

1 August 2017

ROLLS-ROYCE HOLDINGS PLC 2017 HALF YEAR RESULTS

Commenting on the results, Warren East, Chief Executive, said: “Rolls-Royce delivered encouraging year-on-year operational progress in the first six months of the year. Civil Aerospace large engine deliveries increased 27% and we made good further progress improving Trent XWB OE economics. Restructuring savings were ahead of plan. Together with a higher than expected benefit from long-term contract accounting adjustments, this resulted in a good set of results, with financial performance ahead of our expectations for the first half. Looking to the balance of the year, execution and delivery of a number of important milestones across our businesses will be key to achieving our full year expectations. Our outlook for full year profit and cash remains unchanged.”

Half year to 30 June	2017	Reported 2016	Change*	2017	Underlying 2016	Change*
Revenue (£m)	7,566	6,462	+12%	6,865	6,143	+6%
Profit before tax (£m)	1,941	(2,150)	n/a	287	104	+148%
Earnings per share (p)	86.21p	(96.72)p	n/a	11.23p	4.20p	+167%
				2017	2016	Change**
Net funds (£m)				(931)	(712)	-31%
Free cash flow (£m)***				(339)	(414)	+18%

Underlying: for definition see note 2 on page 32 * translated at constant exchange rates; ** translated at actual exchange rates; *** free cash flow defined as operating cash after capital expenditure, pensions and taxes, before payments to shareholders and investigating authorities, foreign exchange and acquisitions & disposals. The derivation of free cash flow is shown on page 24.

H1 highlights

- Reported revenue up 12% at constant exchange rates; 17% at actual exchange rates
- Reported profit before tax of £1,941m (2016 loss: £2,150m)
- Underlying revenue up 6% at constant exchange rates, led by Civil Aerospace and Power Systems
- Underlying profit before tax of £287m, up £183m (2016: £104m)
- Good profit growth in Civil Aerospace and Power Systems with Defence remaining steady; Marine continues to face challenging offshore oil and gas markets
- First half commercial and administration costs down £38m or 7%
- First half R&D spend increased to £411m (2016: £378m), underpinning key growth opportunities
- Free cash flow performance solid with a steady operating performance, helped by effective working capital management
- Interim payment to shareholders unchanged at 4.60 pence per share

Looking forward

- Outlook for full year 2017 unchanged

Warren East added: “Two years ago we set out a programme of change at Rolls-Royce to drive efficiency and sharpen our focus on execution. Our strengthened management team is making good progress in simplifying the organisation and driving the pace of necessary change to develop a more resilient and sustainable business. However, this is no time for complacency. Strong execution and a focus on delivering our customer commitments remains essential as we continue to manage in-service issues in Civil Aerospace alongside key new product introductions and increased production volumes. Our long-held commitment of investing in R&D and future technologies remains unchanged, as we look to secure the long-term success of the business, built on a solid platform of outstanding customer service and strong cash flows.”

This announcement has been determined to contain inside information.

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

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

Results Presentation

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

Online webcast registration details for 1 August presentation

To register for the live webcast (including Q&A participation) please visit this link:

<http://edge.media-server.com/m/p/ebfsbz7c>

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

2017 Half Year Business Highlights

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

	% of Group revenues*	Closing order book £bn	Underlying revenue		Underlying profit before financing	
			£m		£m	
			H1 2017	% change	H1 2017	£m change
Civil Aerospace	53%	73.3	3,676	14%	173	125
Defence Aerospace	15%	4.3	1,048	-4%	148	7
Power Systems	18%	2.2	1,233	3%	66	48
Marine	8%	0.9	524	-15%	(31)	(17)
Nuclear	6%	2.0	391	8%	14	(4)
Eliminations/central/other			(7)		(25)	(4)
Total Group		82.7	6,865	6%	345	155

* Based on gross revenues prior to intra-group eliminations

Civil Aerospace

- Underlying revenue up 14%, principally due to:
 - Original equipment (OE): 27% increase in deliveries of Trent engines
 - Services (AM): strong growth, led by in-production fleet and time & materials activities on older engines; good progress on Rolls-Royce powered aircraft transitions
- Underlying profit before financing of £173m, up from £31m in 2016; helped by aftermarket growth and a higher than expected benefit from long-term contract accounting adjustments (a net gain of £56m v 2016, including a £77m benefit arising from a change to a customer credit rating risk assessment)
- Progress on new engine programmes: ongoing flight testing of Trent 1000 TEN and Trent XWB-97; shipped first set of Trent 7000 test engines to Airbus in June
- Large engine production ramp up continuing; further work to deliver 2017 targets after solid start including good further progress improving Trent XWB OE economics
- Expect increased activity in second half related to Trent 1000 maintenance programme to address a number of technical issues; working with our customers to minimise disruption
- Full year outlook unchanged: increasing deliveries driving OE growth; aftermarket growth led by increased engine flying hours; and further cost reduction initiatives on large engine installed base

Defence Aerospace

- Underlying revenue down 4%; modest reduction in both OE sales and service revenues
- Underlying profit before financing £148m (2016: £128m); led by lower overhead costs
- Two new Service Delivery Centres announced to enhance aftermarket service offering
- Full year outlook unchanged: margins and profits expected to soften from 2016 levels

Power Systems

- Underlying revenue up 3%; led by higher OE volumes
- Underlying profit before financing £66m (2016: £13m); led by better volumes and higher gross margin
- New management revitalising the business; pursuing growth opportunities, manufacturing and product simplification; clearer performance goals
- Full year outlook: improving environment, although visibility in some markets remains limited; improved closing OE order book; improved outlook overall

Marine

- Underlying revenue down 15%; due to weak offshore markets
- Underlying profit before financing down £17m to £(31)m; lower offshore volumes more than offset first half cost savings from restructuring programmes announced over last two years
- Full year outlook: market conditions mixed; focus on operational restructuring

Nuclear

- Underlying revenue up 8%; led by increased submarine work
- Underlying profit before financing down £4m at £14m; reflecting changes in product mix and higher R&D
- Full year outlook unchanged: sustaining improved delivery performance and investing in new R&D programmes to fuel long-term growth

Chief Executive's Review

Steady performance in the first six months of 2017

Rolls-Royce delivered encouraging year-on-year operational progress in the first six months of 2017; large engine volumes increased 27% and restructuring savings were ahead of plan. Together with a higher than expected benefit from long-term contract accounting adjustments, this resulted in a good set of results, with financial performance ahead of our expectations for the first half. At the same time we have maintained our strong investment in products and services to support our customers and reinforce opportunities for further growth in the long-term.

With further growth in the overall value of our order book, order cover remains strong. This includes orders for over 2,700 large engines in Civil Aerospace, which reflects an average five years of production including six years of cover for the Trent XWB family that power the Airbus A350. In Defence, we have maintained a healthy order book, for both original equipment (OE) and services. Power Systems has roughly 80% annualised order cover for its OE activities, a more positive situation than at the same time last year. However, Marine's order book remains weak, mainly reflecting continued softness in its offshore oil and gas markets. Nuclear continues to enjoy healthy order cover for all its submarine activities and is making progress developing its position in key international markets for its civil nuclear products and services.

Group underlying revenue increased 6% on a constant currency basis led by growth in both original equipment (up 5%) and aftermarket services revenues (up 8%). Civil Aerospace made a strong contribution (up 14%) on the back of a 27% increase in large engine deliveries together with good engine flying hour and associated revenue growth from the larger installed base. While Defence revenue was down slightly, Power Systems and Nuclear reported positive revenue growth of 3% and 8% respectively. This was partly offset by further weakness in the trading conditions in Marine's offshore oil and gas markets, resulting in its revenue being 15% lower.

Compared to 2016, underlying profit before finance charges and tax was higher at £345m (2016: £158m), largely reflecting the revenue improvement, our focus on cost management and long-term contract accounting adjustments. Within this, Civil Aerospace improved to £173m (2016: £31m), including the benefit of a favourable change to a customer credit risk assessment; Defence Aerospace delivered £148m (2016: £128m); Power Systems improved to £66m (2016: £13m); Marine generated a loss of £(31)m (2016: £(13)m loss) and Nuclear delivered £14m (2016: £18m). More detail on each business is included in the Operational Review.

After underlying financing costs of £58m (2016: £54m), underlying profit before tax was £287m (2016: £104m). After an underlying tax charge of £81m (2016: £27m), underlying profit for the period was £206m (2016: £77m). With an average 1,834m shares in issue, underlying earnings per share were 11.23p (2016: 4.20p).

Since the end of 2016, the value of sterling relative to the US dollar strengthened by around 5% to the end of the first half, compared to the prior period in which sterling depreciated by around 10%. As a result, we have recognised a net £1.4bn non-cash mark-to-market favourable valuation adjustment for all our derivative contracts (2016: £2.2bn charge). The valuation adjustment was the principal reason for the reported financing gain of £1,470m (2016: £(2,386)m charge) and reported profit before tax being £1,941m (2016: £(2,150)m loss).

On a reported basis, the tax charge of £360m (2016: £378m credit) resulted in a reported profit for the year of £1,581m (2016: £(1,772)m loss). Reported earnings per share were 86.21p (2016: (96.72)p).

A full reconciliation of underlying to reported profit can be found in note 2 from page 32 onwards.

The free cash outflow for the first half was £339m (2016: outflow of £414m¹), better than expected reflecting a steady operating performance, supported by a higher level of working capital management, by around £180m, which was the significant contributor to the year-on-year improvement.

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

Our good progress has been underpinned by our clear focus on four simple priorities for 2017

Our 2017 priorities are four-fold: to strengthen our focus on engineering, operational and aftermarket excellence to drive long-term profitable growth; to sustain our transformation progress; to further rebuild trust and confidence in Rolls-Royce across key stakeholders; and to define an appropriate vision for the business and the best way we can deliver sustainable shareholder value.

We have made steady progress towards all four objectives in the first six months of 2017.

One: Focus on engineering, operational and aftermarket excellence starting to deliver tangible benefits

We have maintained our focus on delivering against the **engineering** excellence commitments that will secure our future growth and performance improvements. In Civil Aerospace this included delivering key milestones towards entry into service for the new Trent 1000 TEN, Trent XWB-97 and Trent 7000. In addition, testing of our new power gearbox design for civil large engines has proceeded well, and we continued to develop next generation engine technologies for different Advance architectures. In the first six months of the year, Power Systems has started a major product rationalisation programme to simplify the customer offering and deliver significant benefits to manufacturing operations. In Marine, we successfully trialled our first unmanned operation system, using a remote operated harbour vessel.

In **operations**, we have invested a further £89m (£67m in 2016, cumulative £1.5bn since 2011) in transforming our manufacturing footprint across the business. This has enabled the Civil Aerospace business to continue to make solid progress on its major production increase – with first half deliveries of large engines up by 27% over the same period in 2016 (2017: 209, 2016: 164). At the same time, the investment paves the way for overall reductions in the impact of OE installed engines sold at prices below manufacturing cost – a key target over the next few years. In Defence, we made good progress with the modernisation of our Indianapolis facility which will help reduce costs and improve delivery performance of both original equipment and spares to support higher standards of customer service. In Marine, implementation of the restructuring announced in December 2016 has proceeded well. As a result, by the end of 2017 we expect the overall Marine headcount to be down by around 30% compared to end 2014. During the first six months of 2017, our Nuclear business has sustained the improvements made to deliver performance on its key submarine programmes with delivery against commitments recording a significant improvement over the same period in 2016.

The focus on improving **aftermarket** excellence continues to be driven across our businesses by customer needs as well as through the broader transformation activities. In Civil Aerospace, this has resulted in a progressive extension to the framework of our engine overhaul services offering, including the introduction of our CareStore, the roll out of LessorCare™ and further demand for SelectCare™ and TotalCare® Flex®. Rolls-Royce powered aircraft transitions also improved further following the introduction of a dedicated team in 2015. As a result, since the end of 2016, 17 Trent 700 powered Airbus A330s and 6 Trent 800 powered Boeing 777s have found new homes.

Since 2016, we have been undertaking a proactive maintenance programme on the Trent 1000 to address a number of technical issues. We will be working closely with our customers to ensure any disruption is minimised as far as possible. In order to reduce the impact on our customers, we have redesigned key elements of the service programme, through various 'lean' improvement initiatives to reduce lead-times, thereby getting the engines back into operation quicker.

In Defence, we opened two new dedicated Service Delivery Centres in Lossiemouth and Bangalore, to support the RAF and Indian Air Force respectively with improved response times and a greater proportion of issues being resolved on-wing. In June, we entered into a new partnership with Aviall to leverage its route to market for a range of defence aftermarket spares and services. Our Marine business also entered into its first 'power by the hour' contract with Norlines. Power Systems has sought to leverage the long-standing experience in Civil Aerospace to take better advantage of its significant installed base of engines. Work is underway to develop a service offering for customers around lifecycle monitoring and support. With an increasing focus on life-cycle costs and a broader use of digital solutions for engine monitoring, this initiative should steadily develop a new growth market through better proactive service management and as more 'digitally' enabled engines and systems are delivered.

Two: On track to deliver 2017 and 2018 transformation benefits

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

Against these commitments we have made a better than expected start. Savings achieved in 2016 were above target at over £60m, with fixed costs reduced further by over £50m in the first half of this year. This momentum will contribute to achieving total incremental benefits for the year at between £80-110m, with further benefits of £30m-60m to be delivered in 2018. Overall, we remain on track to achieve the committed fixed cost reduction of over £200m by the end of 2017.

Three: Rebuilding trust and confidence; further clarity on cash drivers and IFRS 15 transition

The first half of 2017 finished ahead of our expectations, helped by better than expected long-term contract accounting adjustments, and external expectations have remained largely unchanged for the year as a whole. While we have made some improvements to our forecasting and understanding of business drivers, more work needs to be done to increase resilience, and we are bringing more resource and expertise into this area.

Simon Kirby and Stephen Daintith, our new COO and CFO respectively, are further developing the work done on Key Performance Indicators, particularly around cost, working capital and cash drivers. As set out in our presentation today, these new KPIs will be progressively embedded into our external reporting to sharpen our focus and help demonstrate the value of wider financial and non-financial performance improvements.

As highlighted in 2016, the introduction of the new revenue reporting standard, IFRS 15 *Revenue from Contracts with Customers*, will have a significant impact on how we present our revenues and profits, particularly for Civil Aerospace. In November 2016, we provided a detailed representation of our 2015 financial results for Civil Aerospace and today are presenting a similar analysis for 2016. Building a good understanding of the year-on-year drivers of change in our financial results should help analysts and investors to make the transition when we formally change to the new standard from 1 January 2018. Full details of today's update are included as an appendix to this half year results statement and repeated in a separate disclosure on our investor relations website.

