**Annual Report** 2008

# Leveraging global capability

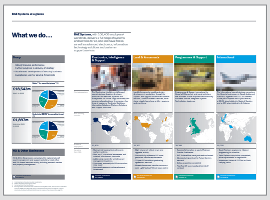
BAE SYSTEMS

REAL PERFORMANCE. REAL ADVANTAGE.

# Contents

# About this report…

See overleaf for an overview of our business today



# What we do…

**BAE Systems,** with 106,400 employees[1] worldwide, delivers a full range of systems and services for air, land and naval forces, as well as advanced electronics, information technology solutions and customer support services.

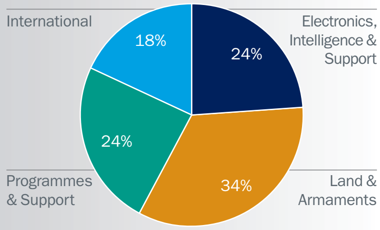
## Group

– Strong financial performance
– Further progress in delivery of strategy
– Accelerated development of security business
– Exceptional year for Land & Armaments

**Sales[1,2] by operating group[3]** (%)

**£18,543m**

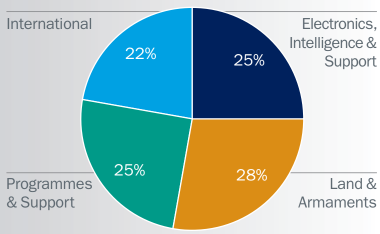
Sales[1] for 2008




**Underlying EBITA[4] by operating group[3]** (%)

**£1,897m**

Underlying EBITA[4] for 2008




## HQ & Other Businesses

HQ & Other Businesses comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

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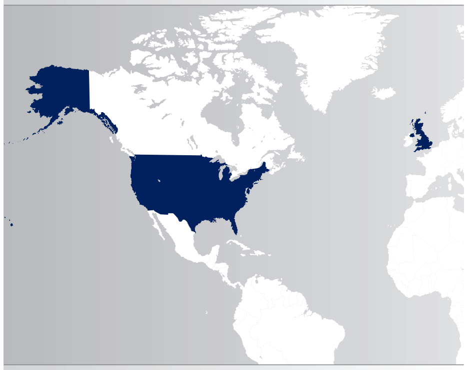
## Electronics, Intelligence & Support

Principal operations

The Electronics, Intelligence & Support operating group designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications. It comprises four lines of business: Electronic Solutions, Information Solutions, Platform Solutions and Support Solutions.

Main operating locations



Number of employees[1,3]

33,900

Key points from 2008

– Maintained leadership in electronic warfare systems
– Won key IT, situational awareness and aviation sustainment contracts
– Addressing market for vehicle power management systems
– Sustained leadership in US non-nuclear ship repair
– Increased research and development investment

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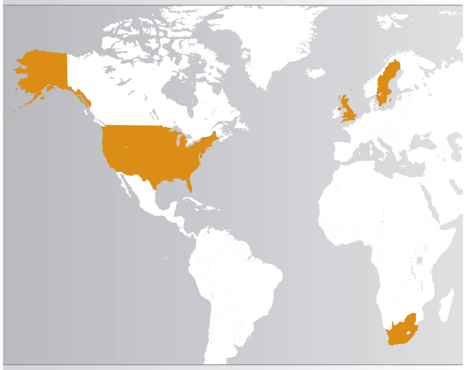
1 Including share of equity accounted investments.
2 Before elimination of intra-group sales.
3 Excluding HQ & Other Businesses.
4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.

## Land & Armaments

Land & Armaments provides design, development, production, through-life support and upgrade of armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems and munitions.



21,300

- High volume of vehicle reset and upgrade activity
- Successfully addressed US mine protected vehicle requirements
- 15-year UK munitions partnering agreement secured
- Wheeled armoured vehicle successes
- Joint Light Tactical Vehicle down select

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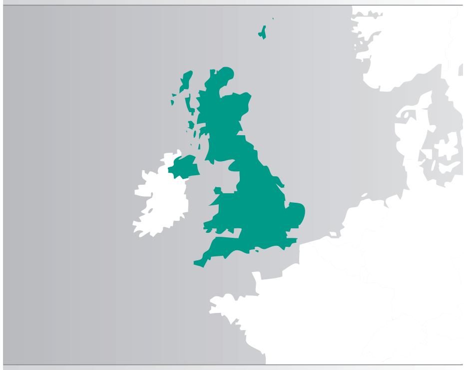
## Programmes & Support

Programmes & Support comprises the Group's UK-based air and naval activities, the activities of the acquired Detica security business and the Integrated System Technologies business.



30,200

- Successful transition to start of Typhoon Tranche 2 deliveries
- BVT Surface Fleet naval joint venture formed
- Manufacturing contract for Future Carriers secured
- Detica acquisition completed
- First Type 45 successfully delivered off contract

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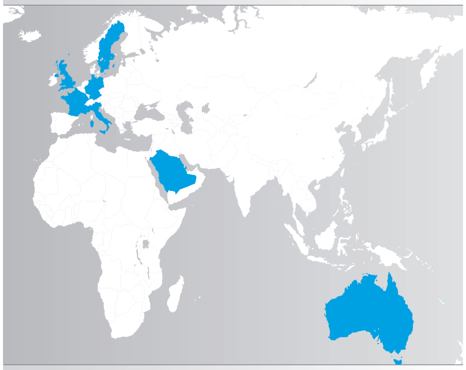
## International

The International operating group comprises the Group's businesses in Saudi Arabia and Australia, together with a 37.5% interest in the pan-European MBDA joint venture, a 20.5% shareholding in Saab of Sweden and a 49% shareholding in Air Astana.



19,200

- Saudi Typhoon programme (Salam) progressing to schedule
- Tenix Defence acquisition completed; price adjustments in negotiation
- Impairment taken of £120m on Saab carrying value

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## Results in brief, highlights and outlook

# Our 2008 performance

**£18,543m** +18%

Sales[1]

**37.1p** +23%

Underlying earnings[3] per share

### Results in brief

| Results from continuing operations | 2008 | 2007 |
|---|---|---|
| Sales[1] | **£18,543m** | £15,710m |
| Underlying EBITA[2] (restated) | **£1,897m** | £1,449m |
| Operating profit | **£1,718m** | £1,177m |
| Underlying earnings[3] per share (restated) | **37.1p** | 30.1p |
| Basic earnings per share[4] | **49.6p** | 26.0p |
| Order book[5] | **£46.5bn** | £38.6bn |
| Other results including discontinued operations | | |
| Dividend per share | **14.5p** | 12.8p |
| Cash inflow from operating activities | **£2,009m** | £2,162m |
| Net cash as defined by the Group[6] | **£39m** | £700m |

### Highlights

– Strong financial performance
– Further progress in delivery of strategy
– Accelerated development of security business
– Exceptional year for Land & Armaments

### Outlook

A feature of our business is the good visibility provided by our strong order book.

