	Other businesses [1] and corporate £m	Total underlying £m	Underlying adjustments and adjustments to foreign exchange £m	Group results at actual exchange rates £m
Year ended 31 December 2017					
Revenue from sale of original equipment	7,415	21	7,436	654	8,090
Revenue from aftermarket services	7,195	20	7,215	1,002	8,217
Total revenue at 2016 exchange rates	**14,610**	**41**	**14,651**	**1,656**	**16,307**
Translation to 2017 exchange rates	436	3	439	(439)	–
Total revenue at 2017 exchange rates	**15,046**	**44**	**15,090**	**1,217**	**16,307**
Gross profit	**2,842**	**4**	**2,846**	**327**	**3,173**
Commercial and administrative costs	**(1,070)**	**(54)**	**(1,124)**	**(98)**	**(1,222)**
Research and development costs	**(712)**	**1**	**(711)**	**(84)**	**(795)**
Share of results of joint ventures and associates	**113**	**(11)**	**102**	**29**	**131**
Operating profit/(loss) at 2016 exchange rates	**1,173**	**(60)**	**1,113**	**174**	**1,287**
Translation to 2017 exchange rates	**64**	**(2)**	**62**	**(62)**	**–**
Operating profit/(loss) at 2017 exchange rates	**1,237**	**(62)**	**1,175**	**112**	**1,287**
Gains arising on the acquisition of ITP Aero	**–**	**–**	**–**	**798**	**798**
Profit/(loss) before financing and taxation	**1,237**	**(62)**	**1,175**	**910**	**2,085**
Net financing		**(104)**	**(104)**	**2,916**	**2,812**
Profit/(loss) before taxation		**(166)**	**1,071**	**3,826**	**4,897**
Taxation		**(328)**	**(328)**	**(361)**	**(689)**
Profit for the year			**743**	**3,465**	**4,208**
Attributable to:					
Ordinary shareholders			**742**	**3,465**	**4,207**
Non-controlling interests			**1**	**–**	**1**
Year ended 31 December 2016					
Revenue from sale of original equipment	7,006	21	7,027	561	7,588
Revenue from aftermarket services	6,740	16	6,756	611	7,367
Total revenue	13,746	37	13,783	1,172	14,955
Gross profit	2,808	10	2,818	230	3,048
Commercial and administrative costs	(1,104)	(54)	(1,158)	(1,045)	(2,203)
Research and development costs	(863)	1	(862)	(56)	(918)
Share of results of joint ventures and associates	119	(2)	117	–	117
Operating profit/(loss)	960	(45)	915	(871)	44
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 year			552	(4,584)	(4,032)
Attributable to:					
Ordinary shareholders			552	(4,584)	(4,032)
Non-controlling interests			–	–	–

[1] Other businesses comprise former Energy businesses not included in the disposal to Siemens in 2014.

	Total assets		Total liabilities		Net assets/(liabilities)	
	2017 £m	2016 £m	**2017 £m**	2016 £m	**2017 £m**	2016 £m
Civil	**16,005**	13,856	**(13,160)**	(14,510)	**2,845**	(654)
Defence	**1,742**	1,759	**(1,837)**	(1,996)	**(95)**	(237)
Power Systems	**3,787**	3,837	**(1,256)**	(1,151)	**2,531**	2,686
Marine	**1,271**	1,520	**(761)**	(903)	**510**	617
Nuclear	**396**	352	**(426)**	(435)	**(30)**	(83)
Inter-segment	**(1,360)**	(1,223)	**1,360**	1,223	**–**	–
Reportable segments	**21,841**	20,101	**(16,080)**	(17,772)	**5,761**	2,329
Other businesses and corporate [1]	**2,565**	51	**(1,524)**	(183)	**1,041**	(132)
Net funds/(debt)	**3,183**	3,132	**(3,488)**	(3,357)	**(305)**	(225)
Tax assets/(liabilities)	**288**	908	**(1,353)**	(987)	**(1,065)**	(79)
Post-retirement scheme surpluses/(deficits)	**2,125**	1,346	**(1,387)**	(1,375)	**738**	(29)
	30,002	25,538	**(23,832)**	(23,674)	**6,170**	1,864

[1] Includes ITP Aero

Group employees average during the year	2017	2016
Civil Aerospace	**24,600**	23,800
Defence Aerospace	**6,100**	6,000
Power Systems	**10,100**	10,300
Marine	**4,600**	5,300
Nuclear	**4,400**	4,300
Other businesses and corporate [1]	**200**	200
	50,000	49,900

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.