Four: Vision and shareholder value work on track for update by end 2017

Looking to the long term, we have committed to providing an update to our long-standing company vision. With key senior leadership changes completed, including new appointments such as our new Chief Technology Officer announced in April, and the consequential reorganisation of our engineering and technology functions, we can now accelerate the work we started to refresh our long-term goals as a business. Our objective remains to provide an update by the end of 2017.

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

In the first half of 2017, we announced that we had received approvals from the US and EU regulatory bodies for the acquisition of ITP. As a result, the only remaining approval needed is from the Spanish authorities. All other aspects of the transaction, including payment options, are unchanged from those set out in November 2016.

Agreement reached with investigating authorities in January 2017

In January 2017, we announced that we had reached agreement with investigating authorities in the UK, US and Brazil related to charges of bribery and corruption involving intermediaries in a number of overseas markets, concerns about which the company passed to the UK's Serious Fraud Office from 2012 onwards. This has involved entering into Deferred Prosecution Agreements (DPAs) in the UK and the US and a Leniency Agreement in Brazil. We have agreed to pay fines and costs totalling £671m, of which £267m was paid in the first half of 2017 with the Brazilian payment of around \$25m due in the second half of the year. Full details of the agreements can be found on our website, including copies of the statements made in January 2017.

Shareholder payments

Our dividend policy, as stated in February 2016, sets out how we intend to rebuild the payment to shareholders to an appropriate level, subject to the short-term cash needs of the business. We are continuing to invest in future growth, as we ramp up engine production and complete our important new product introductions over the next few years. At the same time, we need to sustain a healthy balance sheet to ensure we have the financial flexibility to maintain a strong investment grade credit rating. As a result, the proposed interim payment for 2017 is unchanged at 4.60 pence per share. As in past payments, the distribution will be in the form of C Shares. Further details are included on page 43 at the end of this statement.

Outlook for the balance of 2017

Our overall outlook for 2017 is unchanged from that set out in February 2017. While we have had an encouraging start, we have a great deal of work to do to deliver our overall expectations for the year. Key deliverables in the second half of the year include our Civil Aerospace delivery ramp up, new product introductions and managing installed fleet performance. While the outlook for Power Systems appears more positive, our Marine business remains challenged. As a result, we remain cautiously optimistic for the year as a whole.

Individual outlooks are provided for each business in the Operating Review.

Long-term outlook remains strong

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

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

Board update

During the first six months of the year there have been a number of changes to the Board. In April, Stephen Daintith joined the Board as our new Chief Financial Officer. In May, following our AGM, Colin Smith and John McAdam stepped down from the Board. In June, we announced the appointment of Beverly Goulet, an executive with 24 years of experience at American Airlines. She joined the Board with effect from 3 July 2017 and will be a member of the Nominations and Governance Committee and the Audit Committee.

Group Trading Summary

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

£m	H1 2016	Underlying Change	Acquisitions & disposals	Foreign Exchange*	H1 2017
Order book**	81,351	1,350	-	-	82,701
Underlying revenue	6,143	385	-	337	6,865
<i>Change</i>		+6%		+5%	+12%
Underlying OE revenue	3,018	149	-	181	3,348
<i>Change</i>		+5%		+6%	+11%
Underlying services revenue	3,125	236	-	156	3,517
<i>Change</i>		+8%		+5%	+13%
Underlying gross margin	1,033	133	-	86	1,252
<i>Gross margin %</i>	<i>16.8%</i>	<i>+100bps</i>			<i>18.2%</i>
Commercial and administrative costs	(538)	38	-	(31)	(531)
Restructuring	(6)	(1)	-	(1)	(8)
Research and development costs	(378)	(6)	-	(27)	(411)
Joint ventures and associates	47	(9)	-	5	43
Underlying profit before financing	158	155	-	32	345
<i>Change</i>		+98%		+20%	+118%
Underlying operating margin	2.6%	+220bps			5.0%

*Translational foreign exchange impact **2016 year end comparative, restated for a methodology change – see below

Order book and order intake

Overall, new orders marginally exceeded deliveries. As previously highlighted, we are now transitioning from a period of unprecedented above-trend order book growth in Civil Aerospace (roughly 90% of our order book backlog by value) to one of operational delivery. As a result, overall growth in our order book is expected to moderate from here as we deliver against this significant backlog. To an extent this is reflected in our first half order book which increased by £1.4bn to £82.7bn.

The opening order book has been restated by £1.5bn reflecting a methodology change in the rates used to translate order books – moving from long term planning rates to period spot rates - for overseas subsidiaries. The change in methodology will better reflect the economics of the order books for the subsidiaries affected.

Key Civil Aerospace orders included major wins with Singapore Airlines and Ethiopian Airlines. The Defence Aerospace order book benefited from a change in the foreign exchange rate used to translate the closing order book. Otherwise the defence order book would have been 3% lower, reflecting the steady delivery of new engines against prior year order commitments. Power Systems order book grew by 7%, led by good demand for various industrial and defence applications. Order intake in our Marine business was again soft, as a result of the continuing weak offshore market, but higher than the same period in 2016. Order intake in our Nuclear business was higher as a result of submarine programme activity.

Underlying trading

Underlying group revenue rose 6% in H1 2017 compared to 2016, reflecting growth in both original equipment revenue (up 5%) and services (up 8%), led by Civil Aerospace and Power Systems in particular. By business, Civil Aerospace revenue increased 14%, Defence Aerospace revenue was down 4%, Power Systems revenue increased 3%, Marine revenue decreased 15% and Nuclear revenue increased 8%.

Underlying profit before financing of £345m (2016: £158m) was 98% higher, led by significant improvements in Civil Aerospace and Power Systems which offset a weaker performance in Marine. The improved Civil Aerospace profit of £173m (2016: £31m) largely reflected good growth in aftermarket revenues and margins and a higher than expected benefit from long-term contract accounting adjustments,

including a one-off £77m benefit from a change to a customer credit risk assessment. The improved Defence Aerospace profit of £148m (2016: £128m) largely reflected lower overhead costs. Power Systems profit of £66m (2016: £13m) reflected improved volumes, mix and the benefits of transformation savings from their RRPS 2018 programme. Lower volumes contributed to the Marine loss of £(31)m (2016: £(13)m). Nuclear profit was £14m (2016: £18m) due to the previously announced increase in investment required to develop new products to help drive future growth.

Commercial and administrative costs of £531m were £38m lower reflecting the benefits of transformation initiatives and lower legal costs, following resolution of the long-standing review by investigating authorities in January 2017, although partially offset by rising costs, mainly due to inflation.

Underlying restructuring was £(8)m (2016: £(6)m). Charges relating to the transformation activity launched in November 2015 are treated as exceptional in light of the scale of the programme. An exceptional charge of £18m for this programme was taken in H1 2017 (2016: £53m). The in-period benefits of cost savings arising from this programme in H1 2017 were around £50m.

The R&D charge increased by £6m on a constant currency basis, reflecting an increase in spend offset by an increase in the level of capitalisation as several engine programmes approach entry into service.

Free cash flow

Cash capital expenditure in the first half of 2017 was £378m (2016: £307m), £71m higher than the prior year, largely reflecting phasing of payments for aerospace footprint and capacity investments. Cash taxes were £71m (2016: £62m). The cash cost of defined benefit pension schemes in excess of the operating profit charge was £12m (2016: £10m).

Overall, the free cash outflow for the first half year was £(339)m (2016: £(414¹)m outflow). This was better than expected, reflecting a steady operating performance supported by a higher level of working capital management, by around £180m, principally in receivables, which was the significant contributor to the year-on-year outperformance. Other than this, our cash flow performance was largely as expected and reflected the higher cash outflows related to increased engine production and higher capital investment, partially offset by the increased cash revenues driven by aftermarket growth.

The TotalCare net asset movement from 2016 year end was £119m. The TotalCare net asset is now £2.6bn, in line with the expected peak of around £2.5-2.7bn.

Net debt and foreign currency

The Group is committed to maintaining a robust balance sheet with a strong, 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+/stable outlook and Moody's reconfirmed its A3 rating but moved to a negative outlook in February 2017.

During H1 2017, the Group's net debt position increased from £712m to £931m, reflecting the £339m free cash outflow, £85m of shareholder payments and £267m paid to investigating authorities, as set out earlier in this statement.

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. Flexibility is built into some of 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 growing net US dollar income (currently around \$5bn per year) which is converted into GBP. Since the end of the year a modest amount of net additional hedging has been added to cover our future revenues. As a result the nominal value of the US dollar hedge book as at 30 June 2017 was \$39bn (end 2016: \$38bn). Consequently, the average rate in the hedge book reduced to £/\$1.54 (December 2016: £/\$1.55). Improvements in our achieved rate, as a result of the current weakness of GBP, are likely to benefit revenue and profit in the longer term. However, with a high level of cover for the

next few years built into our hedging arrangements, we do not expect there to be any meaningful benefit to our financial results for the next few years from improvements in our achieved hedge rate.

Group technical factors for 2017

All figures are at constant translational currencies unless otherwise stated.

Should **foreign exchange** rates for the full year remain unchanged from those seen recently, the movements from 2016 rates would improve full year underlying revenues by around £400m and improve underlying profit before tax by around £40m.

There is no change in our guidance on **finance charges**. Overall underlying finance charges in 2017 are expected to be in the region of £100-110m, partly reflecting the higher level of gross and net debt.

There is no change in our guidance on our **underlying effective tax rate**. Given the sensitivity of the underlying tax rate to a number of factors, including the impact of weak marine offshore markets, the underlying **effective tax rate** for 2017 is expected to be between 25-30%, reflecting the high proportion of taxable profit expected to be generated in higher tax rate regions.

We now expect our **capital expenditure** for the full year to be modestly higher and in the region of £700m, (2016: £626m) as we invest in additional aftermarket customer support and infrastructure.

Our expectation for **Net R&D spend** is unchanged and remains in the region of £950m in 2017, largely reflecting investment related to the completion of important new product launches in Civil Aerospace.

There is no change to our full year **free cash flow** guidance; to be similar to that achieved in 2016.

Footnotes from pages 1 to 10

#1 from page 4 and page 9: Re-stated to include a £(15)m exceptional restructuring cash outflow excluded at H1 2016 from free cash flow

Operational Review : Civil Aerospace

References to year-on-year change in the Operational Review are underlying and at constant translational currencies, unless otherwise stated.

£m	H1 2016	Underlying Change	Acquisitions & disposals	Foreign Exchange*	H1 2017
Order book**	72,008	1,271	–	45	73,324
Engine deliveries	312	(4)	–	–	308
Underlying revenue	3,171	432	–	73	3,676
<i>Change</i>		+14%		+2%	+16%
Underlying OE revenue	1,461	171	–	34	1,666
<i>Change</i>		+12%		+2%	+14%
Underlying services revenue	1,710	261	–	39	2,010
<i>Change</i>		+15%		+2%	+18%
Underlying gross margin	399	120	–	24	543
Gross margin %	12.6%	+180bps			14.8%
Commercial and administrative costs	(154)	5	–	(1)	(150)
Restructuring	(2)	(4)	–	–	(6)
Research and development costs	(250)	(3)	–	(10)	(263)
Joint ventures and associates	38	7	–	4	49
Underlying profit before financing	31	125	–	17	173
<i>Change</i>		+403%		+55%	+458%
Underlying operating margin	1.0%	+340bps			4.7%

*Translational foreign exchange impact **2016 year end comparative, restated for a methodology change – see page 8

Financial overview

Overall, **underlying revenue** for Civil Aerospace increased 14%. The 12% increase in original equipment (OE) revenue was underpinned by the ramp up in large engine deliveries which more than offset the continuing decline in business jet engines and V2500 module sales. Service revenues increased 15%, led by flying hour revenues from the growing in-production Trent engine fleet.

£m	H1 2016*	% of whole	Underlying change	Underlying Change %	Foreign exchange	% of whole	H1 2017
Original Equipment	1,461	46%	171	12%	34	45%	1,666
Large Engine: linked and other	657	21%	99	15%	1	20%	757
Large Engine: unlinked installed	312	10%	197	63%	1	14%	510
Business aviation	359	11%	(98)	-27%	32	8%	293
V2500	133	4%	(27)	-20%	–	3%	106
Service	1,710	54%	261	15%	39	55%	2,010
Large Engine	1,050	33%	179	17%	2	33%	1,231
Business aviation	212	7%	44	21%	21	8%	277
Regional	153	5%	1	1%	16	5%	170
V2500	295	9%	37	13%	–	9%	332

*2016 H1 figures have been restated to reflect refinements in allocations

Large engines: linked and other OE revenue was 15% higher reflecting increased sales of Trent 900s for Airbus A380s and Trent 700s for Airbus A330s partly offset by a lower level of Trent 1000 deliveries for the Boeing 787. Sales of spare engines to joint ventures in *large engine: linked and other* generated revenue of £20m (2016 H1: £36m).

The most significant revenue increase was within *large engine: unlinked installed* which was 63% higher, led by Trent XWB volume growth to support the Airbus A350 production ramp.

Large engine service revenue growth of 17% reflects 15% growth in flying hours from our in-production Trent engines together with a higher level of time and material business from mature engines, and a year-on-year improvement in contract accounting effects of £46m. Together, these more than offset the reduction in flying hour revenues from retirements and lower utilisation of older engines.

The expected decline in revenue for *business aviation* OE, largely from reduced BR710 engine sales, reflects the transition to non-Rolls-Royce powered platforms. Volumes of the newer BR725 engine, which powers the Gulfstream G650 and G650ER, remained stable. Overall OE revenues for business aviation reduced 27% whereas business aviation service revenues grew 21% through a combination of fleet growth, price escalation and new CorporateCare® business from engines already in service.

Service revenue from our *regional jet* engines remained stable. Whilst utilisation of Rolls-Royce powered regional aircraft held up better than our initial expectations, we continue to expect declining revenues from our regional fleet over the next few years as older aircraft retire.

Revenues from OE modules and engine assemblies for the V2500 programme declined by 20%, reflecting the production slow-down as Airbus continues to transition from the A320 classic to the A320neo. V2500 service revenues were 13% higher driven by an increase in spare part sales and higher repair and overhaul activity. Revenue from flying hour payments was broadly flat with price escalation offsetting the reduction in flying hours as older aircraft retire.

Overall **gross margins** for Civil Aerospace were 14.8% (2016: 12.6%). The main drivers of the year-on-year increase in margin were the growth in service revenues from in-production large engines, a higher level of 'time and material' service activity on mature engines and the year-on-year improvement in long-term contract accounting adjustments of £56m. These were partly offset by a reduction in business jet engine sales, reduced utilisation of Trent 500 and RB211 engines and £12m of provisions related to a specific customer contract. Gross margin from spare engine sales to joint ventures contributed £19m (2016: £22m), including realisation of profit deferred from sales in earlier periods.