A further year of good growth is anticipated in 2009, despite a lower level of land vehicle sales than in 2008.

In addition, the Group's trading results would be expected to benefit from a continued weakness of sterling against the US dollar.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories (see note 10 to the Group accounts). Restated to exclude profit/(loss) on disposal of businesses. See page 29.
4 Basic earnings per share in accordance with International Accounting Standard 33.
5 Including share of equity accounted investments' order books and after the elimination of intra-group orders of £1.4bn (2007 £1.4bn).
6 See the Financial review on page 31 and note 29 to the Group accounts.

# Chairman's letter

## "BAE Systems has delivered a further year of good performance"

**Dick Olver** Chairman

- Good performance against objectives
- Further progress in delivery of strategy
- Greater focus on the Corporate Responsibility agenda
- Transition to a new Chief Executive

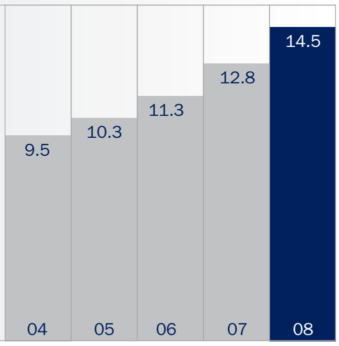
BAE Systems has delivered a further year of good performance against its objectives, delivering on our strategy, financial performance and other non-financial metrics that are becoming an increasingly important component of a successful business operating in global markets.

The more difficult economic climate may restrict many governments' spending, but we believe defence and security will continue to be amongst the priorities for a number of our main government customers. The long-term nature of much of our business, underpinned by a record order book, provides a good level of forward visibility. BAE Systems has been successful in addressing growth opportunities in a strong US defence market, whilst continuing to improve operating performance in the more difficult UK market environment, and winning new business and expanding our presence in other markets around the world. The Group's continued focus on delivering performance and value for money will be increasingly important in its drive to deliver our aspirations for sustainable growth in shareholder value.

**Dividend per share** (pence)

**14.5p**

2008



A key objective for the Board in 2008 was to appoint and achieve a seamless transition to a new Chief Executive. On 1 September 2008, the Board was pleased to announce the appointment of Ian King as Chief Executive on the retirement of Mike Turner after 42 years' service with the Company. Mike had been Chief Executive since 2002 and led the turnaround of the business to today's high performing global enterprise. I am sure our shareholders and other stakeholders join those of us from the Group in thanking Mike for his outstanding contribution to the success of BAE Systems.

Key to that success has been the development and execution of a clear strategy. The Group continues to benefit from delivery against our strategic framework[1]. Prior to his appointment as Chief Executive, Ian King was a key part of the executive team that developed that strategy and contributed to its successful implementation over a number of years. Ian now leads the team and we look forward to supporting him in the continued development of the business.

I was also pleased to welcome two new non-executive directors to the Board during 2008. Ravi Uppal joined in April and Carl Symon in June. Peter Weinberg retired from the Board in May and I would like to extend our thanks to Peter for his contribution to the Group.

Following Peter's retirement from the Board, Andy Inglis has assumed responsibility for the Board's Corporate Responsibility Committee.

The Group is determined that it should be recognised as a leader in responsible business worldwide and we continue to strive for ways to improve our business and its reputation. That is why we asked the Woolf Committee, led by Lord Woolf, to carry out a comprehensive independent review to identify not only the high ethical business standards to which a global company such as BAE Systems should adhere, but also the extent to which the Group currently meets these standards and to recommend the actions to be taken to achieve such standards, and publicly report on its findings.

Appointing the Woolf Committee to undertake this review was a bold move, but we also went one step further and gave a commitment to act on all the Committee's recommendations before even seeing the report. The report was published in May last year, and we are moving fast to implement all recommendations and are already rolling out a new Global Code of Conduct.

We have put in place a comprehensive three-year implementation programme with a dedicated resource drawn from across our business. In order for us to deliver this programme successfully, the outputs must quickly become part of how the Company conducts its day-to-day business as a key part of its total performance culture, one that fully embraces ethics, safety, programme and financial performance.

Recognising the importance of our employees to the success of the Group, I am pleased to report that two were honoured by Her Majesty the Queen in the 2008 Birthday Honours and 2009 New Year's Honours lists: Guy Griffiths, Group Managing Director, International, was appointed a CBE and John Harris, a shipwright with Submarine Solutions, was appointed an MBE.

The Chairman's Award scheme recognises employees and industry partners for outstanding, new and innovative ways in which they shape BAE Systems and contribute to its global success. We celebrated another very successful awards programme in December, reminding all of us of the strong innovation and technological capability of our 106,400 people.

With our belief in the good outlook for the Group the Board has recommended an increased final dividend of 8.7p making a total of 14.5p for the year, an increase of 13.3% over 2007. At this level, the annual dividend is covered 2.6 times by underlying earnings (2007 2.4 times). Subject to shareholder approval at the 2009 Annual General Meeting, the dividend will be paid on 1 June 2009 to holders of ordinary shares registered on 24 April 2009.

**Dick Olver** Chairman

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# Strategy

## "Pursuing our strategy to leverage global capability"

### Strategy contents

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BAE Systems' range of global capabilities in sensors and systems, such as the Long-Range Radar from our Integrated System Technologies (Insyte) business, provides our customers with the power to see, the information to decide, and the knowledge to command.

# "The Group performed well with organic growth from well-positioned businesses"

**Ian King** Chief Executive

BAE Systems continued to make good progress during 2008 in addressing its strategy to deliver sustainable growth in shareholder value by being the premier global defence and aerospace company.

The Group performed well with organic growth in our US businesses benefiting from strong demand in their respective market sectors. The Group has also delivered growth from recent acquisitions. Increased profitability is being achieved across this higher volume of business from good programme execution.