Underlying adjustments	2017				2016			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**15,090**	**1,175**	**(104)**	**(328)**	13,783	915	(102)	(261)
Recognise revenue at exchange rate on date of transaction	**1,217**	**–**	**–**	**–**	1,172	–	–	–
Realised (gains)/losses on settled derivative contracts [1]	**–**	**475**	**173**	**(111)**	–	426	162	(107)
Net unrealised fair value changes to derivative contracts [2]	**–**	**24**	**2,648**	**(463)**	–	–	(4,420)	792
Effect of currency on contract accounting	**–**	**(124)**	**–**	**21**	–	77	–	(14)
Revaluation of trading assets and liabilities	**–**	**(6)**	**84**	**(12)**	–	67	(313)	56
Financial RRSAs – exchange differences and changes in forecast payments	**–**	**–**	**11**	**(3)**	–	–	(8)	(1)
Effect of acquisition accounting [3]	**–**	**(129)**	**–**	**35**	–	(115)	–	35
Impairment goodwill	**–**	**–**	**–**	**–**	–	(219)	–	–
Impairment of assets	**–**	**(12)**	**–**	**–**	–	–	–	–
Pension restructuring [4]	**–**	**–**	**–**	**–**	–	(306)	–	107
Net post-retirement scheme financing	**–**	**–**	**1**	**(1)**	–	–	3	(2)
Disposal of business	**–**	**–**	**–**	**–**	–	(3)	–	–
Exceptional restructuring	**–**	**(104)**	**–**	**31**	–	(129)	–	34
Financial penalties from agreements with investigating bodies	**–**	**–**	**–**	**–**	–	(671)	–	–
Gains arising on the acquisition of ITP Aero	**–**	**798**	**–**	**–**	–	–	–	–
Consolidation of previously non-consolidated subsidiary	**–**	**(12)**	**–**	**–**	–	–	–	–
Other	**–**	**–**	**(1)**	**4**	–	(1)	1	(5)
Recognition of advance corporation tax	**–**	**–**	**–**	**163**	–	–	–	–
Reduction in corporate tax rates [5]	**–**	**–**	**–**	**(25)**	–	–	–	(30)
Total underlying adjustments	**1,217**	**910**	**2,916**	**(361)**	1,172	(874)	(4,575)	865
Reported per consolidated income statement	**16,307**	**2,085**	**2,812**	**(689)**	14,955	41	(4,677)	604

1 Realised (gains)/losses on settled derivative contracts include adjustments to reflect the (gains)/losses in the same year as the related trading cash flows.
2 Unrealised fair value changes to derivative contracts included in profit before financing: (i) include those of equity accounted joint ventures; and (ii) 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 returned to the Group.
5 The 2017 deduction in corporate tax rates relates to the reduction in the Federal tax rate in the US. The 2016 comparative relates to the reduction in the UK corporate tax rate.

3 Research and development

	2017 £m	2016 £m
Expenditure in the year	**(1,035)**	(937)
Capitalised as intangible assets	**342**	99
Amortisation of capitalised costs	**(150)**	(147)
Impairment of capitalised costs	**–**	(2)
Net research and development cost	**(843)**	(987)
Entry fees received	**64**	73
Entry fees deferred in respect of charges in future years	**(44)**	(40)
Recognition of previously deferred entry fees	**28**	36
Net cost recognised in the income statement	**(795)**	(918)
Underlying adjustments relating to the effects of acquisition accounting and foreign exchange	**58**	56
Net underlying cost recognised in the income statement	**(737)**	(862)
Translation to 2016 exchange rates	**26**	–
Net underlying cost at 2016 exchange rates	**(711)**	(862)

4 Net financing

	2017 Per consolidated income statement £m	*Underlying financing £m*	2016 Per consolidated income statement £m	*Underlying financing £m*
Financing income				
Interest receivable	**11**	***11***	14	*14*
Net fair value gains on foreign currency contracts	**2,611**	**–**	1	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	**17**	**–**	23	–
Net fair value gains on commodity contracts	**37**	**–**	16	–
Financing on post-retirement scheme surpluses	**39**	**–**	42	–
Net foreign exchange gains	**258**	**–**	–	–
	2,973	***11***	96	*14*
Financing costs				
Interest payable	**(67)**	***(64)***	(77)	*(77)*
Net fair value losses on foreign currency contracts	**–**	**–**	(4,437)	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	**(6)**	**–**	(31)	–
Financial charge relating to financial RRSAs	**(5)**	***(5)***	(6)	*(6)*
Financing on post-retirement scheme deficits	**(38)**	**–**	(39)	–
Net foreign exchange losses	**–**		(145)	–
Other financing charges	**(45)**	***(46)***	(38)	*(33)*
	(161)	***(115)***	(4,773)	*(116)*
Net financing	**2,812**	***(104)***	(4,677)	*(102)*
Analysed as:				
Net interest payable	**(56)**	***(53)***	(63)	*(63)*
Net fair value gains/(losses) on derivative contracts	**2,648**	**–**	(4,420)	–
Net post-retirement scheme financing	**1**	**–**	3	–
Net other financing	**219**	***(51)***	(197)	*(39)*
Net financing	**2,812**	***(104)***	(4,677)	*(102)*

5 Taxation

The effective reported tax rate for the year is **14.1%** (2016 13.0%). The 2017 reported profit before tax (2016: loss) includes significant mark to market adjustments 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 recognition of UK advance corporation tax and the profit on reclassification of joint ventures to subsidiaries which is not taxable then reduce the 2017 tax rate.

The US Tax Cuts and Jobs Act was enacted on 22 December 2017. This reduces the Federal Tax rate in the US from 35% to 21% with effect from 1 January 2018. As the reduction has been enacted prior to the year end, the closing deferred tax assets and liabilities of US companies within the group 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 OCI or equity.

Accordingly in 2017, £25m has been charged to the income statement and £45m has been charged to OCI.

6 Earnings per ordinary share

Basic earnings per share (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.