In respect of long-term contract accounting adjustments, in the first half of 2017 these totalled a net gain of £33m. The net charge in 2016 of £(23)m included a £35m benefit from a 5 cent change to the estimated long-term US dollar to sterling exchange rate, which brought our own planning rate within updated external benchmark long-term forecast data.

The £33m net gain included a £40m benefit (2016: benefit of £35m) from life-cycle cost improvements, partially offset by technical costs of £(59)m (2016: £(55)m), the largest component of which was for additional maintenance activity on the Trent 1000, and a net £52m benefit (2016: a charge of £(38)m) from other operational changes which included a £77m benefit arising from a change to a customer credit rating risk assessment.

Since 2016, we have been undertaking a proactive maintenance programme on the Trent 1000 to address a number of technical issues. We will be working closely with our customers to ensure any disruption is minimised in so far as possible. A provision has been taken in respect of related costs and is included in the increased technical costs set out above and specific customer contract provision set out above.

Costs below gross margin were £5m lower than the previous year. Within this, R&D charges of £263m were £3m higher. This reflected an increase in the level of spend on several new programmes ahead of entry into service together with reduced development cost contributions from risk and revenue sharing partners. These were partially offset by increased R&D capitalisation on the Trent XWB-97.

Underlying commercial and administrative and other costs were £5m lower than 2016, with cost reduction benefits offsetting inflationary effects. Restructuring costs of £6m were £4m higher, and profits from joint ventures and associates were £7m higher, £11m higher at actual exchange rates.

Overall, **profit before financing and tax** was £125m higher, led by the growth in gross margins. Taking account of foreign exchange effects, underlying profit before financing and tax was £173m (2016: £31m).

TotalCare net assets and Contractual Aftermarket Rights

TotalCare net assets increased in H1 2017 by £119m at actual exchange rates (2016: £149m) to £2.6bn reflecting accounting for new “linked” engines of £265m (2016: £202m) and contract accounting adjustments taken in the year of £33m (2016: £(23)m), offset by net other items of £(179)m (2016: £(30)m).

The CARs balance increased by £113m (2016: increase of £71m) to £687m, largely reflecting higher sales of unlinked Trent XWB engines partly offset by further progress improving Trent XWB OE economics.

Investment and business development

Order intake in the first half of 2017 was £7.0bn (2016: £7.9bn including a £2.1bn uplift from the change in the long-term planning rate). As a result the closing order book was £73.3bn, up £1.3bn (up 2% from 2016 year-end), including inflation effects on historic orders where appropriate price escalation applies.

Significant orders during the first half included an order valued at \$1.5bn at list prices from Ethiopian Airlines, which included Trent XWB engines for 10 new Airbus A350 XWB aircraft as well as extending TotalCare coverage for 14 of the same aircraft already on order. Singapore Airlines selected Trent 1000 engines covered by TotalCare to power 19 Boeing 787 Dreamliner aircraft in a deal valued at \$1.7bn at list prices.

Investment in Civil Aerospace continues to target improvements in the three core areas of focus; engineering excellence, operational excellence and capturing aftermarket value:

Engineering excellence remains the cornerstone of our value to Civil Aerospace customers

In the first half of 2017, we delivered some important milestones in respect of our new product introductions. In March, we powered the first test flight of the Boeing 787-10 aircraft with its Trent 1000 TEN (Thrust, Efficiency and New Technology) engine. The new engine will power all variants of the Boeing 787 Dreamliner family and draws on technologies from the Trent XWB engine and the Advance engine programme.

In June, we despatched the Trent 7000 engines which will power the first test flight of the Airbus A330neo, to Toulouse. The engine brings together experience from the Trent 700, the engine of choice for the current A330, architecture from the Trent 1000 TEN, and technology from the Trent XWB, the world’s most efficient large engine flying today. The Trent XWB has now accumulated more than 500,000 engine flying hours in service and the 300th production engine has been delivered. The newest variant of the engine, the Trent XWB-97, continues to power Airbus A350-1000 flight tests and early testing is progressing well.

Looking further ahead, the Advance3 large engine demonstrator has completed assembly and is being prepared for its first run at our Derby facility. The demonstrator will test the new core architecture for future engine families and other key technologies such as Lean Burn combustion, Ceramic Matrix Composites, CastBond™ (specialist turbine manufacturing) and additive layer manufacturing or 3D printing.

At the same time, we continued to make progress with our UltraFan® engine design, with the power gearbox element of the programme starting its first power runs at its purpose-built facility in Dahlewitz, Germany in May.

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

In June, we announced that, as part of the ongoing planned expenditure, we will invest around £150m in new and existing aerospace facilities in the UK to support the doubling of engine production and deliver on a record Civil Aerospace order book. The majority of the investment will provide a new facility for the testing of large Civil Aerospace engines in Derby.

In the same month we officially opened a new assembly line at our Dahlewitz site in Germany for Trent XWB engines, complementing the main production line in Derby. The facility, which will be delivering up to two engines a week by the end of the year, will help Rolls-Royce meet the high demand for this engine.

Aftermarket development benefiting from enhanced service capabilities and new products

Delivering outstanding service remains at the heart of Rolls-Royce's customer proposition. At the core of this are the range of long-term service packages which started with TotalCare in the late 1990s. Over the last few years we have strengthened the range of services to match the maturing of our growing fleet of engines. As part of this process, in March we introduced the CareStore, a gateway to help customers better understand our range of digitally-enabled services and make informed decisions about which services best fit their needs.

In June, we opened a new Airline Aircraft Availability Centre which will use industry-leading data analytics to plan engine operations and maintenance. The centre complements the Rolls-Royce global network of Customer Service Centres, created to work locally with customers by providing in-depth expertise in the local market. We also announced that we were further expanding our global network of Authorised Service Centres (ASC) for business aviation aircraft under our CorporateCare service provision for customers. Rolls-Royce now has 72 ASCs in place with key maintenance providers worldwide, enabling CorporateCare customers to benefit from streamlined administration and reduced maintenance time.

In May, we celebrated the BR710 business jet engine achieving 10 million hours of service in flight.

Civil Aerospace outlook

On a constant currency basis, we continue to expect our Civil Aerospace business to deliver modest growth in revenue and profit in 2017, supported by large engine aftermarket growth, further life-cycle cost reductions and a higher level of R&D capitalisation. Higher costs related to increased maintenance activity in respect of the Trent 1000 are included in our estimates for the second half, but should temper any upgrades to full year profit following the good start to the year. Business jet demand is expected to weaken further, as will the demand for aftermarket services to support Rolls-Royce powered regional aircraft. We continue to expect trading cash flow to be broadly unchanged year-on-year, reflecting higher volumes of OE sales at prices below manufacturing cost offsetting the positive effects of higher aftermarket cash inflows.

Operational Review: Defence Aerospace

£m	H1 2016	Underlying change	Acquisitions & disposals	Foreign Exchange*	H1 2017
Order book**	4,545	(120)	–	(100)	4,325
Engine deliveries	291	(18)	–	–	273
Underlying revenue	1,002	(38)	–	84	1,048
<i>Change</i>		-4%		+8%	+5%
Underlying OE revenue	412	(17)	–	36	431
<i>Change</i>		-4%		+9%	+5%
Underlying services revenue	590	(21)	–	48	617
<i>Change</i>		-4%		+8%	+5%
Underlying gross margin	211	–	–	19	230
Gross margin %	21.1%	+80bps			21.9%
Commercial and administrative costs	(60)	9	–	(3)	(54)
Restructuring	(3)	2	–	–	(1)
Research and development costs	(29)	2	–	(3)	(30)
Joint ventures and associates	9	(6)	–	–	3
Underlying profit before financing	128	7	–	13	148
<i>Change</i>		+5%		+10%	+16%
Underlying operating margin	12.8%	+120bps			14.1%

*Translational foreign exchange impact **2016 year end comparative, restated for a methodology change – see page 8

Financial Overview

Underlying revenue of £1,048m was down 4% on a constant exchange rate basis (5% higher than the prior year at actual exchange rates). Original equipment sales were down 4%, principally due to lower EJ200 export sales following the completion of the Saudi Typhoon contract in 2016. Service revenues were also 4% lower than the prior year, mainly due to lower one-off revenue from some of our long-term service contracts, particularly as a consequence of the retirement of the UK MoD's Gnome-powered Sea King fleet in 2016. Lower revenue from spare part sales on some legacy programmes was offset by increased overhaul activity for LiftSystem™ and for EJ200 engines in service with the Royal Saudi Air Force.

Gross margin was unchanged on a constant exchange rate basis (up £19m at actual exchange rates) reflecting lower volumes partially offset by the non-repeat of £31m of one-off costs for the TP400 programme in 2016. Catch-up adjustments on existing long-term contracts reflected cost improvements totalling £16m, down £29m on the prior year due to the completion of contracts in 2016 and lower benefits from US contracts.

Overall R&D costs of £30m were similar to the prior year as the business continued to invest in future programme development, while restructuring costs were lower due to reduced level of severance costs. Underlying commercial and administrative costs and other costs were lower than prior year.

As a result, **profit before financing and tax** of £148m was 5% higher than the prior period.

Investment and business development

Order intake for H1 2017 was £928m (2016: £743m), with new orders principally for aftermarket contracts. During the first six months we won aftermarket contracts in the US worth around \$600m, including some major renewals with the US Department of Defence, supporting engine fleets powering C-130, V-22 and T-45 aircraft. Other contract wins included a legacy spares order from the Indian Air Force and smaller orders relating to other programmes. The Defence Aerospace order book closed at £4.3bn.

In respect of *engineering excellence*, led in Defence by product innovation, we saw very positive early operational performance of our T56 Series 3.5 technology insertion in the US NOAA P-3 fleet, and the kits continue to generate significant international interest for legacy P-3 and C-130 aircraft with orders expected in the second half of 2017. A new special operations version of the C-130J was launched in June at the Paris Air Show, alongside the debut of the new LM-100J civil variant of the aircraft.

In May, we announced a new joint venture agreement with Kale, the Turkish industrial conglomerate, to develop an engine solution for Turkey's TF-X combat programme, should they wish to pursue a new local option for engine provision.

Development work continued on the Anglo French Future Combat Air System programme and we announced a partnership with Purdue University in Indiana, which will help design and test components for our next generation engine component programmes.

The major upgrading of the Indianapolis facility, the core driver of *operational excellence* in Defence, passed another milestone with the first production cell, focused on turbines, coming on line. The overall programme remains on track and will deliver significant operational efficiencies and greater flexibility in our largest defence facility.

Aftermarket excellence initiatives have focused on deepening existing customer relationships with enhanced services. In the first half of the year, we opened a further two Service Delivery Centres (SDCs) at RAF Lossiemouth in Scotland and in Bangalore in India. We are preparing for further SDC facilities to be opened over the coming year as we expand our programme following a positive customer response to this approach. The LiftSystem continues to perform well on the F-35B Lightning II, with the aircraft making its first international operational deployment with the US Marine Corps to Japan.

In June, a significant service supply agreement was signed with Aviall, a Boeing Company, in relation to the distribution of engine spares for all defence variants of the global AE engine fleet. This multi-year agreement extends their offering to cover thousands of engines and is expected to significantly improve availability and logistics for our customers, enabling us to secure efficiencies and additional aftermarket demand.

Defence Aerospace outlook

The longer-term outlook remains stable, with margins and profits expected to soften modestly from the recent high levels, reflecting infrastructure and R&D investments to support long-term growth.

The outlook for 2017 is unchanged. While revenues are expected to be broadly unchanged overall, we expect full year profit to be lower than in 2016, reflecting the non-repeat of the significant level of long-term contract accounting benefits which occurred in the prior year.

Operational Review: Power Systems

£m	H1 2016	Underlying change	Acquisitions & disposals	Foreign Exchange*	H1 2017
Order book**	2,035	135	–	59	2,229
Underlying revenue	1,084	35	–	114	1,233
<i>Change</i>		+3%		+11%	+14%
Underlying OE revenue	711	33	–	76	820
<i>Change</i>		+5%		+11%	+15%
Underlying services revenue	373	2	–	38	413
<i>Change</i>		+1%		+10%	+11%
Underlying gross margin	254	36	–	29	319
Gross margin %	23.4%	+250bps			25.9%
Commercial and administrative costs	(158)	6	–	(16)	(168)
Restructuring	–	–	–	–	–
Research and development costs	(83)	7	–	(8)	(84)
Joint ventures and associates	–	(1)	–	–	(1)
Underlying profit before financing	13	48	–	5	66
<i>Change</i>		+369%		+38%	+408%
Underlying operating margin	1.2%	+430bps			5.4%

*Translational foreign exchange impact **2016 year end comparative, restated for a methodology change – see page 8

Financial overview

Underlying revenue of £1,233m increased 3% (14% at actual exchange rates). Original equipment growth of 5% reflected Chinese demand for PowerGen equipment and recovery in several industrial markets, including construction, agricultural and rail. Continued development of our REMAN (remanufacture) activities supported the 1% increase in service revenues. While some industrial and power generation markets improved, other markets were less buoyant, with government related activity lower year on year and marine offshore markets continuing to be impacted by low oil prices.

Overall, **gross margins** increased to 25.9% (2016: 23.4%) reflecting higher production volumes and better factory utilisation together with some improvements in customer and product mix.

Commercial & administrative costs were £6m lower, led by headcount reductions and other efficiency savings arising from the RRPS 2018 transformation programme which more than offset inflationary headwinds. R&D costs were £7m lower, reflecting the more efficient deployment of resources on future product development activity.

As a result, the improved trading performance was the most significant contributor to the increase in underlying **profit before financing and tax** to £66m (2016: £13m).

Investment and business development

Order intake of £1.4bn (2016: £1.2bn) was 6% higher than 2016 at constant foreign exchange, with the year-on-year increase reflecting several notable orders from governments for land and naval based equipment, higher demand from PowerGen customers in Asia and rising European orders for construction and agricultural products.

Product launches in the first half include a diesel genset (a self-contained combination of an engine and a generator) with increased output for emergency and prime power applications which is able to operate in hot climates. Demand for our recently launched propulsion systems which meet the latest emissions standards has also been strong.

Notable orders include ones from market leaders KATO and JCB as we entered the industrial excavator market with our MTU series 1000 engines. In addition a project agreement, also for MTU series 1000 - 1500 engines, was signed with agricultural machinery manufacturer Claas for the supply of 4,000 to 5,000 engines per annum, together with a follow up order for a US defence project and a large order for MTU series 4000 engines for a US data centre.

Turning to broader business developments, our Asian activities saw good progress with the official registration of the joint venture with Yuchai Machinery in advance of production of MTU series 4000 diesel engines under licence, planned for 2018 and targeting off-highway opportunities. An agreement was also signed with Garden Reach Shipbuilders & Engineers Ltd for final assembly in India of MTU series 4000 engines plus options for the local production of parts.