The Group continues to benefit from delivery against its strategic framework. The Group's progression has been achieved through the focus on existing defence capabilities, the broadening to other domains such as the land systems sector, and the substantial expansion of the business footprint across its markets. Activity is starting to increase in India as resources are committed to developing that market.

In 2008, the Group has further developed the business with targeted value-adding acquisitions.

In June, the acquisition of US-based MTC Technologies was completed. The acquisition focuses on the substantial readiness and sustainment opportunities seen in the US defence market and builds on the Group's established through-life support capabilities.

Also in June, the acquisition of the Australia-based defence business Tenix Defence was completed, positioning the Group as the industry leader in the Australian defence market with air, land and naval capabilities. The acquisition is another step in progressing the Group's strategy to grow through the provision of through-life capability in partnership with the armed forces in its home markets.

The acquisition of Detica in September addressed the Group's strategy of targeting national security markets. Opportunities are being identified to leverage the Group's system integration capabilities to meet adjacent, non-military, security requirements for government customers.

## Performance against 2008 Executive Committee top ten objectives

The Board reviews and updates the Group's strategy annually (see page 10). The Chief Executive and Executive Committee agree the Group's strategic objectives, business portfolio actions and integrated business plans. The strategy is also supported by ten short-term objectives agreed annually by the Chief Executive and Executive Committee which address the key challenges in delivering the strategy in the year ahead. Performance against these objectives is measured using a number of key performance indicators which are regularly reported to the Board (see pages 24 to 27). Achievements against the 2008 objectives are summarised below.

| Objective | 2008 performance |
|---|---|
| **1. Meet 2008 financial targets** | Another year of strong performance, with 2008 financial targets for earnings per share and net cash/debt exceeded. |
| **2. Develop our partnering approach** | Further good progress in partnering with customers in the Group's home markets. The acquisition of Tenix Defence in June addresses opportunities to develop through-life business in partnership with the Australian armed forces. |
| **3. Ensure continued application of business policies and processes** | Key business policies and processes are mandated across the Group, and are an important part of the integration of newly acquired businesses. These policies and processes continued to be refined and enhanced with a focus on achieving good, consistent application across all businesses. |
| **4. Further enhance programme execution through schedule and cost performance** | Good programme execution has again been reflected in the performance of the Group. The Group exceeded its 2008 targets for programme margin improvement and schedule adherence. |
| **5. Progress development of security business** | The acquisition of Detica in September built on the Group's established position addressing Homeland Security markets in the US and accelerated the implementation of the Group's strategy to address growth opportunities in national security business across its home markets. |
| **6. Grow our US business, including through investments** | The Group continued to grow its US businesses, with the prior year acquisition of Armor Holdings and strong organic growth from its US land systems business. The acquisition of MTC Technologies in June addresses further growth opportunities in readiness and sustainment activity in the US. |
| **7. Progress the business in the Kingdom of Saudi Arabia** | The Group continued to develop its presence in Saudi Arabia and remains committed to its strategy of developing a greater indigenous capability in the Kingdom. Good progress was made in establishing industrial capabilities to support the modernisation of the Saudi armed forces as part of the Saudi-British Defence Co-operation Agreement. |
| **8. Continue to implement the UK Defence Industrial Strategy (DIS)** | BAE Systems continued to make progress in supporting the UK armed forces through long-term partnering agreements. The formation of the BVT joint venture in July was a key step in the consolidation of the UK naval sector consistent with the objectives of the DIS. |
| **9. Progress export opportunities** | Export opportunities continued to be addressed. The Group's increasing emphasis is on deriving growth in its business by the establishment of industrial capability in defined markets. |
| **10. Continue to drive performance in safety, ethics and diversity** | Good progress was made in embedding the Group's commitment to safety, ethics and diversity. The publication of the Woolf Committee report in May was followed by the establishment of a programme of actions to implement its recommendations. A Group-wide Code of Conduct was developed for roll-out at the start of 2009. |

p24 FOR MORE INFORMATION ON OUR KPIs SEE **PAGES 24 TO 27**

# Chief Executive's review *continued*

The Group will continue to increase emphasis on maximising defence and security capabilities across the home markets in the US, UK, Saudi Arabia, Australia, Sweden and South Africa. In addition, the Group will look to expand where it sees opportunities to establish an industrial presence in new markets, such as India.

Export performance has remained solid with awards including RG-series vehicles to a number of countries, including Spain and Sweden, M777 guns to Canada, CV90 infantry fighting vehicles, and a number of orders for Electronics, Intelligence & Support products, including those in support of US platforms.

In July, BAE Systems completed an agreement with VT Group plc (VT) to consolidate the UK naval shipbuilding industry supported by the signing of the manufacturing contract for the Future Aircraft Carrier programme and by an agreement for the future domestic warship workload with the UK government. The merger of the warship build and support businesses of VT and BAE Systems into the BVT joint venture was achieved in 2008. The joint venture is subject to put and call options and, in January 2009, VT announced that it had decided to exercise its put option to sell its interest in BVT to BAE Systems and that VT expects to be in a position to exercise that option by 1 July 2009.

Even after the active programme of acquisitions over recent years, good cash generation has enabled BAE Systems to maintain a strong balance sheet. Diligent treasury management enabled the Group, during 2008, to avoid the effects of the extreme dislocation in capital markets. Bank counterparty risk has been and continues to be monitored closely on a systematic and ongoing basis, taking account of the size of the institution, its credit rating and its credit default swap price.

The difficult economic environment, and in particular the falls in equity markets in 2008, has affected the Group's pension schemes. Pension scheme funding is regularly reviewed with the Trustees of the schemes. The agreed funding plans have been considered over the longer term and are deemed to continue to be reasonable. An agreement with the Trustees of the Main UK Pension Scheme has recently been concluded following the actuarial valuation carried out as at April 2008. The recovery plan to clear the deficit has been accepted by the Pensions Regulator.

In May 2008, the Woolf Committee, an independent body appointed by the Board under the chairmanship of Lord Woolf to review the Group's ethical standards, published its report. A steering group and associated working groups have been established to address all 23 recommendations and a plan has been developed for implementation of recommendations within three years. The aim is to establish the Group as a leader in business conduct, not just within our sector but within the global business community.

Consistent with the importance attached to Corporate Responsibility and the drive towards leadership in business ethics, the Group has taken steps to embed such issues more directly in its day-to-day operations. An important part of this drive is the establishment of a Global Code of Conduct in which all employees have a clear understanding of what is expected of them. The Code of Conduct was launched in January 2009 to codify the required standards of personal and business conduct.