	2017			2016		
	Basic	**Potentially dilutive share options**	**Diluted**	Basic	Potentially dilutive share options [1]	Diluted
Profit/((loss) attributable to ordinary shareholders (£m)	**4,207**		**4,207**	(4,032)	–	(4,032)
Weighted average number of ordinary shares (millions)	**1,834**	**6**	**1,840**	1,832	–	1,832
EPS (pence)	**229.40p**	**(0.76)p**	**228.64p**	(220.08)p	–	(220.08)p

[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:

	2017		2016	
	Pence	**£m**	Pence	£m
Underlying EPS / Underlying profit attributable to ordinary shareholders	**40.46**	**742**	30.13	552
Total underlying adjustments to profit before tax (note 2)	**208.62**	**3,826**	(297.43)	(5,449)
Related tax effects	**(19.68)**	**(361)**	47.22	865
EPS / Profit/(loss) attributable to ordinary shareholders	**229.40**	**4,207**	(220.08)	(4,032)
Diluted underlying EPS	**40.33**		30.08	

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:

	2017		2016	
	Pence per share	**£m**	Pence per share	£m
Interim (issued in January)	**4.6**	**85**	4.6	85
Final (issued in July)	**7.1**	**131**	7.1	130
	11.7	**216**	11.7	215

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 2017	**1,874**	**1,325**	**1,944**	**1,007**	**540**	**742**	**663**	**8,095**
Exchange differences	**(5)**	**8**	**16**	**–**	**(3)**	**(3)**	**8**	**21**
Reclassifications	**–**	**–**	**(9)**	**–**	**–**	**–**	**9**	**–**
Additions	**–**	**160**	**342**	**286**		**135**	**50**	**973**
Acquisition of business	**–**	**128**	**202**	**70**	**996**	**7**	**44**	**1,417**
Disposals	**–**	**–**	**–**	**–**	**–**	**(13)**	**–**	**(13)**
At 31 December 2017	**1,869**	**1,621**	**2,495**	**1,363**	**1,503**	**868**	**774**	**10,493**
Accumulated amortisation:								
At 1 January 2017	**337**	**440**	**888**	**433**	**209**	**414**	**294**	**3,015**
Exchange differences	**(13)**	**1**	**8**	**–**	**(4)**	**(1)**	**–**	**(9)**
Charge for the year	**–**	**63**	**149**	**57**	**51**	**81**	**29**	**430**
Disposals	**–**	**–**	**–**	**–**	**–**	**(6)**	**–**	**(6)**
At 31 December 2017	**324**	**504**	**1,045**	**490**	**256**	**488**	**323**	**3,430**
Net book value at:								
31 December 2017	**1,545**	**1,117**	**1,450**	**873**	**1,247**	**380**	**451**	**7,063**
31 December 2016	1,537	885	1,056	574	331	328	369	5,080

Goodwill has been tested for impairment during 2017 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. These forecasts cover the next five years. Growth rates for the period not covered by the forecasts are based on a range of growth rates that reflect the products, industries and countries in which the relevant 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. The principal value in use assumptions for goodwill balances considered to be individually significant are:

Marine

- Trading assumptions (e.g. volume of equipment deliveries, capture of aftermarket and cost escalation) are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts, in particular the cyclical recovery of the commercial marine market.
- Cash flows beyond the five-year forecasts are assumed to grow at **2.5%** (2016: 2.5%).
- Pre-tax discount rate **13%** (2016: 13%).
- The estimate of value in use is approximately £50m higher than the carrying value and deterioration of key assumptions could result in an impairment. For example, the value in use would reduce by approximately £50m if alternative trading assumptions resulted in forecast cash flows reducing by 10%, by approximately £60m if the discount rate increased by 1% and by approximately £100m if the market recovery were delayed by one year compared to that assumed.

On 17 January 2018, the Group announced a strategic review of Commercial Marine. Until the review is sufficiently advanced, it is not possible to reliably determine the financial impact.

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%** (2016: 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 (e.g. market size and share, unit costs and programme delays) and other variables (e.g. discount rate and foreign exchange rates), could result in impairment in future years. In making this assessment, the Directors noted that the adoption of IFRS 15 on 1 January 2018 would result in the derecognition of contractual aftermarket rights of £873m, which will itself significantly reduce the risk of impairment on other intangible assets.

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 2017	**1,667**	**4,599**	**491**	**765**	**7,522**
Exchange differences	**(18)**	**(61)**	**(5)**	**(11)**	**(95)**
Additions – purchased	**36**	**155**	**127**	**446**	**764**
Additions arising from TotalCare Flex arrangements (non-cash)	**–**	**–**	**1**	**–**	**1**
Acquisition of business	**74**	**155**	**28**	**11**	**268**
Consolidation of previously non-consolidated subsidiary	**9**	**1**	**–**	**–**	**10**
Reclassifications	**92**	**308**	**29**	**(429)**	**–**
Transferred to assets held for sale	**(5)**	**(11)**	**–**	**–**	**(16)**
Disposals/write-offs	**(13)**	**(111)**	**(4)**	**(9)**	**(137)**
Adjustment [1]	**–**	**–**	**20**	**–**	**20**
At 31 December 2017	**1,842**	**5,035**	**687**	**773**	**8,337**
Accumulated amortisation:					
At 1 January 2017	**515**	**2,765**	**126**	**2**	**3,408**
Exchange differences	**(9)**	**(32)**	**(1)**	**–**	**(42)**
Charge for the year	**58**	**351**	**35**	**–**	**444**
Impairment	**3**	**3**	**–**	**–**	**6**
Reclassifications	**(7)**	**7**	**–**	**–**	**–**
Transferred to assets held for sale	**(3)**	**(10)**	**–**	**–**	**(13)**
Disposals/write-offs	**(3)**	**(100)**	**(1)**	**–**	**(104)**
Adjustment [1]	**–**	**–**	**14**	**–**	**14**
At 31 December 2017	**554**	**2,984**	**173**	**2**	**3,713**
Net book value at:					
31 December 2017	**1,288**	**2,051**	**514**	**771**	**4,624**
31 December 2016	1,152	1,834	365	763	4,114

[1] Adjustment relates to industrial engines sold with the Energy business in 2014.

