Financial summary

David Smith
Chief Financial Officer

Order book and order intake

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

Underlying trading

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

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

Marine profit was sharply lower led by continuing weakness in the offshore markets. Nuclear profit was 37% lower than 2015 due to a lower margin mix in submarine projects.

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

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

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

Reported results

Reported results are impacted by the mark-to-market adjustments driven by movements in USD:GBP and EUR:GBP exchange rates over the year. In addition, we recognised the £671m charge related to the agreements reached in respect of regulatory

GROUP TRADING SUMMARY

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

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

investigations, a goodwill impairment charge of £219m largely reflecting a more cautious outlook for our Marine business and £129m of exceptional restructuring cost. As a result, the reported loss before tax was £(4,636)m (2015: a profit of £160m).

Free cash flow

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

While some of this positive variance is a timing impact and likely to reverse early in 2017, improved efficiencies should drive a level of sustainable benefit.

Net debt and foreign currency

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

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

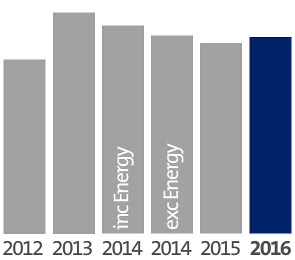
The Group hedges the transactional foreign exchange exposures to reduce volatility to revenues, costs and resulting margins. The hedging policy sets maximum and minimum cover ratios of hedging for net transactional foreign exchange exposure. It allows us to take advantage of attractive foreign exchange rates, whilst remaining within the cover ratios. A level of flexibility is built into the hedging instruments to manage changes in exposure from one period to the next and to reduce volatility by smoothing the achieved rates over time.

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

UNDERLYING REVENUE

£13,783m

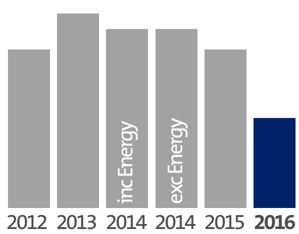
2015	**£13,354m**
2014 exc	**£13,864m**
2014 inc	**£14,588m**
2013	**£15,505m**
2012	**£12,209m**



UNDERLYING PROFIT BEFORE TAX

£813m

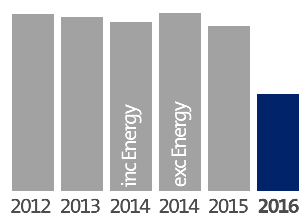
2015	**£1,432m**
2014 exc	**£1,617m**
2014 inc	**£1,618m**
2013	**£1,759m**
2012	**£1,434m**



UNDERLYING OPERATING MARGIN

6.6%

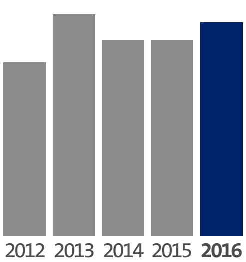
2015	**11.2%**
2014 exc	**12.1%**
2014 inc	**11.5%**
2013	**11.8%**
2012	**12.0%**



REPORTED REVENUE

£14,955m

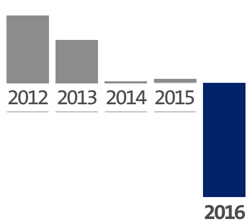
2015	**£13,725m**
2014	**£13,736m**
2013	**£15,513m**
2012	**£12,161m**



REPORTED (LOSS)/PROFIT BEFORE TAX

£(4,636)m

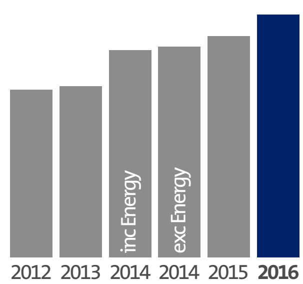
2015	**£160m**
2014	**£67m**
2013	**£1,759m**
2012	**£2,766m**



NET R&D AS A PROPORTION OF UNDERLYING REVENUE

6.8%

2015	**6.2%**
2014 exc	**5.9%**
2014 inc	**5.8%**
2013	**4.8%**
2012	**4.7%**



Financial review

UNDERLYING INCOME STATEMENT

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

SEGMENTAL ANALYSIS

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

* 2015 figures have been restated as a result of £21m of costs previously reported in 'cost of sales', being reclassified as 'other commercial and administrative costs' to ensure consistent treatment with 2016.

Underlying revenue and **underlying profit before financing** are discussed in the Review of 2016 (page 7), the Financial summary (page 16) and the Business reviews (pages 18 to 35).