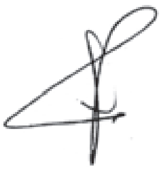
The Group has been reorganised and the Executive Committee restructured[1]. The operating group heads and functional leaders are all now represented on the Executive Committee.

The Executive Committee's top ten objectives for 2009 are summarised opposite. Many of these objectives are consistent with those from 2008. In particular, the team will remain focused on delivering financial performance, consistent programme execution and developing business in its defined home markets. In addition, further emphasis is being placed on safety performance and the Corporate Responsibility agenda is made a key objective for the executive team in 2009.

A well implemented strategy and good programme execution are only two of the elements of high performance. BAE Systems comprises well over 100,000 talented people working in numerous locations around the globe. The challenge and the opportunity is to further develop the Group as a cohesive, inclusive organisation. The move to embrace a single, Group-wide, high performance culture is creating an environment in which all employees can make a real contribution and be recognised for their part in BAE Systems' drive for continuing success.

BAE Systems has consistently delivered progressive performance over recent years. BAE Systems is not insulated from the difficult wider economic environment. The Group recognises that defence budgets are likely at some stage in the future to come under further pressure and it will continue to apply conservatism to its planning assumptions. The Group is well positioned, having a large forward order book, a good balance of market positions around the globe, a well spread portfolio of programmes and a strategy to address anticipated priority areas of spend for its customers.

The following pages describe the Group's strategy, its markets and the way the business is managed.



**Ian King** Chief Executive

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1 FOR MORE INFORMATION ON THE EXECUTIVE COMMITTEE SEE **PAGE 19**

## Global Code of Conduct


We have already made good progress implementing the recommendations of the Woolf Committee.

At the beginning of 2009, we introduced a Global Code of Conduct which provides guidance on the principles, standards and personal behaviour that our people should bring to their business conduct. These build on our existing policies which have been collated into a single document with guidance to explain what they mean to us.

We have appointed a senior Corporate Responsibility executive, reporting directly to the Chief Executive, to ensure that the Group's policies and processes meet with high standards of ethical business conduct.

We have appointed Deloitte to provide external assurance on an annual basis as to the progress of the Woolf implementation programme and this will be reported through our Corporate Responsibility Report which is due to be published in April 2009.

Our global strategy sets out our aspiration to be world-class in total performance. BAE Systems has many business imperatives, but to succeed with them we must develop our business conduct with the same rigour that we apply to our financial and programme execution skills. This includes creating an inclusive culture where the great diversity of talent and capability of our 106,400 employees is fully harnessed.

## 2009 Executive Committee top ten objectives

The Executive Committee has set the following objectives for 2009. A review of performance against these objectives will be contained in the Annual Report 2009. The aim of these objectives is to provide focus for the leadership and engagement of people at all levels in the Group.

| Objective | Description |
|---|---|
| **1. Financial targets** | Meet 2009 financial targets and set challenging and realistic longer-term plans. |
| **2. Programme execution** | Further enhance programme execution through schedule and cost performance. |
| **3. Business conduct** | Progress towards a recognised leadership position on the Corporate Responsibility agenda. |
| **4. Safety** | Drive safety performance to a level comparable with leading performers over a three-year period. |
| **5. Global initiatives** | Make progress on the four global initiatives – Land, Security, Readiness & Sustainment, and Unmanned Aircraft Systems. |
| **6. US business** | Grow our US business including execution of planned investments. |
| **7. Kingdom of Saudi Arabia** | Progress delivery of the Saudi Industrialisation Plan and further develop business in the Kingdom of Saudi Arabia. |
| **8. UK businesses** | Continue to implement the UK Defence Industrial Strategy including execution of our transformation and investment plans. |
| **9. Business development** | Progress export opportunities from each of our home markets. |
| **10. Business policies and processes** | Ensure continued quality application of our mandated business policies and processes. |

# Performing against our strategy

Our Group strategy is 'To deliver sustainable growth in shareholder value by being the premier global defence, security and aerospace company'.

## Our Group strategy

We deliver our strategy through our Group Strategic Objectives, Business Portfolio Actions and Integrated Business Plans. The Group Strategic Objectives are championed by the Executive Committee and apply across all our businesses. The Business Portfolio Actions are championed by the relevant Executive Committee member and are delivered by the businesses either separately or jointly. Both are underpinned by our Integrated Business Plans.

### Group Strategy

To deliver sustainable growth in shareholder value by being the premier global defence, security and aerospace company

### Group Strategic Objectives

Continue to embed a high performance culture including delivery of our Corporate Responsibility agenda
Further enhance our programme execution capabilities
Increase sharing of expertise, technology and best practice between our global businesses
Develop a partnering approach to meet our customer requirements
Develop our capabilities in existing and new home markets

### Business Portfolio Actions

| | | | | | |
|---|---|---|---|---|---|
| Establish in the UK sustainably profitable through life businesses in Air, Land and Sea | Grow our EI&S business both organically and via acquisitions | Implement a home market strategy to grow in the Kingdom of Saudi Arabia | Implement our global land systems strategy | Implement our global initiatives in Security, Readiness & Sustainment (R&S) and Unmanned Aircraft Systems (UAS) | Continue to develop our global markets |

### Integrated Business Plans

## Strategy

**Our consistent strategy**
The Group's strategy has been successful in laying the foundation for our long-term sustainable growth and has provided the framework for the continued development of the business. The strategy has evolved as the Group has progressed and, for 2009, there are again further developments within that consistent framework.

**Evolution of our strategy**
This year, we continued the evolution of our Group Strategic Framework through our strategy review process. With the acquisition of Detica, the Group Strategy statement has been updated to read '…premier global defence, security and aerospace company', reflecting the importance of this growing market opportunity. As part of our commitment to be recognised as a leader in responsible business worldwide, we expanded the first Group Strategic Objective to include 'delivery of our Corporate Responsibility agenda'.