10 Financial assets and liabilities

Other financial assets and liabilities comprise:

	Derivatives							
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total Derivatives £m	Financial RRSAs £m	TotalCare Flex £m	C Shares £m	Total £m
2017								
Non-current assets	**362**	**16**	**232**	**610**	**–**	**–**	**–**	**610**
Current assets	**27**	**9**	**–**	**36**	**–**	**–**	**–**	**36**
Current liabilities	**(493)**	**(10)**	**–**	**(503)**	**(50)**	**–**	**(28)**	**(581)**
Non-current liabilities	**(2,208)**	**(14)**	**(5)**	**(2,227)**	**(194)**	**(14)**	**–**	**(2,435)**
	(2,312)	**1**	**227**	**(2,084)**	**(244)**	**(14)**	**(28)**	**(2,370)**
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)

Derivative financial instruments	2017				2016 [1]
	Foreign exchange £m	Commodity £m	Interest rate £m	Total £m	Total £m
At 1 January	**(5,551)**	**(56)**	**358**	**(5,249)**	(1,731)
Currency options at inception	**–**	**–**	**–**	**–**	(33)
Acquisition of business	**7**	**2**	**–**	**9**	
Movements in fair value hedges [2]	**–**	**–**	**(131)**	**(131)**	345
Movements in other derivative contracts [3]	**2,611**	**37**	**–**	**2,648**	(4,420)
Contracts settled	**621**	**18**	**–**	**639**	590
At 31 December	**(2,312)**	**1**	**227**	**(2,084)**	(5,249)

[1] In 2016, 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.
[2] Loss on related hedged items **£131m** (2016: £343m loss).
[3] Include in financing.

Financial risk and revenue sharing arrangements (RRSAs) and other financial liabilities	Financial RRSAs		TotalCare Flex	
	2017 £m	2016 £m	**2017 £m**	2016 £m
At 1 January	**(101)**	(110)	**(15)**	–
Exchange adjustments included in OCI	**(14)**	5	**–**	–
Acquisition of business	**(157)**	–	**–**	–
Additions	**–**	–	**–**	(14)
Financing charge [1]	**(5)**	(6)	**–**	(1)
Excluded from underlying profit:				
Changes in forecast payments [1]	**1**	5		
Exchange adjustments [1]	**10**	(13)	**1**	(3)
Cash paid to partners	**22**	18		
Other	**–**	–	**–**	3
At 31 December	**(244)**	(101)	**(14)**	(15)

[1] Included in net financing.

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

	2017		2016	
	Book value £m	**Fair value £m**	Book value £m	Fair value £m
Borrowings	**(3,488)**	**(3,557)**	(3,357)	(3,413)
Financial RRSAs	**(244)**	**(247)**	(101)	(109)

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, other non-derivative financial assets and liabilities, 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*).
- Borrowings are carried at amortised cost. The fair value is estimated by discounting contractual future cash flows (Level 2 as defined by IFRS 13 *Fair Value Measurement*).
- Financial RRSAs and TotalCare Flex liabilities are carried at amortised cost. The fair value is estimated by discounting contractual future cash flows. Contractual cash flows are based on future trading activity, based on latest forecasts. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date (Level 3 as defined by IFRS 13 *Fair Value Measurement*).

Borrowings

During the year, the Group has repaid £166m of short-term borrowings and entered into new facilities of £366m.

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 2017	**1,336**	**(1,365)**	**(29)**
Exchange adjustments	**–**	**25**	**25**
Current service cost and administrative expenses	**(190)**	**(58)**	**(248)**
Past service credit/(cost)	**8**	**–**	**8**
Financing recognised in the income statement	**38**	**(37)**	**1**
Contributions by employer	**174**	**75**	**249**
Actuarial gains/(losses) recognised in OCI [1]	**477**	**(64)**	**413**
Returns on plan assets excluding financing recognised in OCI [1]	**265**	**57**	**322**
Other	**–**	**(3)**	**(3)**
At 31 December 2017	**2,108**	**(1,370)**	**738**
Analysed as:			
Post-retirement scheme surpluses - included in non-current assets	**2,108**	**17**	**2,125**
Post-retirement scheme deficits - included in non-current liabilities	**–**	**(1,387)**	**(1,387)**
	2,108	**(1,370)**	**738**

[1] 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

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. Prosecutions of individuals may follow and enforcement action may be taken by other authorities. 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 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$3.3bn** (2016: US$3.2bn) (on a discounted basis) to provide borrowing facilities to enable customers to purchase aircraft (of which approximately **US$390m** (on a discounted basis) could be called during 2018). 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 2017		31 December 2016	
	£m	***$m***	£m	*$m*
Gross commitments	**145**	***196***	238	*293*
Value of security [1]	**(41)**	***(55)***	(103)	*(126)*
Indemnities	**(51)**	***(69)***	(74)	*(91)*
Net commitments	**53**	***72***	61	*76*
Net commitments with security reduced by 20% [2]	**64**	***86***	86	*106*
[1] Security includes unrestricted cash collateral of:	**22**	***29***	38	*47*

[2] Although sensitivity calculations are complex, the reduction of the relevant security by 20% illustrates the sensitivity 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.

13 Related party transactions

Transactions with related parties are shown in note 24 of the 2017 Annual Report. Significant transactions in the current financial period are as follows:

	2017 **£m**	2016 £m
Sales of goods and services to joint ventures and associates	**2,469**	2,022
Purchases of goods and services from joint ventures and associates	**(2,224)**	(1,881)

Included in sales of goods and services to joint ventures and associates are sales of spare engines amounting to **£418m** (2016: £356m).

Profit recognised in the year on such sales amounted to **£75m** (2016: £119m), 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 **£67m** (2016: £97m).