Within the services business, long term contracts were won for mining vehicles in Zambia and with Mediterranean ferry operator Virtu Ferries. In addition, leveraging the longstanding experience in Civil Aerospace, we have established a digital solutions unit which will focus on creating digital value adding services.

Our transformation programme is on track and is delivering results across all work streams, generating reductions in headcount, material costs and to our footprint. The changes we have made to our organisational structure together with lean processes implementation are facilitating better customer focus which is in turn helping to grow our revenues and achieve a more balanced profile across the year. We are also making good progress on our product portfolio simplification activity.

Power Systems outlook

The long-term outlook for Power Systems remains positive. Demand for its products looks set to grow steadily led by strong growth in key sectors where standalone power generation remains mission-critical. Together with new initiatives around product simplification and new market development, the businesses transformation programme will deliver progressive improvements

The outlook for 2017 remains cautiously positive, following a good first half which in part reflects efforts to rebalance profitability across the year. As a result, supported by a solid order book with good order coverage in several key longer cycle markets, albeit with limited visibility for our important service activity, we expect to achieve a second-half performance broadly consistent with the strong finish to 2016.

Operational Review: Marine

£m	H1 2016	Underlying change	Acquisitions & disposals	Foreign Exchange*	H1 2017
Order book**	988	(92)	–	(9)	887
Underlying revenue	548	(82)	–	58	524
<i>Change</i>		-15%		+11%	-4%
Underlying OE revenue	303	(67)	–	32	268
<i>Change</i>		-22%		+11%	-12%
Underlying services revenue	245	(15)	–	26	256
<i>Change</i>		-6%		+11%	+4%
Underlying gross margin	108	(25)	–	11	94
Gross margin %	19.7%	-190bps			17.9%
Commercial and administrative costs	(104)	12	–	(9)	(101)
Restructuring	(1)	2	–	(2)	(1)
Research and development costs	(16)	(6)	–	(1)	(23)
Underlying profit before financing	(13)	(17)	–	(1)	(31)
<i>Change</i>		-131%		-8%	-138%
Underlying operating margin	-2.4%	-410bps			-5.9%

*Translational foreign exchange impact **2016 year end comparative, restated for a methodology change – see page 8

Financial overview

Underlying revenue of £524m was 15% lower. Within this, original equipment revenues were down 22% and service revenues declined 6%. This was primarily due to the ongoing weakness within the offshore market, but also some softness in the merchant markets through over-capacity in cargo-carrying vessels. Within the weak overall revenues there were some highlights including delivery of several major orders secured in 2016, including the diesel gensets for the UK's new polar research ship, RRS Sir David Attenborough.

Gross margins decreased 190 basis points to just under 18% and overall gross margin was £94m, £25m lower than in 2016 on a constant exchange rate basis. While margins declined due to volumes, foreign exchange and product mix, the impact was partly offset by cost reduction programmes, particularly for OE, and the impact of the headcount reduction programme benefitting both trading margin and overheads.

R&D spend increased, mainly due to higher design spend on ship intelligence. Commercial and Administrative costs were over 12% lower at £101m.

As a result, the business reported an overall underlying **loss before financing and tax** of £(31)m, compared to a loss of £(13)m in 2016.

Investment and business development

The order book declined 9% during the first half of this year, despite an improved order intake compared to the first half of 2016. (2017: £449m v 2016: £362m). Offshore demand remained very weak, reflecting the impact of the continued low oil price and reduced investment by oil majors and their key suppliers. Service revenues were more stable, but remain at historically low levels.

Our Marine business did have some success in merchant opportunities outside of oil-related markets, including orders for equipment for ferries and fishing vessels. The Naval business secured a number of significant contract wins, including power, propulsion and handling systems for the US Coastguard's new fleet of offshore patrol cutters, and MT30 gas turbines for the Republic of Korea Navy. The start of sea trials by the Royal Navy's new aircraft carrier, HMS Queen Elizabeth was also a significant milestone for the business.

To help develop future products and capabilities, we have increased our investment in R&D to focus on reshaping the Marine product portfolio, as shipping shifts from mechanical to electrical and the adoption of digital technologies. Examples include the launch of a new Energy Management solution to drive down ship

operating costs, and the first power-by-the-hour contract for two cargo ships for Norlines. There was also further uptake of our Autocrossing system, which automatically controls vessel speed and optimises energy use.

Progress in our strategy for developing remote and autonomous ship operation included securing third-party funding to help develop a centre in Finland to focus on future land-based control centres, and establishing a Fleet Management Centre in Norway for remote optimisation of ship operation. A contract was also signed with global towage operator Svitzer to jointly test remote manoeuvring of commercial vessels, following a successful first demonstration.

Marine restructuring activities remain on track, including the programme of actions announced last December which target a further significant headcount reduction and £45-50m of annualised savings. As a result, by the end of 2017 we expect the overall Marine headcount to be down by around 30% compared to end 2014.

Other cost actions have included further simplifying the organisation, streamlining processes and operations across the value chain and the closure of the Shanghai factory. The investment in our Rauma facility is on track and will create a world-class assembly and test capability for propulsion products.

Marine outlook

We expect the outlook for our traditional offshore markets to remain challenging throughout 2017 and to only start to stabilise in 2018; we expect to benefit from a strong efficiency and internal cost focus when offshore markets eventually start to recover. The range of factors expected to influence future growth in marine markets include digitalisation, autonomy, electrification and increased focus on environmental and safety aspects amongst others. This is reflected in our strategy, ongoing transformation and investment focus.

In the near-term, with prevailing markets remaining weak our expectations for the second half of the year are more cautious. Transformation and restructuring savings should partially offset market challenges. As a result, we now expect the reported loss to be similar to the second half of 2016.

Operational Review: Nuclear

£m	H1 2016	Underlying change	Acquisitions & disposals	Foreign Exchange*	H1 2017
Order book**	1,825	172	–	5	2,002
Underlying revenue	356	27	–	8	391
<i>Change</i>		+8%		+2%	+10%
Underlying OE revenue	141	25	–	4	170
<i>Change</i>		+18%		+3%	+21%
Underlying services revenue	215	2	–	4	221
<i>Change</i>		+1%		+2%	+3%
Underlying gross margin	51	3	–	2	56
Gross margin %	14.3%	-20bps			14.3%
Commercial and administrative costs	(33)	3	–	(2)	(32)
Restructuring	–	–	–	–	–
Research and development costs	–	(10)	–	–	(10)
Underlying profit before financing	18	(4)	–	–	14
<i>Change</i>		-22%		–	-22%
Underlying operating margin	5.1%	-140bps			3.6%

*Translational foreign exchange impact **2016 year end comparative, restated for a methodology change – see page 8

Financial overview

Underlying revenue increased 8%, with solid performances across both submarine and civil nuclear activities. This reflected the phasing of activities on several long term contracts as well as improved trading across all civil nuclear businesses.

Gross margin was unchanged at 14.3%. Below gross margin there was no R&D credit in the first half (2016: £3m). In addition, led by investment in small modular reactors, the R&D charge was £10m higher than the prior year. These were partly offset by savings in commercial and administrative costs driven by transformation initiatives.

As a result, **underlying profit before financing** was £4m lower than the prior year, at £14m.

Investment and business developments

The order book remained relatively steady at £2.0bn, reflecting the nature of the nuclear business with the majority of the order book being the long term contracts under UK government procurement arrangements.

During the first half, submarine activities focused on performance improvement initiatives to support long-term contracts for the UK Royal Navy's nuclear submarine fleet, including delivery of the nuclear propulsion system to power the Astute class submarines. This included signing the contract for the 6th of 7 Astute boats.

We also made good progress in the de-fuelling programme at HMS Vulcan Naval Reactor Test Establishment. In addition, significant work was undertaken with our programme partners to agree a new delivery model for the new Dreadnought class deterrent submarines.

The civil nuclear business, which focuses on multi-year engineering projects and specialist technical services, saw steady growth. In the UK, we started early work on Hinkley Point C, for which we are the preferred bidder to deliver heat exchangers, waste treatment systems and emergency diesel generators.

Internationally, the Instrumentation and Controls business focused on delivery of long-term safety-critical retrofit contracts in France and Finland, as well as developing our access to new build markets. Progress in our global business development activities were reflected in three notable successes. In China we strengthened our collaboration both for the domestic and export market for Instrumentation and Controls. This included signing of a Letter of Intent to develop our instrumentation and controls business with CTEC (CGN) and securing orders within the current China build programme at Tianwan 5 and 6. In May, we made good progress developing our digital services business in North America, with the award of a contract to support Canada's largest nuclear utility operator, Bruce Power, with digital analytical tools designed to optimise the operational lifetime of nuclear plants. Finally, in June we were selected as preferred bidder for Instrumentation and Controls supply to a new Russian-designed reactor at Fennovoima's Hanhikivi nuclear power plant in Finland, due for completion in 2024.

We have continued to develop our small modular reactor R&D programme, working with potential partners on a whole-plant design. Market interest remains positive as large scale reactor programmes continue to suffer from ongoing investment and programme challenges. We remain of the firm belief that these smaller, more flexible units offer the potential for lower cost and more flexible power generation in future decades and directly build on the knowledge and specialist skills of our Nuclear business.

Nuclear outlook

The long-term outlook for Nuclear remains solid with a steady outlook for submarines, supported by the recent confirmation of the ongoing investment in the UK's Dreadnought class deterrent. Improving revenues will largely be driven by renewed activities in the civil market, particularly in the UK and China, which provide encouraging growth opportunities.

In the near-term, while revenues and gross margins are expected to be largely unchanged year-on-year, full year profit is expected to be roughly half that delivered in 2016, largely reflecting the increase in R&D spend.

Financial review

Underlying income statement

Six months to 30 June			
£m	2017	2016	Change
Revenue	6,865	6,143	+722
Gross profit	1,252	1,033	+219
Commercial and administrative costs	(531)	(538)	+7
Restructuring	(8)	(6)	-2
Research and development costs	(411)	(378)	-33
Share of results of joint ventures and associates	43	47	-4
Profit before financing	345	158	+187
Net financing	(58)	(54)	-4
Profit before tax	287	104	+183
Tax	(81)	(27)	-54
Profit for the period	206	77	+129
Earnings per share (EPS)	11.23p	4.20p	+7.03p
Payments to shareholders	4.60p	4.60p	–
Gross R&D investment	645	638	+7
Net R&D charge	411	378	+33

Segmental analysis

	Revenue			Gross profit			Profit before financing		
Six months to 30 June									
£m	2017	2016	Change	2017	2016	Change	2017	2016	Change
Civil	3,676	3,171	+505	543	399	+144	173	31	+142
Defence	1,048	1,002	+46	230	211	+19	148	128	+20
Power Systems	1,233	1,084	+149	319	254	+65	66	13	+53
Marine	524	548	-24	94	108	-14	(31)	(13)	-18
Nuclear	391	356	+35	56	51	+5	14	18	-4
Other	28	21	+7	7	12	-5	(2)	12	-14
Intra-segment	(35)	(39)	+4	3	(2)	+5	3	(2)	+5
Central costs							(26)	(29)	+3
Group	6,865	6,143	+722	1,252	1,033	+219	345	158	+187

Underlying revenue and **underlying profit before financing** are discussed in the Business Highlights (page 3), the Group Trading Summary (page 8) and the Operational Reviews (from page 11).

Underlying financing costs increased by £4m to £58m. Net interest payable reduced by £4m to £31m largely due to repayment of a bond in 2016 on which the Group was paying a higher than average rate of interest. Other underlying financing costs increased by £8m to £27m.

Underlying taxation was £81m, an underlying tax rate of 28.2% compared with 26.0% in 2016. The primary reason for the increase is the non-recognition of deferred tax assets on losses in Norway, reflecting the continued uncertainty in the oil & gas market.

Underlying EPS increased from 4.20p to 11.23p, in line with profit for the period.

Payments to shareholders are made in the form of C Shares, details of which are set out on page 43. An interim payment of 4.6p per share will be made.

Reported income statement

Six months to 30 June			
£m	2017	2016	Change
Revenue	7,566	6,462	+1,104
Gross profit	1,408	1,193	+215
Other operating income	4	2	+2
Commercial and administrative costs	(556)	(605)	+49
Research and development costs	(436)	(404)	-32
Share of results of joint ventures and associates	51	51	-
Operating profit	471	237	+234
Loss on disposal of businesses	-	(1)	+1
Profit before financing	471	236	+235
Net financing	1,470	(2,386)	+3,856
Profit/(loss) before tax	1,941	(2,150)	+4,091
Tax	(360)	378	-738
Profit/(loss) for the period	1,581	(1,772)	+3,353
Earnings/(losses) per share (EPS)	86.21p	(96.72)p	+182.93p

The changes in 2017 resulting from underlying trading are described in the previous sections.

Consistent with past practice and IFRS, the Group provides both reported and underlying figures. We believe underlying figures are more representative of the trading performance, by excluding the impact of period-end mark-to-market adjustments, principally the GBP:USD hedge book. In addition, post-retirement financing and the effects of acquisition accounting are excluded. The adjustments between the underlying income statement and the reported income statement are set out below and in more detail in note 2 to the Condensed Financial Statements. This basis of presentation has been applied consistently.

Reconciliation between underlying and reported results

Six months to 30 June	Revenue		Profit before financing		Financing		Profit before tax	
	2017	2016	2017	2016	2017	2016	2017	2016
Underlying	6,865	6,143	345	158	(58)	(54)	287	104
Revenue recognised at exchange rate on date of transaction	701	319	-	-	-	-	-	-
Mark-to-market adjustments on derivatives and related adjustments	-	-	223	207	1,526	(2,326)	1,749	(2,119)
Movements on other financial instruments	-	-	-	-	4	(8)	4	(8)
Effects of acquisition accounting	-	-	(62)	(62)	-	-	(62)	(62)
Exceptional restructuring	-	-	(31)	(68)	-	-	(31)	(68)
Acquisitions and disposals	-	-	-	(1)	-	-	-	(1)
Post-retirement schemes	-	-	-	-	(1)	3	(1)	3
Other	-	-	(4)	2	(1)	(1)	(5)	1
Reported	7,566	6,462	471	236	1,470	(2,386)	1,941	(2,150)

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 £701m (2016: £319m) and increased profit before financing by £223m (2016: £207m).

The effects of acquisition accounting £62m (2016: £62m), principally relating to the amortisation of intangible assets arising on the acquisition of Power Systems in 2013.

Exceptional restructuring costs of £31m (2016: £68m). These are costs associated with the substantial closure or exit of a site, facility or activity, largely as a result of the ongoing transformation programme.

Financing and taxation

The mark-to-market adjustments on the Group's hedge book of £1,526m (2016: £(2,326)m). These reflect: the large hedge book held by the Group (e.g. GBP:US\$39bn); and the strengthening of sterling against the US dollar. At each period end, our foreign exchange hedge book is included in the balance sheet at fair value (mark-to-market) and the movement in the period 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 £279m (2016: credit of £405m), largely as a result of the mark-to-market adjustments. This leads to an effective tax rate of 18.5% (2016: 17.6%).