Building on past progress, new and revised actions to support the strategy in 2009 have been developed. A new Business Portfolio Action – 'Implement our global initiatives in Security, Readiness & Sustainment (R&S) and Unmanned Aircraft Systems (UAS)' – has been added to highlight the importance of these global initiatives. We also added the Business Portfolio Action 'Continue to develop our global markets' as we continue to develop our existing home markets, broaden our home market base and seek to export to selected markets.

p12 FOR MORE INFORMATION ON OUR STRATEGY IN ACTION SEE **PAGES 12 TO 14**

## Our Operational Framework

The Operational Framework defines the mandated policies and core business processes that provide a common framework for how we do business. These mandated policies and core business processes, together with our key resources, help us to achieve the Group's strategic objectives.

p18 FOR MORE INFORMATION ON OUR OPERATIONAL FRAMEWORK SEE **PAGE 18**

## Our Key Performance Indicators (KPIs)

The Group delivers its strategy through the Group Strategic Objectives, Business Portfolio Actions and Integrated Business Plans. The strategy is also supported by ten short-term objectives agreed annually by the Executive Committee and the Board (see page 9) which address the key challenges in delivering the strategy in the year ahead. The objectives are directly underpinned by a set of financial and non-financial performance indicators that are regularly reported to the Board. Certain of these are linked to executive remuneration. These KPIs are detailed on pages 24 to 27, and provide a succinct and meaningful measurement system to assess enterprise performance and continuous improvement in line with our strategy.

p24 FOR MORE INFORMATION ON OUR KPIs SEE **PAGES 24 TO 27**

## Our risks

Effective management of risk and opportunity is essential to the delivery of the Group's objectives and achievement of sustainable shareholder value. The Group's approach to risk management is aimed at the early identification of key risks and then removing or reducing the likelihood and effect of risks before they occur, and dealing effectively with them if they do.

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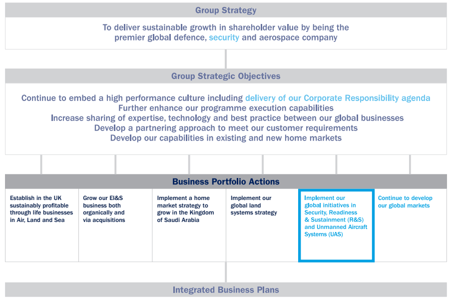
# Leveraging global capability in readiness and sustainment

### Business Portfolio Actions addressed:




Readiness and sustainment describes the provision of through-life operational capability for the armed forces, embracing a wide range of activities to support and sustain equipment and systems. Set within the context of both a demanding operational tempo and a challenging financial environment, effective readiness and sustainment programmes can deliver increased operational availability of systems and equipment at reduced cost. In response to customer demands, the Group has developed a partnered support approach which is providing cost savings and efficiencies while also providing a substantial business stream for the Group. Recognising the growth potential in the through-life support market, the Group has established the readiness and sustainment global initiative to accelerate the deployment of our capabilities in this area across our businesses.

In the UK, the Group's involvement in the support of Royal Air Force (RAF) aircraft has been expanded into contracts to manage the maintenance and support of whole aircraft fleets. These include Availability Transformation: Tornado Aircraft Contract (ATTAC), Harrier Joint Upgrade and Maintenance Programme (JUMP), Nimrod MR2 and the VC-10 Joint Approach to VC-10 Engineering and Logistics Integration (JAVELIN).

The ATTAC partnership provides the RAF with whole-platform availability support. In a partnered arrangement with the RAF and the UK MoD, the Group currently has some 430 staff (including contractors) at RAF Marham and manages a large element of deep support which has resulted in a significant reduction in Tornado flying hour costs.

At RAF Cottesmore, JUMP encompasses a number of Harrier-related partnered support programmes. Essential maintenance is combined with the upgrade of aircraft from Harrier GR7 to the Harrier GR9 standard. JUMP has extended the operational life of the Harrier fleet, reduced customer costs and significantly improved aircraft availability to the front line.

For Nimrod MR2, the Group is responsible for on-aircraft depth maintenance, spares management and fleet maintenance management. This includes maintenance of aircraft under the Nimrod Integrated Support Contract which has delivered a 40% increase in aircraft availability and reduced costs.

Although the VC-10 aircraft is approaching the end of its service life, it continues to provide an essential operational capability for the UK. Through JAVELIN, and in partnership with the UK MoD, the Group is responsible for fleet maintenance management and maintenance policy with performance incentivised against aircraft availability.

On Typhoon, the UK MoD has already awarded the Group a contract to provide a guaranteed repair service for key Typhoon aircraft components. This represents a significant step towards establishing a partnered through-life support availability service and supports the underlying principles behind the UK government's

## Australian Hawk Lead-In Fighter

**The Hawk Lead-In Fighter project is viewed as the role model for future through-life support contracting in Australia. Under a performance-based contract, BAE Systems ensures the aircraft are delivered in line with customer requirements by continuously improving ways of working with our customer. This partnership approach helps to reduce cost while maintaining the availability of the aircraft to meet the needs of the Royal Australian Air Force.**

## Tornado – ATTAC

The Group's UK Tornado support programme is a key example of how BAE Systems is meeting customer demands for through-life capability and support. The Tornado Availability Transformation: Tornado Aircraft Contract (ATTAC) programme includes on-aircraft maintenance of the Tornado GR4 aircraft fleet, spares support, technical support and training.

Under the ATTAC agreement, BAE Systems has taken responsibility for deep support at RAF Marham, and combines this with a capability development and sustainment service as a structured and cost-effective approach to inserting new capability into the aircraft, so as to maintain its war-fighting effectiveness throughout its service life.

ATTAC is an availability contract where BAE Systems is responsible for ensuring the required aircraft, at an agreed capability, are provided to the front line, while saving the UK MoD some £500m over an initial ten-year period.

Defence Industrial Strategy. The Typhoon Availability Service (TAS) is expected to be progressively contracted for from 2009.

Within the Kingdom of Saudi Arabia, the Group has developed extensive support capabilities over several decades. The Group continues to provide significant support to both Royal Saudi Air Force (RSAF) and Royal Saudi Naval Forces operations. In particular, steps are being taken with the RSAF to maintain the capability of its Tornado aircraft while extending their operational life.

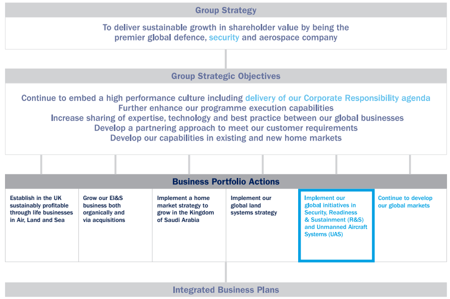
In Australia, in addition to supporting the Hawk Lead-In Fighter aircraft, the acquisition of Tenix Defence, a diversified provider of engineering and technical maintenance services to the Australian Defence Force, has provided us with the opportunity to enhance our through-life support services and capabilities to the land and naval forces.