14 Acquisition

On 19 December 2017, the Group completed the acquisition of the 53.1% of the shares of Industria de Turbo Propulsores SA (ITP Aero) owned by SENER Grupo de Ingenieria SA (SENER) which it did not already own.

The consideration of €718m is payable in eight quarterly instalments, commencing on 15 January 2018. At the Group's election, each instalment may be settled in either cash or Rolls-Royce Holdings plc shares. If the consideration is in shares, a 3% premium is applied. Interest is accrued on the outstanding balance based on LIBOR + 1.5%.

The fair value of the previous joint venture investment in ITP Aero of £204m was re-measured using a discounted cash flow methodology using judgement in estimating future cash flows, assessing the discount rate and establishing a non-controlling interest discount. This gave rise to a gain of £553m.

Given the proximity of the acquisition to the year end and as permitted by IFRS 3 *Business Combinations*, the fair value of acquired identifiable assets and liabilities have been presented on a provisional basis. Fair values were determined on the basis of an initial assessment performed by an independent professional expert prior to the acquisition date. Measurement techniques and estimation of future cash flows have been used to assess the value of the intangible assets at the date of acquisition. The total fair value of acquired identifiable assets and liabilities is £1,650m of which a significant value was allocated to intangible assets. The valuation indicated a bargain purchase of £245m, which has been recognised in the income statement.

The acquisition of the controlling interest in ITP Aero on 19 December 2017 did not have a significant impact on the Group's underlying results for the year.

Recognised amounts of identifiable assets acquired and liabilities assumed:

	2017 **£m**
Intangible assets	**1,417**
Property, plant and equipment	**268**
Deferred tax assets	**148**
Inventory	**316**
Trade and other receivables	**497**
Taxation recoverable	**2**
Cash and cash equivalents	**263**
Trade and other payables	**(625)**
Borrowings	**(34)**
Other financial assets and liabilities	**(148)**
Deferred tax liability	**(386)**
Provisions	**(68)**
Total identifiable assets and liabilities	**1,650**
Total consideration	**(1,405)**
Bargain purchase gain arising	**245**
Consideration satisfied by:	
Deferred consideration to be paid in cash or shares	**648**
Existing shareholding	**757**
	1,405
Net cash outflow arising on acquisition:	
Cash consideration	**–**
Less: cash and cash equivalents acquired	**(263)**
Cash inflow per the cash flow statement	**(263)**
Identifiable intangible assets comprise:	
Technology, patents and licences	**245**
Customer relationships	**833**
Trademark	**44**
In-process development	**91**
Other	**204**
	1,417

15 Derivation of summary funds flow statement

The table below shows the derivation of the summary funds flow statement (lines marked *) on page 32 from the cash flow statement on page 38.

		2017		2016		
		£m	**£m**	£m	£m	**Source**
*	**Underlying profit before tax (PBT) – page 53**		**1,071**		813	
	Depreciation and impairment of property, plant and equipment	**450**		426		Cash flow statement
	Amortisation of intangible assets	**430**		628		Cash flow statement
	Impairment of goodwill	**–**		(219)		Reversal of underlying adjustment
	Impairment of property, plant and equipment	**(6)**		–		Reversal of underlying adjustment
	Acquisition accounting	**(129)**		(115)		Reversal of underlying adjustment
*	**Depreciation and amortisation**		**745**		720	
	Increase in inventories	**(235)**		(161)		Cash flow statement
	Non-underlying impairment	**(6)**		–		Reversal of underlying adjustment (included in £12m impairment of assets)
	Decrease in trade and other receivables/payables	**946**		288		Cash flow statement
	Realised losses on settled foreign exchange derivatives in financing	**(173)**		(162)		Reported to underlying adjustment (note 2)
	Revaluation of trading assets	**(6)**		67		Reversal of underlying adjustment
*	**Movement on net working capital**		**526**		32	
	Additions of intangible assets	**(973)**		(631)		Cash flow statement
	Purchases of property, plant and equipment	**(773)**		(585)		Cash flow statement
	Government grants received	**14**		15		Cash flow statement
*	**Expenditure on property, plant and equipment and intangible assets**		**(1,732)**		(1,201)	
	Realised losses on hedging instruments	**475**		426		Reversal of underlying adjustment
	Net unrealised fair value to changes to derivatives	**24**		–		Reversal of underlying adjustment
	Foreign exchange on contract accounting	**(124)**		77		Reversal of underlying adjustment
	Exceptional restructuring	**(104)**		(129)		Reversal of underlying adjustment
	Other	**(3)**		(1)		Reversal of underlying adjustment
	Underlying financing	**104**		102		Reversal of underlying adjustment
	Loss on disposal of property, plant and equipment	**11**		5		Cash flow statement
	Joint ventures	**(52)**		(43)		Joint venture dividends less share of results – cash flow statement
	Increase in provisions	**58**		44		Cash flow statement
	Cash flows on other financial assets and liabilities included in underlying operating profit	**(488)**		(446)		Cash flow statement
	Share based payments	**34**		35		Cash flow statement
	Additions of unlisted investments	**(4)**		–		Cash flow statement
	Disposal of intangible assets	**7**		8		Cash flow statement
	Disposal of property, plant and equipment	**4**		8		Cash flow statement
	Investments in joint ventures and associates	**(48)**		(30)		Cash flow statement
	Net interest	**(53)**		(72)		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	**21**		1		Cash flow statement
	Purchase of ordinary shares for share schemes	**(24)**		(21)		Cash flow statement
*	**Other**		**(162)**		(40)	
*	**Trading cash flow**		**448**		324	
	Net defined benefit plans – underlying operating charge	**240**		204		Cash flow statement
	Cash funding of defined benefit plans	**(249)**		(271)		Cash flow statement
*	**Contributions to defined benefit schemes in excess of underlying PBT charge**		**(9)**		(67)	
*	**Tax**		**(180)**		(157)	Cash flow statement
*	**Free cash flow**		**259**		100	
*	**Shareholder payments**		**(214)**		(301)	Redemption of C Shares – cash flow statement
*	**Payment of penalties to investigating authorities**		**(286)**		–	Cash flow statement
*	**Acquisition of ITP Aero**		**229**		–	Cash flow statement
*	**Other acquisitions and disposals**		**(17)**		(153)	Cash flow statement
	Other		**8**		–	
*	**Foreign exchange**		**(59)**		240	Cash flow statement
*	**Change in net funds**		**(80)**		(114)	

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.