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

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

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

At the Annual General Meeting on 4 May 2017, the Directors will recommend an issue of 71 C Shares with a total nominal value of 7.1 pence for each ordinary share. Together with the interim issue on 4 January 2017 of 46 C Shares for each ordinary share with a total nominal value of 4.6 pence, this is the equivalent of a total annual **payment to ordinary shareholders** of 11.7 pence for each ordinary share. Further details are included on page 186.

Reported results

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

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

REPORTED INCOME STATEMENT

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

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

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

Profit before financing

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

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

The impairment of goodwill of £219m (2015: £75m), principally relating to the Marine business as a result of the continued weakness in the oil & gas market (see note 9).

RECONCILIATION BETWEEN UNDERLYING AND REPORTED RESULTS

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

SUMMARY BALANCE SHEET

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

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

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

Financial penalties of £671m from agreements with investigating bodies (see page 8).

Costs of restructuring the UK pension schemes in 2016 of £306m, principally a settlement charge on the transfer of the Vickers Group Pension Scheme to an insurance company (see note 19).

Financing and taxation

The mark-to-market adjustments on the Group's hedge book of £4,420m (2015: £1,306m). These reflect: the large hedge book held by the Group (eg. US$38bn); and the weakening of sterling, particularly against the US dollar and the euro, as noted above. At each year end, our foreign exchange hedge book is included in the balance sheet at fair value (mark-to-market) and the movement in the year included in reported financing costs.

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

Balance sheet

Intangible assets (note 9) increased by £435m mainly due to exchange differences of £438m. Additions of £631m (including £154m of certification and participation fees, £100m of development costs and £208m of contractual aftermarket rights) were largely offset by amortisation of £406m and impairment of £222m (including £200m on Marine goodwill).

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain: reductions in assumed market share; programme timings; increases in unit cost assumptions; and adverse movements in discount rates.

Property, plant and equipment (note 10) increased by £624m, around half of which was caused by exchange differences of £330m. Additions of £701m (including £75m of TotalCare Flex engines) were offset by depreciation of £424m and £41m was added from the reclassification of joint ventures to joint operations.

Investments in joint ventures and associates (note 11) increased by £268m, including an increase of £154m in the Group's share of authorised maintenance centre joint ventures. The other main movements were: exchange gains of £107m; and the Group's share of retained profit of £43m; offset by a £57m reclassification of certain joint ventures to joint operations.

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

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

Provisions (note 18) largely relate to warranties and guarantees provided to secure the sale of OE and services. The increase of £119m includes reclassifications from accruals of £92m, following a review of accounting consistency during the period. The remaining increase of £27m includes net additional charges of £271m (including £147m for warranties and guarantees), and foreign exchange movements of £75m, offset by utilisation of £227m.

Net post-retirement scheme deficits (note 19) have reduced by £48m.

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

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

Net financial assets and liabilities (note 17) principally relate to the fair value of foreign exchange, commodity and interest rate contracts. All contracts continue to be held for hedging purposes. The fair value of foreign exchange derivatives is a net financial liability of £5.6bn, an increase of £3.9bn in the period, mainly a result of the weakening of sterling against the US dollar and euro.

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

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

Customer financing facilitates the sale of OE and services by providing financing support to certain customers. Where such support is provided by the Group, it is generally to customers of the Civil Aerospace business and takes the form of various types of credit and asset value guarantees. These exposures produce contingent liabilities that are outlined in note 23. The contingent liabilities represent the maximum aggregate discounted gross and net exposure in respect of delivered aircraft, regardless of the point in time at which such exposures may arise. The reduction in gross exposures is a result of guarantees expiring.

Funds flow

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

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

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

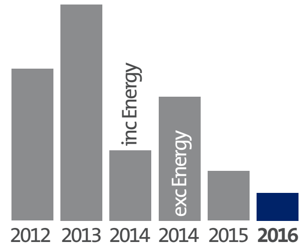
Shareholder payments – the change in shareholder payments reflects the difference between the 2014 and 2015 payments, which are paid in the following year.

Acquisitions and disposals include the £154m increase in stake in joint ventures described on the opposite page.

FREE CASH FLOW

£100m

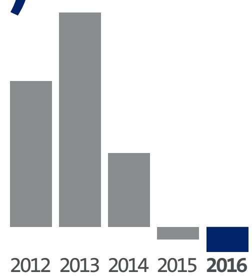
2015	179
2014 exc	447
2014 inc	254
2013	781
2012	548



NET (DEBT)/FUNDS

£(225)m

2015	(111)
2014	666
2013	1,939
2012	1,317



SUMMARY FUNDS FLOW STATEMENT[1]

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

[1] The derivation of the summary funds flow statement above from the reported cash flow statement is included in note 26 of the condensed consolidated financial statements.