In the US, through-life support is often referred to as readiness and sustainment, and the Group has capabilities throughout its businesses. These range from the Group's ship repair facilities which provide complete marine repair, modernisation and conversion services, to the upgrade, reset and support of armoured fighting vehicles. The Group's FastTrack contract provides the US Navy with an affordable, performance-based solution to the challenging issue of providing continuing spare parts availability for ageing US military aircraft.

The acquisition of MTC Technologies, a provider of technical and professional services and equipment integration, was an important step in addressing growth in the US readiness and sustainment markets and has added to our existing capabilities.

# Leveraging a global capability in security

## Business Portfolio Actions addressed:




BAE Systems has identified the security market as an evolving and growing business opportunity that continues to benefit from increasing government attention. While the security market covers a broad range of sectors, the Group's focus is on information and intelligence. The Group established a strategic objective for 2008 of 'establishing security businesses in its home markets'. In parallel with organic investment, the acquisition of Detica in 2008 accelerated implementation of its strategy to address these opportunities.

The digital revolution – the widespread diffusion of telecommunications and computer technology – has driven exceptional economic and social development. A decade ago very little was digital, now the vast majority of information is digitised and volumes are growing at an exponential rate. The growth of the internet, which has stimulated this explosion, now makes it impossible to conceive of a modern economy operating without it. However, the digital revolution is both exploited by, and vulnerable to, terrorists and criminals who have increased their threat potential through this new environment.

## Detica

**Demonstrating BAE Systems' strategic objective of growth into adjacent markets is the acquisition of the information intelligence capability provider, Detica. In the UK, Detica has established itself as a leading consultancy servicing the counter-threat agenda and its acquisition will help BAE Systems establish security businesses in its home markets, accelerating planned organic growth in the national security sector.**


The Group expects the historically fragmented security sector to consolidate and grow as customers' requirements evolve around more integrated information intelligence solutions. The combination of Detica's well-established customer relationships and technical capabilities and BAE Systems' system integration capabilities will result in a depth of financial and technical capability to address growth opportunities and better serve customers in this area.

Governments, the military, financial institutions and private businesses amass a great deal of information about their customers, products, research and financial status, and protection of this confidential information is key to their sustainability. The Group provides innovative thinking and solutions in the area of information exploitation to create actionable intelligence.

Detica works with the UK government in areas such as counter-terrorism, serious and organised crime, identity management, and immigration and border control. Clients include agencies within intelligence and defence sectors as well as the Department for Transport, the Metropolitan Police and HM Revenue and Customs. Much of our work in this market is at the heart of our clients' mission, and focuses on large scale data integration and the application of advanced analytical techniques. With larger and longer-term delivery contracts becoming increasingly important, the Group expects to benefit from the UK government's increasing focus on intelligence, security and resilience.

The Group's broad geographic footprint provides substantial opportunities to grow its security business across its other home markets. In particular, existing activities and structures in the US provide a platform to apply Detica's capabilities into the US homeland security market.

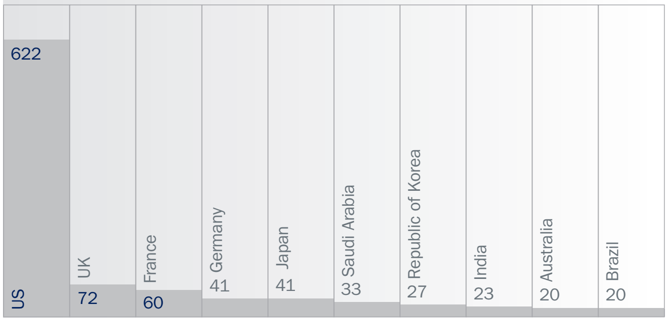
With terrorism remaining a mainstream political issue which continues to affect governments and the public, it is anticipated that there will be a requirement for protection strategies in counter-terrorism, border controls and critical national infrastructure which will need collaboration across agencies and government departments. The growth of identity theft has accelerated the development of new approaches to identifying and combating increasingly complex forms of internal and external fraud.

With relationships at the heart of the security community in both the UK and the US, BAE Systems is now in a position to utilise its capabilities in the security sector across the Atlantic and in our other home markets. Detica has previously benefited from contracts such as the UK/US collaborative Joint Narcotics Analysis Centre and from the award of a contract for the Detica NetReveal® software from the US Internal Revenue Service.

# The global defence market

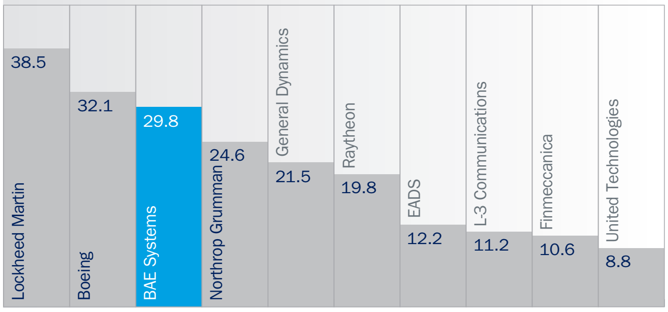
Whilst the more difficult economic climate will undoubtedly restrict many governments' spending, at the macro level, global defence expenditure is expected to remain robust in the near term. The US defence market is estimated to account for approximately 44% of the global total in 2007.

**Accessible defence markets** (US$bn)
Top ten markets accessible for business by the Group
(based on 2007 total defence spending)



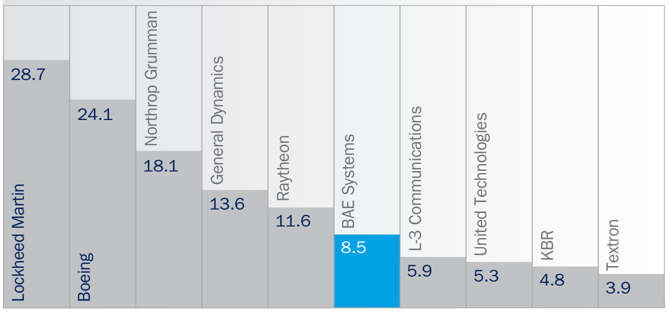

Source: BAE Systems internal analysis

**BAE Systems' global market position** (US$bn)
Top ten defence companies
(based on 2007 defence revenues)




Source: Defense News

**BAE Systems' US market position** (US$bn)
Top ten US defence companies
(based on 2007 Department of Defense revenues)




Source: GovernmentExecutive.com

Spending has been rising in a number of Asian economies, such as India, while there has also been increased defence spending in the Gulf. Global market growth is expected to continue in the near term but then flatten from 2010 as US deployments are expected to be scaled back leading to lower supplemental budgets.