	2017		2016		
	£m	£m	£m	£m	Source
Reported operating profit		1,287		44	
Realised losses on hedging instruments	(475)		(426)		Reported to underlying adjustment (note 2)
Net unrealised fair value to changes to derivatives	(24)		–		Reported to underlying adjustment (note 2)
Foreign exchange on contract accounting	124		(77)		Reported to underlying adjustment (note 2)
Revaluation of trading assets and liabilities	6		(67)		Reported to underlying adjustment (note 2)
Effect of acquisition accounting	129		115		Reported to underlying adjustment (note 2)
UK pension restructuring	–		306		Reported to underlying adjustment (note 2)
Impairments	24		219		Reported to underlying adjustment (note 2)
Exceptional restructuring	104		129		Reported to underlying adjustment (note 2)
Accrual for deferred prosecution agreement penalties	–		671		Reported to underlying adjustment (note 2)
Other	–		1		Reported to underlying adjustment (note 2)
Adjustments to reported operating profit		(112)		871	
Underlying profit before financing		1,175		915	
Underlying financing		(104)		(102)	Underlying income statement (note 2)
Underlying profit before tax		1,071		813	

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 38.

	2017		2016	
	£m	£m	£m	£m
Change in cash and cash equivalents		231		(691)
Returns to shareholders		214		301
Net cash flow from changes in borrowings and finance leases		(200)		345
Increase/decrease in short-term investments		–		1
Acquisition of business	(263)		6	
Consolidation of previously unconsolidated subsidiary	(1)		–	
Increase in share in joint ventures	–		(154)	
Debt of joint ventures reclassified as joint operations	–		(9)	
Disposal of other businesses	–		(7)	
Changes in group structure		(264)		144
Payment of deferred prosecution agreement penalties		286		–
Other		(8)		–
Free cash flow		259		100
Exclude cash outflow of ITP Aero		14		–
Free cash flow excluding ITP Aero		273		100

16 Impact of adoption of IFRS 15

The segmental analysis shown in note 2 would have been as follows under the IFRS 15 policies set out in note 1:

	Civil £m	Defence £m	Power Systems £m	Marine £m	Nuclear £m	Inter-segment £m	Total reportable segments £m
Year ended 31 December 2017							
Underlying revenue from sale of original equipment	**2,862**	**911**	**1,825**	**539**	**377**	**(27)**	**6,487**
Underlying revenue from aftermarket services	**3,671**	**1,287**	**896**	**476**	**430**	**(37)**	**6,723**
Total underlying revenue at 2016 exchange rates	**6,533**	**2,198**	**2,721**	**1,015**	**807**	**(64)**	**13,210**
Translation to 2017 exchange rates	**80**	**84**	**198**	**60**	**11**	**(5)**	**428**
Total underlying revenue at 2017 exchange rates	**6,613**	**2,282**	**2,919**	**1,075**	**818**	**(69)**	**13,638**
Gross profit	**350**	**551**	**786**	**213**	**131**	**–**	**2,031**
Commercial and administrative costs	**(370)**	**(126)**	**(310)**	**(193)**	**(71)**	**–**	**(1,070)**
Research and development costs	**(442)**	**(77)**	**(165)**	**(44)**	**(23)**	**–**	**(751)**
Share of results of joint ventures and associates	**109**	**7**	**(3)**	**–**	**–**	**–**	**113**
Underlying operating profit/(loss) at 2016 exchange rates	**(353)**	**355**	**308**	**(24)**	**37**	**–**	**323**
Translation to 2017 exchange rates	**23**	**15**	**23**	**(2)**	**1**	**–**	**60**
Underlying operating profit/(loss) at 2017 exchange rates	**(330)**	**370**	**331**	**(26)**	**38**	**–**	**383**
2017 accounting policies							
Total underlying revenue	*8,023*	*2,275*	*2,923*	*1,077*	*818*	*(70)*	*15,046*
Underlying operating profit	*520*	*374*	*330*	*(25)*	*38*	*–*	*1,237*