Summary balance sheet

£m	30 June 2017	31 December 2016	Change
Intangible assets	5,269	5,080	+189
Property, plant and equipment	4,071	4,114	-43
Joint ventures and associates	850	844	+6
Net working capital ¹	(1,031)	(1,553)	+522
Net funds ²	(931)	(225)	-706
Provisions	(734)	(759)	+25
Net post-retirement scheme deficits	(121)	(29)	-92
Net financial assets and liabilities ²	(4,014)	(5,751)	+1,737
Other net assets and liabilities ³	(116)	143	-259
Net assets	3,243	1,864	+1,379
Other items			
US\$ hedge book (US\$bn)	39.2	37.8	+1.4
TotalCare assets	3,545	3,348	+197
TotalCare liabilities	(985)	(907)	-78
Net TotalCare assets	2,560	2,441	+119
Gross customer finance commitments	211	238	-27
Net customer finance commitments	60	61	-1

1 Net working capital includes inventories, trade and other receivables, trade and other payables and current tax assets and liabilities.

2 Net funds includes £302m (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.

Intangible assets (note 8) increased by £189m mainly due to additions of £375m (partially offset by amortisation charge of £208m). The additions primarily relate to £139m of contractual aftermarket rights, £84m of development expenditure and £79m of certification and participation fees.

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

Property, plant and equipment (note 9) decreased by £43m. Additions of £209m were offset by depreciation of £221m. Exchange differences were £(22)m.

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

Investments in joint ventures and associates increased by £6m.

Net post-retirement scheme deficits (note 11) have increased by £92m largely due to movements on discount rates in the period.

The UK plan comprises 85% of the gross liabilities and 95% of the gross assets and has a surplus of £1,229m. There was a £125m reduction in the surplus in H1 due to plan assets underperforming liabilities measured on an IAS19 basis (which discounts liabilities at a AA bond rate). 90% of pension assets are in low risk investments to match liabilities; this has been key to protecting our funding position in low yield environment.

The overseas plans comprise 15% of the gross liabilities and 5% of the gross assets. The deficit of £1,350m (IAS19 basis) is principally made up of unfunded US healthcare/pension plans (£534m) and German unfunded pension plans (£728m).

Provisions largely relate to warranties and guarantees provided to secure the sale of OE and services. The decrease of £25m includes additional charges of £139m, principally for warranty and guarantees and other provisions, offset by utilisation of £125m and unused amounts of £39m.

Net financial assets and liabilities relate to the fair value of foreign exchange, commodity and interest rate contracts and financial RRSAs, 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 financial liability of £3.8bn, a decrease of £1.8bn in the period, mainly a result of the strengthening of sterling.

The US\$ hedge book increased by 4% to US\$39.2bn. This represents around six years of net exposure and has an average book rate of £1 to US\$1.54.

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

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

The reduction in gross exposures is a result of guarantees expiring.

Summary funds flow statement

Six months to 30 June £m	2017	2016 ¹	Change
Underlying profit before tax	287	104	+183
Depreciation and amortisation	372	335	+37
Movement in net working capital	(110)	(255)	+145
Expenditure on property, plant and equipment and intangible assets	(753)	(539)	-214
Other	(52)	13	-65
Trading cash flow	(256)	(342)	+86
Contributions to defined benefit pensions in excess of operating cost	(12)	(10)	-2
Taxation paid	(71)	(62)	-9
Free cash flow	(339)	(414)	+75
Shareholder payments	(85)	(168)	+83
Increase in share of joint ventures	–	(154)	+154
Payments for financial penalties from agreements with investigating bodies	(267)	–	-267
Other acquisitions/disposals	5	7	-2
Foreign exchange	(20)	128	-148
Change in net funds	(706)	(601)	-105
Opening net funds	(225)	(111)	
Closing net funds	(931)	(712)	

¹ 2016 £(15)m exceptional restructuring expenditure has been re-presented to be included in free cash flow

Movement in working capital – the £110m decrease includes higher levels of inventory to support the progressive ramp up in Civil Aerospace's large engine production and higher Civil Aerospace long-term contract balances, offset by a higher level of working capital management, by around £180m, principally in receivables.

Expenditure on property, plant and equipment and intangibles – the increase largely reflects higher capital spend (£71m), IT and Marine intangibles (£88m) and contractual aftermarket rights (£50m).

Pensions – UK contributions were £90m (2016: £88m), including £15m financed by employees under salary sacrifice arrangements. A statutory funding valuation currently being conducted as at 31 March 2017 is expected to show material surplus. No deficit funding is anticipated and the new contribution schedule is expected to take effect from 2018. Overseas contributions were £40m (2016: £40m). Some modest increases in contributions to overseas schemes have been offset by changes in exchange rates.

Shareholder payments – the change in shareholder payments reflects the difference between the 2015 and 2016 interim payments, which are paid in the following January.

The derivation of the summary funds flow statement above from the reported cash flow statement is included in note 14.

Condensed consolidated financial statements

Condensed consolidated income statement

For the half-year ended 30 June 2017

	Notes	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Revenue	2	7,566	6,462	14,955
Cost of sales		(6,158)	(5,269)	(11,907)
Gross profit		1,408	1,193	3,048
Other operating income		4	2	5
Commercial and administrative costs ²		(556)	(605)	(2,208)
Research and development costs	3	(436)	(404)	(918)
Share of results of joint ventures and associates		51	51	117
Operating profit		471	237	44
Loss on disposal of businesses		–	(1)	(3)
Profit before financing and taxation		471	236	41
Financing income	4	1,570	36	96
Financing costs	4	(100)	(2,422)	(4,773)
Net financing		1,470	(2,386)	(4,677)
Profit/(loss) before taxation¹		1,941	(2,150)	(4,636)
Taxation	5	(360)	378	604
Profit/(loss) for the period		1,581	(1,772)	(4,032)
Attributable to:				
Ordinary shareholders		1,581	(1,772)	(4,032)
Non-controlling interests		–	–	–
Profit/(loss) for the period		1,581	(1,772)	(4,032)
Earnings/(losses) per ordinary share attributable to shareholders	6			
Basic		86.21p	(96.72)p	(220.08)p
Diluted		86.06p	(96.72)p	(220.08)p
Underlying earnings per ordinary share are shown in note 6.				
Payments to ordinary shareholders in respect of the period	7			
Pence per share		4.6p	4.6p	11.7p
Total		85	85	215
¹ Underlying profit before taxation	2	287	104	813

² In 2016 (full year), 'commercial and administrative costs' include £671m for financial penalties from agreements with investigating bodies.

All activities comprise continuing operations.

Condensed consolidated statement of comprehensive income

For the half-year ended 30 June 2017

	Notes	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Profit/(loss) for the period		1,581	(1,772)	(4,032)
Other comprehensive income (OCI)				
Items that will not be reclassified to profit or loss				
Movements in post-retirement schemes	11	(112)	346	495
Share of OCI of joint ventures and associates		(1)	(2)	(2)
Related tax movements		42	(123)	(179)
		(71)	221	314
Items that may be reclassified to profit or loss				
Foreign exchange translation differences on foreign operations		(59)	557	861
Share of OCI of joint ventures and associates		(3)	(6)	(7)
Related tax movements		1	3	4
		(61)	554	858
Total comprehensive income/(expense) for the period		1,449	(997)	(2,860)
Attributable to:				
Ordinary shareholders		1,449	(997)	(2,860)
Non-controlling interests		–	–	–
Total comprehensive income/(expense) for the period		1,449	(997)	(2,860)

Condensed consolidated balance sheet

At 30 June 2017

	Notes	30 June 2017 £m	30 June 2016 £m	31 December 2016 £m
ASSETS				
Intangible assets	8	5,269	4,990	5,080
Property, plant and equipment	9	4,071	3,718	4,114
Investments – joint ventures and associates		850	765	844
Investments – other		40	37	38
Other financial assets	10	413	351	382
Deferred tax assets		634	617	876
Post-retirement scheme surpluses	11	1,243	1,545	1,346
Non-current assets		12,520	12,023	12,680
Inventories		3,501	3,165	3,086
Trade and other receivables		7,241	7,145	6,956
Taxation recoverable		13	16	32
Other financial assets	10	15	45	5
Short-term investments		3	1	3
Cash and cash equivalents		2,336	2,287	2,771
Assets held for sale		3	5	5
Current assets		13,112	12,664	12,858
TOTAL ASSETS		25,632	24,687	25,538
LIABILITIES				
Borrowings		(170)	(120)	(172)
Other financial liabilities	10	(648)	(521)	(651)
Trade and other payables		(8,117)	(7,524)	(7,957)
Tax liabilities		(185)	(119)	(211)
Provisions for liabilities and charges		(407)	(408)	(543)
Current liabilities		(9,527)	(8,692)	(9,534)
Borrowings		(3,402)	(3,212)	(3,185)
Other financial liabilities	10	(3,492)	(3,497)	(5,129)
Trade and other payables		(3,484)	(2,807)	(3,459)
Tax liabilities		–	(1)	–
Deferred tax liabilities		(793)	(863)	(776)
Provisions for liabilities and charges		(327)	(369)	(216)
Post-retirement scheme deficits	11	(1,364)	(1,404)	(1,375)
Non-current liabilities		(12,862)	(12,153)	(14,140)
TOTAL LIABILITIES		(22,389)	(20,845)	(23,674)
NET ASSETS		3,243	3,842	1,864
EQUITY				
Called-up share capital		367	367	367
Share premium account		196	180	181
Capital redemption reserve		162	159	162
Cash flow hedging reserve		(110)	(105)	(107)
Other reserves		756	508	814
Retained earnings		1,870	2,731	445
Attributable to ordinary shareholders		3,241	3,840	1,862
Non-controlling interests		2	2	2
TOTAL EQUITY		3,243	3,842	1,864

Condensed consolidated cash flow statement

For the half-year ended 30 June 2017

	Notes	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Reconciliation of cash flows from operating activities				
Operating profit		471	237	44
Loss on disposal of property, plant and equipment		6	2	5
Share of results of joint ventures and associates		(51)	(51)	(117)
Dividends received from joint ventures and associates		28	14	74
Amortisation and loss on disposal of intangible assets	8	213	201	628
Depreciation of property, plant and equipment	9	221	196	426
(Decrease)/increase in provisions		(33)	86	44
Increase in inventories		(421)	(339)	(161)
(Increase)/decrease in trade and other receivables		(352)	(459)	54
(Payments)/accruals for financial penalties from agreements with investigating bodies		(267)	–	671
Increase in trade and other payables		780	514	234
Cash flows on other financial assets and liabilities		(341)	(139)	(608)
Net defined benefit post-retirement cost recognised in operating profit	11	118	118	510
Cash funding of defined benefit post-retirement schemes	11	(130)	(128)	(271)
Share-based payments		15	14	35
Net cash inflow from operating activities before taxation		257	266	1,568
Taxation paid		(71)	(62)	(157)
Net cash inflow from operating activities		186	204	1,411
Cash flows from investing activities				
Additions of intangible assets	8	(375)	(232)	(631)
Disposals of intangible assets		–	–	8
Purchases of property, plant and equipment	9	(381)	(307)	(585)
Government grants received		3	–	15
Disposals of property, plant and equipment		9	10	8
Acquisitions of businesses		–	–	(6)
Disposals of businesses		–	1	7
Increase in share in joint ventures		–	(154)	(154)
Other investments in joint ventures and associates		(8)	(11)	(30)
Cash and cash equivalents in joint ventures reclassified as joint operations		–	5	5
Net cash outflow from investing activities		(752)	(688)	(1,363)
Cash flows from financing activities				
Repayment of loans	10	(5)	(325)	(434)
Proceeds from increase in loans	10	280	–	93
Capital element of finance lease payments		(1)	–	(4)
Net cash flow from increase/(decrease) in borrowings		274	(325)	(345)
Interest received		3	7	14
Interest paid		(36)	(54)	(84)
Interest element of finance lease payments		–	(1)	(2)
Decrease/(increase) in short-term investments		–	1	(1)
Issue of ordinary shares		–	–	1
Other transactions in ordinary shares and cash received on share-based schemes vesting		20	–	–
Purchase of ordinary shares for share schemes		(22)	(20)	(21)
Redemption of C Shares		(85)	(168)	(301)
Net cash inflow/(outflow) from financing activities		154	(560)	(739)
Net decrease in cash and cash equivalents		(412)	(1,044)	(691)
Cash and cash equivalents at 1 January		2,771	3,176	3,176
Exchange (losses)/gains on cash and cash equivalents		(25)	155	286
Cash and cash equivalents at period end*		2,334	2,287	2,771

* The Group considers overdrafts (repayable on demand) to be an integral part of its cash management activities and these are included in cash and cash equivalents for the purposes of the cash flow statement

	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds			
Net decrease in cash and cash equivalents	(412)	(1,044)	(691)
Net cash flow from (increase)/decrease in borrowings	(274)	325	345
Net cash flow from (decrease)/increase in short-term investments	–	(1)	1
Change in net funds resulting from cash flows	(686)	(720)	(345)
Net funds joint ventures reclassified to joint operations	–	(9)	(9)
Exchange (losses)/gains on net funds	(20)	128	240
Fair value adjustments	56	(319)	(345)
Movement in net funds	(650)	(920)	(459)
Net funds at 1 January excluding the fair value of swaps	(583)	(124)	(124)
Net funds at period end excluding the fair value of swaps	(1,233)	(1,044)	(583)
Fair value of swaps hedging fixed rate borrowings	302	332	358
Net funds at period end	(931)	(712)	(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	Exchange differences £m	Fair value adjustments £m	Reclass- ifications £m	At 30 June 2017 £m
Cash at bank and in hand	872	(145)	(13)	–	–	714
Money market funds	552	(43)	(2)	–	–	507
Overdrafts	–	(2)	–	–	–	(2)
Short-term deposits	1,347	(222)	(10)	–	–	1,115
Cash and cash equivalents	2,771	(412)	(25)	–	–	2,334
Investments	3	–	–	–	–	3
Current borrowings (excluding overdrafts)	(169)	5	3	–	(4)	(165)
Non-current borrowings	(3,121)	(280)	(1)	56	4	(3,342)
Finance leases	(67)	1	3	–	–	(63)
Net funds excluding the fair value of swaps	(583)	(686)	(20)	56	–	(1,233)
Fair value of swaps hedging fixed rate borrowings	358	–	–	(56)	–	302
Net funds	(225)	(686)	(20)	–	–	(931)