Most of the Group's businesses are focused on the defence industry and are subject both to competition from national and multi-national firms and to government regulation.

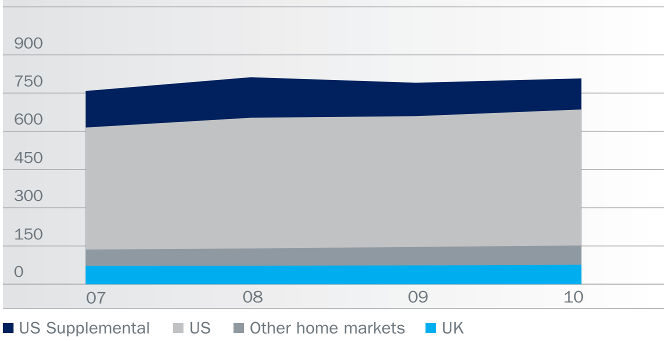
**BAE Systems' position in each home market**

| Home market | Position in home market defence industrial base 2007 | Total defence spend 2007 Actual US$bn |
|---|---|---|
| US | 6 | 622 |
| UK | 1 | 72 |
| Saudi Arabia | 1 | 33 |
| Australia[1] | 1 | 20 |
| Sweden | 2 | 7 |
| South Africa | 2 | 4 |

1 Assuming Tenix Defence included.

Source: BAE Systems internal analysis

**Forecast defence budgets for BAE Systems' home markets**
(US$bn in constant 2007 prices)




Source: BAE Systems internal analysis

# Our home markets

Our global business is based around six home markets in Australia, Saudi Arabia, South Africa, Sweden, the UK and US. These are markets identified as having a significant and sustained commitment to defence and security and an openness to foreign investment. They are also markets where we have a good existing position in their defence industrial base along with strong customer relationships. We intend to invest and grow in these markets.

The **United States** is the world's largest single defence market, estimated to account for approximately 44% of total global expenditure in 2007.

Within this market, BAE Systems is a large and high-performing part of the defence industrial base and ranked number six among the leading US defence contractors in 2007. The Electronics, Intelligence & Support (EI&S) and Land & Armaments (L&A) operating groups employ almost 47,000 people across 38 states.

**Market environment**
The near-term outlook for US defence spending remains relatively strong with estimated 2008 total spending levels of US$672bn, the highest in real terms since World War II. Supplemental spending continues but is expected to decline as it is anticipated that the US will scale back its operations in Iraq. Uncertainty increases beyond 2010 pending decisions to be made by the new US administration although support for defence spending is expected to remain robust.

The US is one of BAE Systems' key markets and is expected to continue offering programme scale and high levels of investment in research and development. The Group has continued to grow in the US, leveraging its market leadership positions in areas such as land vehicles and electronic warfare, and is also introducing new capabilities to meet customer needs.

**Opportunities**
Demand continued through 2008 for our wide range of high technology systems and sensors, and for the reset and upgrade of tracked vehicles. We also saw a peak in demand for Mine Resistant Ambush Protected (MRAP) vehicles.

Our Business Portfolio Actions include growing our EI&S business both organically and via acquisitions, as well as implementing our global land systems strategy[1]. Future growth opportunities exist in areas such as cyber-space activity, through-life product support, services, mission support and sustainment. We will continue to pursue opportunities globally leveraging leadership positions in Tracked Combat Systems, Medium Tactical Vehicles, Mine Resistant Vehicles, Armour and Survivability Technologies and Artillery Systems. Additionally, the acquisition of MTC Technologies in June further strengthened our position in the US readiness and sustainment market.


Note: Employee numbers exclude the Group's share of equity accounted investments.

p10 1 FOR MORE INFORMATION ON OUR STRATEGY SEE **PAGE 10**

**United Kingdom** Overall defence spending in the UK is at a low level of real growth despite commitments to operations in Afghanistan and Iraq which have resulted in high levels of activity due to Urgent Operational Requirements.

The Group's UK-based businesses have a key role in supporting the UK armed forces as well as developing security and resilience capabilities for the UK. Some 32,800 people are employed in the UK.

### Market environment

The defence market in the UK is expected to become more challenging in the coming years and a strategic defence review is expected following the next general election. Defence expenditure was 2.4% of GDP for 2007/08.

The Group's UK businesses have a secure backlog of contracted business across large air systems and naval platform programmes. The businesses are seeing the benefits of the transition from development to production activity, and, as these platforms enter service, are expected to benefit from through-life support contracts.

### Opportunities

Our strategy is to establish in the UK sustainably profitable through-life businesses in air, land and sea[1]. We continue to make progress in supporting the UK armed forces through partnering agreements in response to the UK Defence Industrial Strategy (DIS). In 2008, we announced the formation of the naval shipbuilding joint venture BVT Surface Fleet, signed a 15-year partnering agreement with the UK MoD on munitions supply and continued to make progress in supporting in-service equipment.

The acquisition of Detica in September was a major step in the implementation of our strategy to develop a security and resilience business across our home markets.

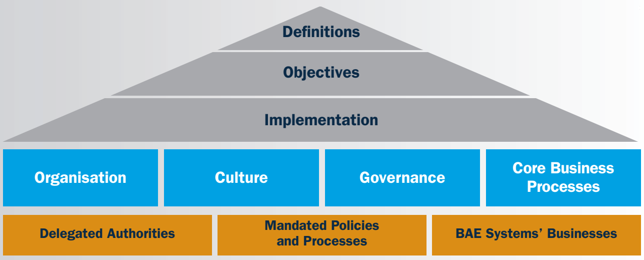
Saudi Arabia
employees:
4,400

South Africa
employees:
800

# How we manage our business to deliver on our strategy

The Board promotes a common culture and identity through the Operational Framework. It sets out the way we do business and what it means to be part of the Group. It is the Group's framework for a sound system of internal controls. All employees are required to comply with the Operational Framework in their business conduct.

## Our Operational Framework




### Objectives and implementation

BAE Systems is a large global business with responsibilities to its shareholders, customers, partners, employees and the communities in which it operates. Its strategy is to deliver sustainable growth in shareholder value.