Reconciliation to reported results	Total reportable segments £m	Other businesses and corporate £m	Total underlying £m	Underlying adjustments and foreign exchange £m	Group at actual exchange rates £m	*Group at actual exchange rates - 2017 accounting policies £m*
Year ended 31 December 2017						
Revenue from sale of original equipment	**6,487**	**22**	**6,509**	**771**	**7,280**	*8,090*
Revenue from aftermarket services	**6,723**	**20**	**6,743**	**775**	**7,518**	*8,217*
Total revenue at 2016 exchange rates	**13,210**	**42**	**13,252**	**1,546**	**14,798**	*16,307*
Translation to 2017 exchange rates	**428**	**2**	**430**	**(430)**	**–**	*–*
Total revenue at 2017 exchange rates	**13,638**	**44**	**13,682**	**1,116**	**14,798**	*16,307*
Gross profit	**2,031**	**4**	**2,035**	**244**	**2,279**	*3,173*
Commercial and administrative costs	**(1,070)**	**(54)**	**(1,124)**	**(98)**	**(1,222)**	*(1,222)*
Research and development costs	**(751)**	**–**	**(751)**	**(83)**	**(834)**	*(795)*
Share of results of joint ventures and associates	**113**	**(10)**	**103**	**29**	**132**	*131*
Operating profit/(loss) at 2016 exchange rates	**323**	**(60)**	**263**	**92**	**355**	*1,287*
Translation to 2017 exchange rates	**60**	**(2)**	**58**	**(58)**	**–**	*–*
Operating profit/(loss) at 2017 exchange rates	**383**	**(62)**	**321**	**34**	**355**	*1,287*
Gains arising on the acquisition of ITP Aero	**–**	**–**	**–**	**798**	**798**	*798*
Profit/(loss) before financing and taxation	**383**	**(62)**	**321**	**832**	**1,153**	*2,085*
Net financing		**(112)**	**(112)**	**2,966**	**2,854**	*2,812*
Profit/(loss) before taxation		**(174)**	**209**	**3,798**	**4,007**	*4,897*
Taxation		**(166)**	**(166)**	**(381)**	**(547)**	*(689)*
Profit for the year			**43**	**3,417**	**3,460**	*4,208*

Underlying adjustments

	2017			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**13,682**	**321**	**(112)**	**(166)**
Recognise revenue at exchange rate on date of transaction	**1,116**	**–**	**–**	**–**
Realised (gains)/losses on settled derivative contracts	**–**	**453**	**195**	**(111)**
Net unrealised fair value changes to derivative contracts	**–**	**24**	**2,648**	**(463)**
Effect of currency on contract accounting	**–**	**(180)**	**–**	**21**
Revaluation of trading assets and liabilities	**–**	**(6)**	**113**	**(12)**
Financial RRSAs – exchange differences and changes in forecast payments	**–**	**–**	**11**	**(3)**
Effect of acquisition accounting	**–**	**(129)**	**–**	**35**
Impairment of assets	**–**	**(12)**	**–**	**–**
Net post-retirement scheme financing	**–**	**–**	**1**	**(1)**
Exceptional restructuring	**–**	**(104)**	**–**	**31**
Gains arising on the acquisition of ITP Aero	**–**	**798**	**–**	**–**
Consolidation of previously non-consolidated subsidiary	**–**	**(12)**	**–**	**–**
Other	**–**	**–**	**(2)**	**9**
Recognition of advance corporation tax	**–**	**–**	**–**	**163**
Reduction in corporate tax rates	**–**	**–**	**–**	**(50)**
Total underlying adjustments	**1,116**	**832**	**2,966**	**(381)**
Reported per consolidated income statement	**14,798**	**1,153**	**2,854**	**(547)**

As processes and procedures are further embedded during 2018, it is possible that some changes to the information above may result.

Principal risks and uncertainties

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

Risk or uncertainty and potential impact	How we manage it
Disruptive technologies and business models Disruptive technologies, new entrants with alternative business models or disruptions to key markets or customers could reduce our ability to sustainably win future business, achieve operating results and realise future growth opportunities.	• Horizon and emerging technology scanning and understanding our competitors, including patent searches. • Investing in innovation and new technologies. • Focusing on enhancing our skills and capabilities to maintain our technology leadership. • Forming strategic partnerships and conducting joint research programmes. • Establishing our digital business.
Competitive position The presence of large, financially strong competitors in the majority of our markets means that the Group is susceptible to significant price pressure for original equipment or services even where our markets are mature or the competitors few. Our main competitors have access to significant government funding programmes as well as the ability to invest heavily in technology and industrial capability.	• Accessing and developing key technologies and service offerings which differentiate us competitively. • Focusing on being responsive to our customers and improving the quality, delivery and reliability of our products and services. • Partnering with others effectively. • Driving down cost and improving margins. • Protecting credit lines. • Investing in innovation, manufacturing and production, and continuing governance of technology programmes. • Maintaining a healthy balance sheet to enable access to cost-effective sources of third party funding. • Understanding our competitors.
Major product programme delivery Failure to deliver a major programme on time, within budget, to specification, or technical performance falling significantly short of customer expectations, or not delivering the planned business benefits, would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation.	• Major programmes are subject to Board approval. • Reviewing major programmes at levels and frequencies appropriate to their criticality and performance, against key financial and non-financial deliverables and potential risks throughout the programmes lifecycle. • Investing in facilities and people to minimise the level of disruption to our customers from Trent 1000 and Trent 900 in-service challenges and developing longer term solutions to these issues. • Conducting technical audits at pre-defined points which are performed by a team that is independent from the programme. • Requiring programmes to address the actions arising from reviews and audits and monitoring and controlling progress through to closure. • Applying knowledge management principles to provide benefit to current and future programmes.
Product safety The lives of people that our customers serve depend on the safety of our products wherever and whenever they operate them. Any failure to meet this expectation, or if our product causes significant environmental impact, would adversely affect our reputation and long-term sustainability.	• Ensuring a culture that puts safety first. • Applying our engineering design and validation process from initial design, through production and into service. • Reviewing the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards. • Operating a safety management system (SMS), governed by the product safety review board, and subject to continual improvement based on experience and industry best practice. Product safety training is an integral part of our SMS. • Improving our supply chain quality.
Talent and capability Inability to attract and retain the critical capabilities and skills needed in sufficient numbers to effectively organise, deploy and incentivise our people to deliver our strategies, business plans and projects.	• Attracting, rewarding and retaining the right people with the right skills globally in a planned and targeted way, including regular benchmarking of remuneration. • Developing and enhancing organisational, leadership, technical and functional capability to deliver global programmes. • Continuing a strong focus on individual development and succession planning. • Proactively monitoring retirement in key areas and actively managing the development and career paths of our people with a special focus on employees with the highest potential. • Embedding a lean, agile, high-performance culture that tightly aligns Group strategy with individual and team objectives. • Retaining, incentivising and effectively deploying the critical capabilities, skills and people needed to deliver our strategic priorities, plans and projects whilst implementing the Group's major programme to transform its business, to be resilient and to act with pace and simplicity. • Tracking engagement through our annual employee opinion survey and a commitment to drive year-on-year improvement to the employee experience and communications.