Condensed consolidated statement of changes in equity

For the half-year ended 30 June 2017

	Attributable to ordinary shareholders								Total equity
	Share capital	Share premium	Capital redemption reserve	Cash flow hedging reserve	Other reserves ¹	Retained earnings ²	Total	Non-controlling interests	
	£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
Total comprehensive income for the period	–	–	–	(5)	559	(1,551)	(997)	–	(997)
Issue of C Shares	–	–	(171)	–	–	1	(170)	–	(170)
Redemption of C Shares	–	–	169	–	–	(169)	–	–	–
Ordinary shares purchased	–	–	–	–	–	(20)	(20)	–	(20)
Share-based payments – direct to equity ³	–	–	–	–	–	14	14	–	14
Related tax movements	–	–	–	–	–	(1)	(1)	–	(1)
Other changes in equity in the period	–	–	(2)	–	–	(175)	(177)	–	(177)
At June 30, 2016	367	180	159	(105)	508	2,731	3,840	2	3,842
Total comprehensive income for the period	–	–	–	(2)	306	(2,167)	(1,863)	–	(1,863)
Arising on issue of ordinary shares	–	1	–	–	–	–	1	–	1
Issue of C Shares	–	–	(130)	–	–	–	(130)	–	(130)
Redemption of C Shares	–	–	133	–	–	(133)	–	–	–
Ordinary shares purchased	–	–	–	–	–	(1)	(1)	–	(1)
Share-based payments – direct to equity ³	–	–	–	–	–	16	16	–	16
Related tax movements	–	–	–	–	–	(1)	(1)	–	(1)
Other changes in equity in the period	–	1	3	–	–	(119)	(115)	–	(115)
At 31 December 2016	367	181	162	(107)	814	445	1,862	2	1,864
Total comprehensive income for the period	–	–	–	(3)	(58)	1,510	1,449	–	1,449
Arising on issues of ordinary shares	–	15	–	–	–	(15)	–	–	–
Issue of C Shares	–	–	(85)	–	–	–	(85)	–	(85)
Redemption of C Shares	–	–	85	–	–	(85)	–	–	–
Ordinary shares purchased	–	–	–	–	–	(22)	(22)	–	(22)
Share-based payments – direct to equity ³	–	–	–	–	–	35	35	–	35
Related tax movements	–	–	–	–	–	2	2	–	2
Other changes in equity in the period	–	15	–	–	–	(85)	(70)	–	(70)
At 30 June 2017	367	196	162	(110)	756	1,870	3,241	2	3,243

¹ Other reserves include a merger reserve of £3m and a translation reserve of £753m.

² At 30 June 2017, 6,801,654 ordinary shares with a book value of £55m were held for the purposes of share-based payment plans and included in retained earnings. During the period, the Company acquired 2,771,349 ordinary shares through purchases on the London Stock Exchange for use in share-based payment plans. During the period, the Company issued 1,740,355 new ordinary shares to the Group's share trust for its employees share-based payment plans with a net book value of £15m.

³ Share-based payments- direct to equity includes the net of the credit to equity in respect of the share-based charge to the income statement and the actual cost of shares vesting in the period, and cash received on share-based schemes vesting.

1 Basis of preparation and accounting policies

Reporting entity

Rolls-Royce Holdings plc is a company domiciled in the UK. These condensed consolidated half-year financial statements of the Company as at and for the six months ended 30 June 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 (Annual Report 2016) are available upon request from the Company Secretary, Rolls-Royce Holdings plc, 62 Buckingham Gate, London SW1E 6AT.

Statement of compliance

These condensed consolidated half-year financial statements have been prepared in accordance with IAS 34 *Interim Financial Reporting* as adopted by the European Union. They do not include all of the information required for full annual statements, and should be read in conjunction with the 2016 Annual Report.

The comparative figures for the financial year 31 December 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 half-year financial statements on 31 July 2017.

Significant accounting policies

The accounting policies applied by the Group in these condensed consolidated half-year financial statements are the same as those that applied to the consolidated financial statements of the Group for the year ended 31 December 2016 (International Financial Reporting Standards issued by the International Accounting Standards Board (IASB), as adopted for use in the EU effective at 31 December 2016).

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

The results of the Group's analysis of the impact of IFRS 15 were described on page 130 of the Annual Report 2016 with the principal impacts being in the Civil Aerospace business. In summary:

- Revenues and costs relating to deliveries of engines will generally be recognised when OE is delivered. The revenue recognised in the Civil Aerospace business will comprise that included in the contract with the airframer reduced (if applicable) by any OE concession agreed with the operator (which IFRS 15 describes as a payment to "a customer's customer"). Consequently, the revenues and costs recognised on OE deliveries will more closely match the related cash flows. No contractual aftermarket revenue will be allocated to the OE delivery (where contracts are currently combined – 'linked accounting') and no intangible asset will be recognised (where contracts are not currently combined – 'unlinked accounting'). This will result in a loss being recognised on engine deliveries when the direct costs exceed the direct revenues.
- Revenues on LTSAs will be recognised as services are performed rather than as the equipment is used (engine flying hours) as is the case under the current accounting policy. The stage of completion will be measured using the actual costs incurred to date compared to the estimated costs to complete the performance obligation. In practice the bulk of the revenue and costs will relate to overhaul activity which occurs at distinct points of time during the period of the LTSA. As the first major overhaul typically occurs some years after delivery, this change will generally defer the recognition of revenue on LTSAs, as compared to the current accounting policy.

Taken together, had IFRS 15 been applicable with effect from 1 January 2015, the Group currently estimates the results for the years ended 31 December 2015 and 2016 would have been as follows:

Reported results	IAS 11 and IAS 18		IFRS 15	
	2016 £bn	2015* £bn	2016 £bn	2015* £bn
Revenue*	15.0	13.7	13.3	12.6
Gross profit	3.0	3.3	1.9	2.4
Profit/(loss) before financing and taxation	0.0	1.5	(1.1)	0.6
Net financing	(4.6)	(1.3)	(4.5)	(1.3)
Taxation	0.6	(0.1)	0.8	0.1
Profit/(loss) for the year	(4.0)	0.1	(4.8)	(0.6)
Net assets*	1.9	5.0	(2.1)	1.8

* Estimates of 2015 reported results under IFRS 15 have been amended to reflect latest information following our continued work during this year to design, implement and refine procedures to apply the new requirements of IFRS 15 and finalise accounting policy choices. Revenue in 2015 under IFRS 15 was previously estimated at £12.8bn with Net Assets of £2.0bn. There has been no material change in our estimate of profit for the year 2015 under the new standard.

Underlying results	IAS 11 and IAS 18		IFRS 15	
	2016 £bn	2015* £bn	2016 £bn	2015* £bn
Revenue				
Civil Aerospace original equipment	3.4	3.3	2.6	2.4
Civil Aerospace aftermarket services	3.7	3.7	3.2	3.5
Other	6.7	6.4	6.7	6.4
Total revenue	13.8	13.4	12.5	12.3
Gross profit				
Civil Aerospace	1.2	1.5	0.4	0.6
Other	1.6	1.7	1.6	1.7
Total gross profit	2.8	3.2	2.0	2.3
Profit before financing and taxation	0.9	1.5	0.1	0.6
Net financing	(0.1)	(0.1)	(0.1)	(0.1)
Taxation	(0.2)	(0.3)	(0.1)	(0.1)
Profit/(loss) for the year	0.6	1.1	(0.1)	0.4

* Estimates of 2015 underlying results under IFRS 15 have been amended to reflect latest information following our continued work during this year to design, implement and refine procedures to apply the new requirements of IFRS 15 and finalise accounting policy choices. Underlying revenue in 2015 under IFRS 15 was previously estimated at £12.5bn. There has been no material change in our estimate of profit for the year 2015 under the new standard.

In preparing the information above, the Group has elected to use the practical expedient not to adjust revenue for the effect of financing components where the expectation was that the period between the transfer of goods and services to customers and the receipt of payment was less than a year.

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

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

Key sources of estimation uncertainty

In applying the accounting policies, management has made appropriate estimates in many areas, and the actual outcome may differ from those calculated. The key sources of estimation uncertainty at the balance sheet date were the same as those that applied to the consolidated financial statements of the Group for the year ended 31 December 2016.

2 Analysis by business segment

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

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

The operating results are prepared on an underlying basis, which the Board considers reflects better the economic substance of the Group's trading during the year. The principles adopted to determine the underlying results are:

Underlying revenues – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these reflect the achieved exchange rates arising on settled derivative contracts.

Underlying profit before financing – Where transactions are denominated in a currency other than the functional currency of the Group undertaking, this reflects the transactions at the achieved exchange rates on settled derivative contracts. In addition, adjustments have been made to exclude one-off past-service costs on post-retirement schemes, exceptional restructuring, profits or losses on acquisitions and disposals and eliminating charges recognised as a result of recognising assets in acquired businesses at fair value.

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

- Include 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.
- Exclude 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 that arises from the above adjustments are also excluded.

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

	Civil £m	Defence £m	Power Systems £m	Marine £m	Nuclear £m	Inter- segment £m	Total reportable segments £m
For the half-year ended 30 June 2017							
Underlying revenue from original equipment	1,666	431	820	268	170	(17)	3,338
Underlying revenue from aftermarket services	2,010	617	413	256	221	(18)	3,499
Total underlying revenue	3,676	1,048	1,233	524	391	(35)	6,837
Gross profit	543	230	319	94	56	3	1,245
Commercial and administrative costs	(150)	(54)	(168)	(101)	(32)	–	(505)
Restructuring	(6)	(1)	–	(1)	–	–	(8)
Research and development costs	(263)	(30)	(84)	(23)	(10)	–	(410)
Share of results of joint ventures and associates	49	3	(1)	–	–	–	51
Underlying profit before financing and taxation	173	148	66	(31)	14	3	373
For the half-year ended 30 June 2016							
Underlying revenue from original equipment	1,461	412	711	303	141	(19)	3,009
Underlying revenue from aftermarket services	1,710	590	373	245	215	(20)	3,113
Total underlying revenue	3,171	1,002	1,084	548	356	(39)	6,122
Gross profit	399	211	254	108	51	(2)	1,021
Commercial and administrative costs	(154)	(60)	(158)	(104)	(33)	–	(509)
Restructuring	(2)	(3)	–	(1)	–	–	(6)
Research and development costs	(250)	(29)	(83)	(16)	–	–	(378)
Share of results of joint ventures and associates	38	9	–	–	–	–	47
Underlying profit before financing and taxation	31	128	13	(13)	18	(2)	175
For the year ended 31 December 2016							
Underlying revenue from original equipment	3,357	890	1,810	631	354	(37)	7,005
Underlying revenue from aftermarket services	3,710	1,319	845	483	423	(39)	6,741
Total underlying revenue	7,067	2,209	2,655	1,114	777	(76)	13,746
Gross profit	1,185	565	707	236	121	–	2,814
Commercial and administrative costs	(342)	(134)	(340)	(224)	(70)	–	(1,110)
Restructuring	(11)	9	–	2	–	–	–
Research and development costs	(568)	(71)	(177)	(41)	(6)	–	(863)
Share of results of joint ventures and associates	103	15	1	–	–	–	119
Underlying profit before financing and taxation	367	384	191	(27)	45	–	960

Reconciliation to reported results

	Total reportable segments £m	Other businesses* and corporate £m	Total underlying £m	Underlying adjustments £m	Reported results £m
For the half-year ended 30 June 2017					
Revenue from original equipment	3,338	10	3,348	252	3,600
Revenue from aftermarket services	3,499	18	3,517	449	3,966
Total revenue	6,837	28	6,865	701	7,566
Gross profit	1,245	7	1,252	156	1,408
Other operating income	–	–	–	4	4
Commercial and administrative costs	(505)	(26)	(531)	(25)	(556)
Restructuring	(8)	–	(8)	8	–
Research and development costs	(410)	(1)	(411)	(25)	(436)
Share of results of joint ventures and associates	51	(8)	43	8	51
Loss on disposal of businesses	–	–	–	–	–
Profit before financing and taxation	373	(28)	345	126	471
Net financing	–	(58)	(58)	1,528	1,470
Profit before taxation	–	(86)	287	1,654	1,941
Taxation	–	(81)	(81)	(279)	(360)
Profit for the period	373	(167)	206	1,375	1,581
Attributable to:					
Ordinary shareholders			206	1,375	1,581
Non-controlling interests			–	–	–
For the half-year ended 30 June 2016					
Revenue from original equipment	3,009	9	3,018	156	3,174
Revenue from aftermarket services	3,113	12	3,125	163	3,288
Total revenue	6,122	21	6,143	319	6,462
Gross profit	1,021	12	1,033	160	1,193
Other operating income	–	–	–	2	2
Commercial and administrative costs	(509)	(29)	(538)	(67)	(605)
Restructuring	(6)	–	(6)	6	–
Research and development costs	(378)	–	(378)	(26)	(404)
Share of results of joint ventures and associates	47	–	47	4	51
Loss on disposal of businesses	–	–	–	(1)	(1)
Profit before financing and taxation	175	(17)	158	78	236
Net financing	–	(54)	(54)	(2,332)	(2,386)
Profit before taxation	–	(71)	104	(2,254)	(2,150)
Taxation	–	(27)	(27)	405	378
Profit for the period	175	(98)	77	(1,849)	(1,772)
Attributable to:					
Ordinary shareholders			77	(1,849)	(1,772)
Non-controlling interests			–	–	–
For the year ended 31 December 2016					
Revenue from original equipment	7,005	22	7,027	561	7,588
Revenue from aftermarket services	6,741	15	6,756	611	7,367
Total revenue	13,746	37	13,783	1,172	14,955
Gross profit	2,814	9	2,823	225	3,048
Other operating income	–	–	–	5	5
Commercial and administrative costs	(1,110)	(53)	(1,163)	(1,045)	(2,208)
Research and development costs	(863)	1	(862)	(56)	(918)
Share of results of joint ventures and associates	119	(2)	117	–	117
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 before taxation	–	(147)	813	(5,449)	(4,636)
Taxation	–	(261)	(261)	865	604
Profit for the period	960	(408)	552	(4,584)	(4,032)
Attributable to:					
Ordinary shareholders			552	(4,584)	(4,032)
Non-controlling interests			–	–	–

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

	Total assets			Total liabilities			Net assets/(liabilities)		
	30 June 2017 £m	30 June 2016 £m	31 December 2016 £m	30 June 2017 £m	30 June 2016 £m	31 December 2016 £m	30 June 2017 £m	30 June 2016 £m	31 December 2016 £m
Civil	14,671	13,261	13,856	(11,706)	(11,671)	(14,510)	2,965	1,590	(654)
Defence	1,692	1,535	1,759	(2,508)	(1,643)	(1,996)	(816)	(108)	(237)
Power Systems	3,766	3,680	3,837	(1,271)	(1,084)	(1,151)	2,495	2,596	2,686
Marine	1,361	1,528	1,520	(1,092)	(816)	(903)	269	712	617
Nuclear	290	289	352	(591)	(304)	(435)	(301)	(15)	(83)
Inter-segment	(662)	(452)	(1,223)	662	435	1,223	–	(17)	–
Reportable segments	21,118	19,841	20,101	(16,506)	(15,083)	(17,772)	4,612	4,758	2,329
Other businesses	(17)	48	51	31	(43)	(183)	14	5	(132)
Net funds	2,641	2,620	3,132	(3,572)	(3,332)	(3,357)	(931)	(712)	(225)
Tax assets/(liabilities)	647	633	908	(978)	(983)	(987)	(331)	(350)	(79)
Post-retirement scheme surpluses/(deficits)	1,243	1,545	1,346	(1,364)	(1,404)	(1,375)	(121)	141	(29)
	25,632	24,687	25,538	(22,389)	(20,845)	(23,674)	3,243	3,842	1,864

Group employees at period end	30 June 2017	30 June 2016	31 December 2016
Civil	24,300	23,500	23,800
Defence	6,200	6,100	6,000
Power Systems	10,200	10,300	10,300
Marine	4,600	5,300	5,300
Nuclear	4,200	4,300	4,300
Other businesses and corporate	200	200	200
	49,700	49,700	49,900

Underlying revenue adjustments	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Underlying revenue	6,865	6,143	13,783
Recognise revenue at exchange rate on date of transaction	701	319	1,172
Revenue per consolidated income statement	7,566	6,462	14,955

Underlying profit adjustments	Half-year to 30 June 2017			Half-year to 30 June 2016			Year to 31 December 2016		
	Profit before financing £m	Net financing £m	Taxation £m	Profit before financing £m	Net financing £m	Taxation £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	345	(58)	(81)	158	(54)	(27)	915	(102)	(261)
Realised losses/(gains) on settled derivative contracts ¹	234	108	(57)	131	5	(25)	426	162	(107)
Net unrealised fair value changes to derivative contracts ²	8	1,391	(249)	4	(2,155)	377	–	(4,420)	792
Effect of currency on contract accounting	(15)	–	3	32	–	(6)	77	–	(14)
Revaluation of trading assets and liabilities	(4)	27	(3)	40	(176)	26	67	(313)	56
Financial RRSAs – exchange differences and changes in forecast payments	–	4	(1)	–	(8)	1	–	(8)	(1)
Effect of acquisition accounting	(62)	–	18	(62)	–	17	(115)	–	35
Impairment of goodwill	–	–	–	–	–	–	(219)	–	–
Pension restructuring	–	–	–	–	–	–	(306)	–	107
Net post-retirement scheme financing	–	(1)	–	–	3	(1)	–	3	(2)
Disposal of business	–	–	–	(1)	–	–	(3)	–	–
Exceptional restructuring ³	(31)	–	9	(68)	–	13	(129)	–	34
Financial penalties from agreements with investigating bodies	–	–	–	–	–	–	(671)	–	–
Other	(4)	(1)	1	2	(1)	3	(1)	1	(5)
Recognition of advance corporation tax	–	–	–	–	–	–	–	–	–
Reduction in rate of UK corporation tax	–	–	–	–	–	–	–	–	(30)
Total underlying adjustments	126	1,528	(279)	78	(2,332)	405	(874)	(4,575)	865
Reported per consolidated income statement	471	1,470	(360)	236	(2,386)	378	41	(4,677)	604

¹ The adjustments for realised losses/(gains) on settled derivative contracts include adjustments to reflect the losses/(gains) in the same period as the related trading cash flows.

² The adjustments for unrealised fair value changes to derivative contracts include those included in equity accounted joint ventures and exclude those for which the related trading contracts have been cancelled when the fair value changes are recognised immediately in underlying profit.

³ Restructuring is excluded from underlying performance when it concerns the closure of a significant business or site or a fundamental reorganisation of the business.

3 Research and development

	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Expenditure in the period	(465)	(433)	(937)
Capitalised as intangible assets	84	54	99
Amortisation and impairment of capitalised costs	(76)	(71)	(149)
Net cost	(457)	(450)	(987)
Entry fees received	40	59	73
Entry fees deferred in respect of charges in future periods	(30)	(27)	(40)
Recognition of previously deferred entry fees	11	14	36
Net cost recognised in the income statement	(436)	(404)	(918)
Underlying adjustments relating to the effects of acquisition accounting and foreign exchange	25	26	56
Net underlying cost recognised in the income statement	(411)	(378)	(862)

4 Net financing

	Half-year to 30 June 2017		Half-year to 30 June 2016		Year to 31 December 2016	
	Per consolidated income statement £m	Underlying financing £m	Per consolidated income statement £m	Underlying financing £m	Per consolidated income statement £m	Underlying financing £m
Financing income						
Interest receivable	5	5	7	7	14	14
Net fair value gains on foreign currency contracts	1,407	–	1	–	1	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	4	–	–	–	23	–
Net fair value gains on commodity contracts	–	–	6	–	16	–
Financing on post-retirement scheme surpluses	18	–	22	–	42	–
Net foreign exchange gains	136	–	–	–	–	–
	1,570	5	36	7	96	14
Financing costs						
Interest payable	(36)	(36)	(42)	(42)	(77)	(77)
Net fair value losses on foreign currency contracts	–	–	(2,162)	–	(4,437)	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	–	–	(8)	–	(31)	–
Financial charge relating to financial RRSAs	(2)	(2)	(2)	(2)	(6)	(6)
Net fair value losses on commodity contracts	(16)	–	–	–	–	–
Financing on post-retirement scheme deficits	(19)	–	(19)	–	(39)	–
Net foreign exchange losses	–	–	(171)	–	(145)	–
Other financing charges	(27)	(25)	(18)	(17)	(38)	(33)
	(100)	(63)	(2,422)	(61)	(4,773)	(116)
Net financing	1,470	(58)	(2,386)	(54)	(4,677)	(102)
Analysed as:						
Net interest payable	(31)	(31)	(35)	(35)	(63)	(63)
Net fair value gains /(losses) on derivative contracts	1,391	–	(2,155)	–	(4,420)	–
Net post-retirement scheme financing	(1)	–	3	–	3	–
Net other financing	111	(27)	(199)	(19)	(197)	(39)
Net financing	1,470	(58)	(2,386)	(54)	(4,677)	(102)

5 Taxation

The effective tax rate for the half year is 18.5% (2016 half-year 17.6%, full year 13.0%).

6 Earnings per ordinary share (EPS)

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

	Half-year to 30 June 2017 Potentially dilutive share options			Half-year to 30 June 2016 Potentially dilutive share options ¹			Year to 31 December 2016 Potentially dilutive share options ¹		
	Basic		Diluted	Basic		Diluted	Basic		Diluted
Profit/(loss) attributable to ordinary shareholders (£m)	1,581	–	1,581	(1,772)	–	(1,772)	(4,032)	–	(4,032)
Weighted average shares (millions)	1,834	3	1,837	1,832	9	1,841	1,832	–	1,832
EPS (pence)	86.21p	(0.15)p	86.06p	(96.72)p	–	(96.72)p	(220.08)p	–	(220.08)p

¹ As there is a loss on continuing operations, the effect of potentially dilutive ordinary shares is anti-dilutive.

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

	Half-year to 30 June 2017		Half-year to 30 June 2016		Year to 31 December 2016	
	Pence	£m	Pence	£m	Pence	£m
Underlying EPS / Underlying profit attributable to ordinary shareholders re-presented	11.23	206	4.20	77	30.13	552
Total underlying adjustments to profit before tax (note 2)	90.19	1,654	(123.03)	(2,254)	(297.43)	(5,449)
Related tax effects	(15.21)	(279)	22.11	405	47.22	865
EPS / Profit/(loss) attributable to ordinary shareholders	86.21	1,581	(96.72)	(1,772)	(220.08)	(4,032)
Diluted underlying EPS	11.21		4.18		30.08	

7 Payments to shareholders in respect of the period

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

	Half-year to 30 June 2017		Year to 31 December 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	130
	4.6	85	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	6	11	–	(2)	(1)	7	26
Additions	–	79	84	139	–	51	22	375
Disposals	–	–	–	–	–	(10)	–	(10)
At 30 June 2017	1,879	1,410	2,039	1,146	538	782	692	8,486
Accumulated amortisation:								
At 1 January 2017	337	440	888	433	209	414	294	3,015
Exchange differences	(7)	1	6	–	(1)	(1)	1	(1)
Charge for the period	–	31	76	26	25	36	14	208
Disposals	–	–	–	–	–	(5)	–	(5)
At 30 June 2017	330	472	970	459	233	444	309	3,217
Net book value at:								
30 June 2017	1,549	938	1,069	687	305	338	383	5,269
31 December 2016	1,537	885	1,056	574	331	328	369	5,080

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 full year 9-13%), based on the Group's weighted average cost of capital.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Company's control (discount rate, exchange rate and airframe delays), could result in impairment in future periods.

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	(6)	(28)	(3)	(5)	(42)
Additions	15	48	22	124	209
Reclassifications	23	117	18	(158)	–
Transferred to assets held for sale	(3)	–	–	–	(3)
Disposals	(4)	(53)	(2)	(2)	(61)
At 30 June 2017	1,692	4,683	526	724	7,625
Accumulated depreciation:					
At 1 January 2017	515	2,765	126	2	3,408
Exchange differences	(5)	(14)	(1)	–	(20)
Reclassifications	(3)	8	(5)	–	–
Charge for the period	29	175	17	–	221
Transferred to assets held for sale	(2)	–	–	–	(2)
Disposals	(1)	(50)	(2)	–	(53)
At 30 June 2017	533	2,884	135	2	3,554
Net book value at:					
30 June 2017	1,159	1,799	391	722	4,071
31 December 2016	1,152	1,834	365	763	4,114

10 Financial assets and liabilities

Other financial assets and liabilities comprise:

	Derivatives			Total £m	Financial RRSAs £m	Other £m	C Shares £m	Total £m
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts ¹ £m					
At 30 June 2017								
Non-current assets	104	1	308	413	–	–	–	413
Current assets	14	1	–	15	–	–	–	15
Current liabilities	(567)	(24)	–	(591)	(29)	–	(28)	(648)
Non-current liabilities	(3,369)	(39)	(6)	(3,414)	(64)	(14)	–	(3,492)
	(3,818)	(61)	302	(3,577)	(93)	(14)	(28)	(3,712)
At 30 June 2016								
Non-current assets	8	2	341	351	–	–	–	351
Current assets	44	1	–	45	–	–	–	45
Current liabilities	(443)	(30)	–	(473)	(17)	–	(31)	(521)
Non-current liabilities	(3,324)	(53)	(9)	(3,386)	(97)	(14)	–	(3,497)
	(3,715)	(80)	332	(3,463)	(114)	(14)	(31)	(3,622)
At 31 December 2016								
Non-current assets	13	5	364	382	–	–	–	382
Current assets	4	1	–	5	–	–	–	5
Current liabilities	(566)	(24)	–	(590)	(33)	–	(28)	(651)
Non-current liabilities	(5,002)	(38)	(6)	(5,046)	(68)	(15)	–	(5,129)
	(5,551)	(56)	358	(5,249)	(101)	(15)	(28)	(5,393)

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

Derivative financial instruments

	Half-year to 30 June 2017				Half-year to 30 June 2016	Year to 31 December 2016
	Foreign exchange £m	Commodity £m	Interest rate £m	Total £m	Total £m	Total £m
At January 1	(5,551)	(56)	358	(5,249)	(1,731)	(1,731)
Currency options at inception	–	–	–	–	(33)	(33)
Movements in fair value hedges	–	–	(56)	(56)	319	345
Movements in other derivative contracts	1,407	(16)	–	1,391	(2,155)	(4,420)
Contracts settled	326	11	–	337	137	590
At period end	(3,818)	(61)	302	(3,577)	(3,463)	(5,249)

Financial risk and revenue sharing arrangements (RRSAs) and other financial liabilities

	Financial RRSAs			Other		
	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
At January 1	(101)	(110)	(110)	(15)	–	–
Exchange adjustments included in OCI	2	4	5	–	–	–
Additions	–	–	–	–	(14)	(14)
Financing charge ¹	(2)	(2)	(6)	–	–	(1)
Changes to forecast payments	–	–	5	–	–	–
Exchange adjustments – excluded from underlying results ¹	4	(8)	(13)	1	–	(3)
Cash paid to partners	4	2	18	–	–	–
Other	–	–	–	–	–	3
At period end	(93)	(114)	(101)	(14)	(14)	(15)

¹ Included in net financing.

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

	Half-year to 30 June 2017		Half-year to 30 June 2016		Year to 31 December 2016	
	Book value £m	Fair value £m	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	(3,572)	(3,628)	(3,332)	(3,320)	(3,357)	(3,413)

Fair values

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

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

Borrowings

During the period, the Group has drawn down £280m on the EIB loan facility. There were no other significant changes in the Group's borrowings during the six months ended 30 June 2017.

11 Pensions and other post-retirement benefits

The net post-retirement scheme deficit as at 30 June 2017 is calculated on a year to date basis, using the latest valuation as at 31 December 2016, updated to 30 June 2017 for the principal schemes.

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	–	10	10
Current service cost	(93)	(28)	(121)
Past service credit/(cost)	3	–	3
Net financing	18	(19)	(1)
Contributions by employer	90	40	130
Actuarial gains /(losses) ¹	(125)	13	(112)
Other	–	(1)	(1)
At 30 June 2017	1,229	(1,350)	(121)
Analysed as:			
Post-retirement scheme surpluses - included in non-current assets	1,229	14	1,243
Post-retirement scheme deficits - included in non-current liabilities	–	(1,364)	(1,364)
	1,229	(1,350)	(121)

¹ The net actuarial losses in the UK arose principally due to changes in the yield curves used to value the assets and the liabilities.

12 Contingent liabilities

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

In January 2017, after full cooperation, the Company concluded deferred prosecution agreements with the SFO and the US Department of Justice and a leniency agreement with the MPF, the Brazilian federal prosecutors which are described on page 6. Prosecutions of individuals may follow and investigations may be commenced in other jurisdictions. In addition, we could still be affected by actions from customers and customers' financiers. The Directors are not currently aware of any matters that are likely to lead to a financial loss, but cannot anticipate all the possible actions that may be taken or their potential consequences.

In connection with the sale of its products the Group will, on some occasions, provide financing support for its customers - generally in respect of civil aircraft. The Group's commitments relating to these financing arrangements, which are spread over many years, relate to a number of customers and a broad product portfolio and are generally secured on the asset subject to the financing. These include commitments of US\$3.1bn (31 December 2016 \$3.2bn) to provide borrowing facilities to enable customers to purchase aircraft (of which approximately US\$239m could be called in 2017). These facilities may only be used if the customer is unable to obtain financing elsewhere and are priced at a premium to the market rate. Consequently, the directors do not consider that there is a significant exposure arising from the provision of these facilities.