Risk or uncertainty and potential impact	How we manage it
Business continuity Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster (including those caused by climate change), regional conflict, financial insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results.	• Continuing our investment in adequate capacity and modern equipment and facilities. • Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and the skills of our people. • Selecting stronger suppliers, developing dual sources or dual capability. • Ensuring our suppliers are aware of the 2018 Registration, Evaluation, Authorisation and restriction of Chemicals (REACH) deadline and conducting research on alternative materials. • Crisis management exercises and testing site-level incident management and business recovery plans. • Providing improved response to supply chain disruption through customer excellence centres.
IT vulnerability Breach of cyber security causing controlled or critical data to be lost, made inaccessible, corrupted or accessed by unauthorised users.	• Implementing 'defence in depth' through deployment of multiple layers of software and processes including web gateways, filtering, firewalls, intrusion, advanced persistent threat detectors and integrated reporting. • Running security and network operations centres. • Actively sharing cyber security information through industry, government and security forums.
Market and financial shock The Group is exposed to a number of market risks, some of which are of a macro-economic nature (e.g. foreign currency, oil price, rates) and some of which are more specific to the Group (e.g. liquidity and credit risks, reduction in air travel or disruption to other customer operations). Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness. This would affect operational results or the outcomes of financial transactions.	• Maintaining a strong balance sheet, through managing cash balances and debt levels. • Providing financial flexibility by maintaining high levels of liquidity and an investment grade credit rating. • Sustaining a balanced portfolio through earning revenue both from the sale of original equipment and aftermarket services, providing a broad product range and addressing diverse markets that have differing business cycles. • Deciding where and what currencies to source in, and where and how much credit risk is extended or taken. The Group has a number of treasury policies that are designed to hedge residual risks using financial derivatives (foreign exchange, interest rates and commodity price risk). • Review debt financing and hedging in light of volatility in external financial markets caused by external events, such as Brexit or other geopolitical changes.
Political risk Geopolitical factors that lead to an unfavourable business climate and significant tensions between major trading parties or blocs which could impact the Group's operations. Examples include: explicit trade protectionism, differing tax or regulatory regimes, potential for conflict or broader political issues.	• Where possible, locating our facilities and supply chain in countries with a low level of political risk and/or ensuring that we maintain dual capability. • Diversifying global operations to avoid excessive concentration of risks in particular areas. • The Group's businesses and its strategic marketing network proactively monitoring local situations. • Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base. • Proactively influencing regulation where it affects us. • Steering Committee to co-ordinate activities across the Group and minimise the impact of Brexit.
Compliance Non-compliance by the Group with legislation, the terms of the deferred prosecution agreements or other regulatory requirements in the heavily regulated environment in which it operates (e.g. export controls; use of controlled chemicals and substances; and anti-bribery and corruption legislation) compromising the ability to conduct business in certain jurisdictions and exposing the Group to potential: reputational damage; financial penalties; debarment from government contracts for a period of time; and/or suspension of export privileges (including export credit financing), each of which could have a material adverse effect.	• Taking an uncompromising approach to compliance. • Operating an extensive compliance programme. This programme and the Global Code of Conduct are disseminated throughout the Group and are updated from time to time to ensure their continued relevance, and to ensure that they are complied with, both in spirit and to the letter. The Global Code of Conduct and the Group's compliance programme are supported by appropriate training. • Strengthening of the ethics, anti-bribery and corruption, compliance and export control teams. • A legal team is in place to manage any ongoing regulatory investigations. • Engaging with external regulatory authorities. • Implementing a comprehensive REACH compliance programme. This includes ensuring that we and our supply chain are covered by REACH authorisations for a number of chemicals needed for our products, establishing appropriate data systems and processes and working with our suppliers, customers and trade associations.

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 3 May 2018 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 2018 must ensure that their instructions are lodged with the Registrar no later than 5:00pm on 1 June 2018 (CREST holders must submit their election in CREST before 3:00pm BST on 1 June 2017). Redemption will take place on 5 July 2018.

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 2 July 2018 to shareholders on the register on 27 April 2018 and the final day of trading with entitlement to C Shares is 25 April 2018. Together with the interim issue on 3 January 2018 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.

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 2017. Certain parts thereof are not included in this announcement.

The Board have agreed to extend Brad Singer's initial two-year appointment as a Non-Executive Director for a further three years. The Company and Brad Singer are party to a relationship agreement with ValueAct (a summary of which can be found on our website). That agreement will expire on 3 May 2018 but will be replaced with a new agreement covering treatment of confidential information and conflicts of interest only.

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 2017, the Group had borrowing facilities of £5.4bn and total liquidity of £5.1bn, including cash and cash equivalents of £3.0bn and undrawn facilities of £2.1bn. £82m of the facilities mature in 2018.

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
6 March 2018

Stephen Daintith
Chief Financial Officer
6 March 2018