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

	30 June 2017		31 December 2016	
	£m	\$m	£m	\$m
Gross contingent liabilities	211	274	238	293
Value of security ¹	(79)	(103)	(103)	(126)
Indemnities	(72)	(94)	(74)	(91)
Net commitments	60	77	61	76
Net commitments with security reduced by 20% ²	78	101	86	106
¹ Security includes unrestricted cash collateral of:	36	47	38	47

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

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

those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group.

On 11 July 2016, the Group announced that it will purchase the outstanding 53.1% shareholding in ITP owned by SENER Grupo de Ingeniería SA ("SENER"). This follows a decision by SENER to exercise its put option. On 28 November 2016, and following due diligence, the Group confirmed the valuation of €720m. Under the agreement, consideration will be settled over a two-year period following completion in eight evenly spaced instalments of equal value. The updated agreement allows flexibility to settle the consideration either in cash, in the form of Rolls-Royce shares or any mixture of the two, as preferred by Rolls-Royce. A decision as to whether each payment will be settled in cash, shares or cash and shares will be determined by Rolls-Royce during the payment period. Completion remains subject to regulatory clearances and is expected in 2017.

13 Related party transactions

Transactions with related parties are shown on page 164 of the 2016 Annual Report. Significant transactions in the current financial period are as follows:

	Half-year to 30 June 2017 £m	Half-year to 30 June 2016 £m	Year to 31 December 2016 £m
Sales of goods and services to joint ventures and associates	980	887	2,022
Purchases of goods and services from joint ventures and associates	(1,399)	(1,072)	(1,881)

Included in sales of goods and services to joint ventures and associates are sales of spare engines amounting to £24m (2016: half-year £39m, full-year £356m).

Profit recognised in the year on such sales amounted to £23m (2016: half-year £24m, full-year £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 £19m (2016: half-year £22m, full-year £97m).

14 Derivation of summary funds flow statement from reported cash flow statement

The table below shows the derivation of the summary funds flow statement (lines marked *) on page 24 from the consolidated cash flow statement on page 27.

	Half-year to 30 June 2017		Half-year to 30 June 2016		Year to 31 December 2016		
	£m	£m	£m	£m	£m	£m	Source
* Underlying profit before tax (PBT) - below		287		104		813	
Depreciation of property, plant and equipment	221		196		426		A
Amortisation of intangible assets	213		201		628		A
Impairment of goodwill	–		–		(219)		B
Acquisition accounting	(62)		(62)		(115)		B
* Depreciation and amortisation		372		335		720	
Increase in inventories	(421)		(339)		(161)		A
(Increase)/decrease in trade and other receivables	(357)		(465)		54		C
Increase in trade and other payables	780		514		234		C
Realised (losses)/gains on settled foreign exchange derivatives in financing	(108)		(5)		(162)		B
Revaluation of trading assets	(4)		40		67		B
* Movement on net working capital		(110)		(255)		32	
Additions of intangible assets	(375)		(232)		(631)		A
Purchases of property, plant and equipment	(381)		(307)		(585)		A
Government grants received	3		–		15		A
* Expenditure on property, plant and equipment and intangible assets		(753)		(539)		(1,201)	
Realised losses on hedging instruments	234		131		426		B
Net unrealised fair value to changes to derivatives	8		4		–		B
Foreign exchange on contract accounting	(15)		32		77		B
Exceptional restructuring	(31)		(68)		(129)		B
Other	(4)		2		(1)		B
Underlying financing	58		54		102		B
Loss on disposal of property, plant and equipment	6		2		5		A
Joint ventures	(23)		(37)		(43)		A
(Decrease)/increase in provisions	(33)		86		44		A
Cash flows on other financial assets and liabilities excluding realised (losses)/gains on settled foreign exchange derivatives in financing	(233)		(134)		(446)		A and B
Share based payments	19		14		35		A
Disposal of intangible assets	–		–		8		A
Disposal of property, plant and equipment	9		10		8		A
Investments in joint ventures and associates	(8)		(11)		(30)		A
Net interest	(33)		(48)		(72)		A
Net funds of joint ventures reclassified to joint operations	–		(4)		(4)		A
Issue of ordinary shares	–		–		1		A
Purchase of ordinary shares for share schemes	(6)		(20)		(21)		A
* Other		(52)		13		(40)	
* Trading cash flow		(256)		(342)		324	
Net defined benefit plans – underlying operating charge	118		118		204		A
Cash funding of defined benefit plans	(130)		(128)		(271)		A
* Contributions to defined benefit schemes in excess of underlying PBT charge		(12)		(10)		(67)	
* Tax		(71)		(62)		(157)	A
* Free cash flow		(339)		(414)		100	
* Shareholder payments		(85)		(168)		(301)	A
* Increase in share in joint ventures		–		(154)		(154)	A
* Payments of financial penalties from agreements with investigating bodies		(267)		–		–	A
* Other acquisitions and disposals		5		7		1	A
* Foreign exchange		(20)		128		240	A
* Change in net debt		(706)		(601)		(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.

	Half-year to 30 June 2017		Half-year to 30 June 2016		Year to 31 December 2016		
	£m	£m	£m	£m	£m	£m	Source
Reported operating profit		471		237		44	
Realised losses on hedging instruments	(234)		(131)		(426)		B
Net unrealised fair value to changes to derivatives	(8)		(4)		–		B
Foreign exchange on contract accounting	15		(32)		(77)		B
Revaluation of trading assets and liabilities	4		(40)		(67)		B
Effect of acquisition accounting	62		62		115		B
UK pension restructuring	–		–		306		B
Impairment of goodwill	–		–		219		B
Exceptional restructuring	31		68		129		B
Financial penalties from agreements with investigating bodies	–		–		671		B
Other	4		(2)		1		B
Adjustments to reported operating profit		(126)		(79)		871	
Underlying profit before financing		345		158		915	
Underlying financing		(58)		(54)		(102)	B
Underlying profit before tax		287		104		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 27.

	Half-year to 30 June 2017		Half-year to 30 June 2016		Year to 31 December 2016		
	£m	£m	£m	£m	£m	£m	Source
Change in cash and cash equivalents		(412)		(1,044)		(691)	A
Returns to shareholders		85		168		301	A
Net cash flow from changes in borrowings and finance leases		(274)		325		345	A
Increase/decrease in short-term investments		–		(1)		1	A
Increase in share in joint ventures	–		154		154		A
Debt of joint ventures reclassified as joint operations	–		(9)		(9)		A
Acquisition of businesses	–		–		6		A
Disposal of other businesses	(5)		(7)		(7)		C
Changes in group structure		(5)		138		144	
Payments of financial penalties from agreements with investigating bodies		267		–		–	A
Free cash flow		(339)		(414)		100	

Sources:

- A Cash flow statement
- B Note 2 - underlying profit adjustments
- C Cash flow statement adjusted for non-underlying items including exchange differences

Principal risks and uncertainties

Whilst the Group has a consistent strategy and long performance cycles, it continues to be exposed to a number of risks and has an established, structured approach to identifying, assessing and managing those risks.

The principal risks facing the Group for the remaining six months of the financial year are unchanged from those reported on pages 50 and 52 of the Annual Report 2016, as set out below:

Disruptive technologies and business models

Disruptive technologies, new entrants with alternative business models or disruptions to key markets or customers could reduce our ability to win sustainable future business, achieve operating results and realise future growth opportunities.

Product failure

Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.

Business continuity

Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, financial insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results.

IT vulnerability

Breach of IT security causing controlled or critical data to be lost, made inaccessible, corrupted or accessed by unauthorised users.

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.

Political risk

Geopolitical factors that lead to an unfavourable business climate and significant tensions between major trading parties or blocs which could impact the Group's operations. For example: explicit trade protectionism, differing tax or regulatory regimes, potential for conflict; or broader political issues.

Major programme delivery

Failure to deliver a major programme on time, within budget, to specification, or technical performance falling significantly short of customer expectations, or not delivering the planned business benefits, would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation.

Compliance

Non-compliance by the Group with legislation or other regulatory requirements in the heavily regulated environments 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.

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. oil price, exchange rates) and some of which are more specific to the Group (e.g. liquidity and credit risks, credit rating, profitability post IFRS 15, reduction in air travel or disruption to other customer operations). Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness.

This would affect operational results or the outcomes of financial transactions.

Talent and capability

Inability to attract and retain the critical capabilities and skills needed in sufficient numbers and to effectively organise, deploy and incentivise our people to deliver our strategy, business plan and projects.

Going concern

After making enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. There have been no significant changes to the basis described on page 53 of the Annual Report 2016. For this reason they continue to adopt the going concern basis in preparing the consolidated financial statements.

Payments to shareholders

The Company makes payments to shareholders by allotting non-cumulative redeemable preference shares of 0.1 pence each (C Shares). Shareholders can opt to redeem the C Shares for a cash payment, or reinvest the cash proceeds by purchasing additional ordinary shares via the C Share Reinvestment Plan (CRIP), which is operated by our Registrar, Computershare Investor Services PLC. On 3 January 2018, 46 C Shares, with a total nominal value of 4.6p, will be allotted for each ordinary share to those shareholders on the register on 27 October 2017. The final day of trading with entitlement to C Shares is 26 October 2017. Shareholders wishing to redeem their C Shares, or participate in the CRIP, must lodge instructions with our Registrar to arrive no later than 5.00 pm on 1 December 2017 (CREST holders must submit their election in CREST by 3pm GMT). The payment of C Shares redemption monies will be made on 5 January 2018 and the CRIP purchase will begin as soon as practicable after 5 January 2018.

Statement of directors' responsibilities

The directors confirm that, to the best of their knowledge:

- the condensed consolidated half-year financial statements have been prepared in accordance with IAS 34 *Interim Financial Reporting* as adopted by the EU;
- the interim management report includes a fair review of the information required by:
 - (a) DTR 4.2.7R of the *Disclosure and Transparency Rules*, being an indication of important events that have occurred during the first six months of the financial year and their impact on the condensed consolidated half-year financial statements; and a description of the principal risks and uncertainties for the remaining six months of the year; and
 - (b) DTR 4.2.8R of the *Disclosure and Transparency Rules*, being related party transactions that have taken place in the first six months of the current financial year and that have materially affected the financial position or performance of the entity during that period; and any changes in the related party transactions described in the last Annual Report that could do so.

The directors of Rolls-Royce Holdings plc at 13 February 2017 are listed in its Annual Report 2016 on pages 54 to 57. Since that date, the following changes have taken place:

- Colin Smith and John McAdam retired as directors at the conclusion of the AGM on 4 May 2017; and
- Stephen Daintith was appointed as Chief Financial Officer on 7 April 2017 and Beverly Goulet was appointed as a non-executive director on 3 July 2017.

By order of the Board

Warren East
Chief Executive
31 July 2017

Stephen Daintith
Chief Financial Officer
31 July 2017

Independent review report to Rolls-Royce Holdings plc

Conclusion

We have been engaged by the company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2017 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated balance sheet, the condensed consolidated cash flow statement, the condensed consolidated statement of changes in equity and the related explanatory notes.

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2017 is not prepared, in all material respects, in accordance with IAS 34 Interim Financial Reporting as adopted by the EU and the Disclosure Guidance and Transparency Rules ("the DTR") of the UK's Financial Conduct Authority ("the UK FCA").

Scope of review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity issued by the Auditing Practices Board for use in the UK. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. We read the other information contained in the half-yearly financial report and consider whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Directors' responsibilities

The half-yearly financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-yearly financial report in accordance with the DTR of the UK FCA.

As disclosed in note 1, the annual financial statements of the group are prepared in accordance with International Financial Reporting Standards as adopted by the EU. The directors are responsible for preparing the condensed set of financial statements included in the half-yearly financial report in accordance with IAS 34 as adopted by the EU.

Our responsibility

Our responsibility is to express to the company a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review.

The purpose of our review work and to whom we owe our responsibilities

This report is made solely to the company in accordance with the terms of our engagement to assist the company in meeting the requirements of the DTR of the UK FCA. Our review has been undertaken so that we might state to the company those matters we are required to state to it in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company for our review work, for this report, or for the conclusions we have reached.

Jimmy Daboo
for and on behalf of KPMG LLP
Chartered Accountants
15 Canada Square
London E14 5GL
31 July 2017

IFRS 15 Revenue from Contracts with Customers

Restatement of 2016

During the first half of 2017 Rolls-Royce has continued to refine policies on the detailed interpretation of the application of IFRS 15. Alongside today's trading statement, we are publishing an update on IFRS 15 *Revenue from Contracts with Customers* which evaluates its application to our 2016 results. This follows on from the work presented at the Capital Market Day in November 2016, where using 2015 as an example, the company evaluated how the standard would have changed underlying revenue and profit for Civil Aerospace if it had been applied to that year.

The following IFRS 15 principles and consequences have previously been highlighted:

- Cumulative profit and cash flow recognised over the life cycle of a product is not changed by the new standard
- No change to in-year cash flow
- There are significant changes to the timing of revenue and profit recognition:
 - Original Equipment: changed to more closely reflect the cash received on original equipment sales
 - Aftermarket: changed to match the timing of actual work done to provide aftermarket services, irrespective of the commercial value of implicit activities (this new aftermarket approach is known as the 'input' method)

For 2016 underlying results, IFRS 15 changes result in adverse estimated adjustments to Civil Aerospace revenues of £0.8bn for original equipment (OE) sales and £0.5bn for aftermarket services (AM). For operating profit the impact is £0.6bn and £0.2bn for OE and AM respectively.

- Drivers of change in revenue and profit are largely led by:
 - Elimination of linked profit on OE accounting
 - Removal of the 'capitalisation' of linked and unlinked engine losses and adjustments in both OE and AM accounting for the related 'depreciation'
 - Reduction in the magnitude of beneficial long-term contract accounting adjustments
 - When applied to CorporateCare® service packages in business aviation, the input method required by the new standard also has an adverse effect on the timing of AM revenue and profit recognition (included in the above estimated adjustments)
- From a balance sheet perspective, if IFRS 15 had been applied to the 2016 closing Civil Aerospace TotalCare® net asset and Contractual Aftermarket Rights balances then approximately £3.9bn of transition adjustments (post tax) would have been applied to reduce shareholder reserves.
- The analysis previously published for 2015 has been reviewed in light of the refinements undertaken for the 2016 exercise. There were no material changes to the 2015 revenue or profit analysis but the 2015 post-tax balance sheet adjustment would have been £0.2bn higher than the £3.0bn referenced in the 2016 Annual Report.

The new standard will be adopted from January 2018. When 2017 full year results are presented in March 2018, the intention is for them to be prepared and reported under existing standards as well as on an IFRS 15 basis.

A more detailed analysis of the 2016 figures are included as an appendix to the H12017 slideshow and available through the investor relations tab on the Rolls-Royce website.