In support of the Group's strategy, the Board promotes a common corporate culture and identity as set out in the Operational Framework. This is based on principles of good governance, a set of definitions, values, policies and processes that guide our work and behaviour, and a clear system of delegated authority. The Operational Framework is mandatory across all wholly and majority-owned businesses and describes the Group's approach to its organisation, culture (including its vision, values and ethical principles of business conduct), governance framework, core business processes and delegated authorities.

Operational line leaders ensure that detailed controls (both operational and financial) are defined and implemented within their businesses in accordance with the Operational Framework. They are required to confirm twice-yearly through the Operational Assurance Statement process that their businesses are in compliance with the Operational Framework. This is a mandated policy under the Operational Framework and a key performance indicator relating to mandated policies and processes. See page 27 for more details.

### Organisation

The Board is responsible for the management of the Group. Its principal aim is to enhance the Group's long-term value for the benefit of shareholders. The members of the Board are shown on pages 64 and 65. The ways in which the Board and its committees discharge their duties are described on pages 66 to 76.

The Chief Executive has established a line leadership organisational structure with accountability for business delivery and performance. To support line leaders, Functional Councils have been established to promote consistent best practice policies and processes throughout the Group.

The Executive Committee provides the executive forum in which the operating group and functional leaders come together to communicate, review issues and agree on actions of Group-wide significance. See opposite for the organisation chart of the executive leadership.

The Chief Executive is responsible for the leadership and operational management of the Group to achieve the strategy and business plan agreed by the Board. This is managed through clearly defined levels of delegated authorities to the line leaders. Responsibility for establishing and operating the detailed control procedures lies with the line leader for each operating business.

For joint ventures and other collaborative organisations, similar processes and controls are promoted and influence exerted through Board representation.

### Culture

The Group's vision, values and ethical principles of business conduct form the basis of the culture we wish to achieve – a high-performance culture. Ethical business conduct is fundamental to the Group's reputation and success. The Group will not compromise on its ethical principles and policies. Further information on ethics, the Group's Corporate Responsibility agenda and the Global Code of Conduct is set out on pages 48 to 55.

### Governance and core business processes

The Group and its employees are required to comply at all times with the laws and regulations of the countries in which it conducts business. The internal controls that line leaders apply to their businesses reflect the different activities and risk environment in which their businesses operate and are based on a common framework of five core business processes and 32 policies mandated by the Operational Framework.

Corporate governance, including the five core business processes, is discussed in more detail on pages 66 to 69 and risk management within BAE Systems is discussed in more detail on pages 56 to 61.

The Operational Framework is reviewed and revised on a six-monthly basis.

# How our executive leadership is organised

The Executive Committee, as set out by the Operational Framework, is the forum chaired by the Chief Executive in which the operating group and functional leaders come together to communicate, review and agree on issues and actions of Group-wide significance. It also drives the Group Corporate Responsibility agenda and takes responsibility for Group-wide strategic initiatives.

**Ian King**
Chief Executive

## Line leadership

- **Walt Havenstein** – Chief Operating Officer, President and CEO, BAE Systems, Inc.
  - **Mike Heffron** – President, Electronics, Intelligence & Support
  - **Linda Hudson** – President, Land & Armaments
- **Guy Griffiths** – Group Managing Director, International
- **Nigel Whitehead** – Group Managing Director, Programmes & Support

## Functional leadership

- **George Rose** – Group Finance Director
- **Phillip Bramwell** – Group General Counsel
- **Andrew Davies** – Group Strategy Director
- **Alan Garwood** – Group Business Development Director
- **Alastair Imrie** – Group HR Director
- **Charlotte Lambkin** – Group Communications Director

## Chief Executive's Office

- **Peter Fielder** – Managing Director, Performance Excellence
- **Grenville Hodge** – Director, Audit
- **Raj Rajagopal** – Managing Director, Corporate Responsibility
- **Fiona Davies** – Chief of Staff

Board member
Executive Committee member

# Our key resources are fundamental to the success of the Group

The Group's key resources and arrangements include the people it employs, its relationships with customers, subcontractors and other suppliers, research and development, and intellectual property. These resources, together with the application of the mandated policies and processes in the Operational Framework, help the Group to achieve its strategy.

**People**

The contribution made by the Group's employees is fundamental to its success. Through global implementation of its People Policy the Group obliges each employee to contribute to the creation of an inclusive work environment where individuals are respected, the value of having a diverse workforce is recognised and the recruitment, employment and development of people is based on qualifications, skills and competencies to do the job. This helps the Group attract and retain highly talented people who can deliver the systems and services that its customers need.

The Group's workforce encompasses the broad spectrum of skills and experience needed to deliver a full range of systems and services for air, land and naval forces as well as advanced electronics, information technology solutions and customer support services. The Group works in partnership with education providers in its home markets to ensure that there continues to be a supply of talented and qualified people to fill its early career programmes for university graduates and apprentices. We invest in education schemes with a particular emphasis on promoting the teaching and study of science, technology, engineering and mathematics subjects.

The Group drives high performance through its Performance Centred Leadership (PCL) process. PCL is a mandated core process under the Operational Framework and addresses the setting of objectives and performance assessment together with the determination of reward, development needs and potential. It drives business success by linking individuals' goals with the wider goals of the organisation, enabling employees to understand how their own success contributes to the success of the Group. The Group's 2008 target to increase the roll-out of PCL by a further 500, to a total of 6,700 executives worldwide, was achieved.

The Group is committed to equal opportunities regardless of sex, race, colour, nationality, ethnic origin, religion, age, sexual orientation or disability, subject to considerations of national security and the territories in which it operates. The Group operates a policy that discrimination against any person on the grounds of disability shall not be tolerated.

The Group has put into place a number of ways of consulting with employees, and providing them with information on the performance of the Group and other matters that affect them. These include regular employee surveys, global, regional and departmental newsletters, and a global intranet site. We also engage with our people through employee representative bodies and trade unions. The effectiveness of the communication process is assessed regularly.

Employees are actively encouraged to become shareholders in the Company by way of all-employee share schemes.

This year, the Group's biennial employee opinion survey was completed by more than 58,000 employees. See page 53 for more details.

## Partnering with customers

**An example of the UK Defence Industrial Strategy in action is a new partnering arrangement known as Munitions Acquisition – the Supply Solution (MASS). BAE Systems and the UK Ministry of Defence entered into a 15-year agreement for supplies of ammunition to UK troops which includes opportunities to share savings achieved through improved performance, innovation, overseas sales and the expansion of scope. Under the agreement, we will invest over £120m in new, highly automated facilities.**

Crown copyright.

In 2007, the Group declared its aspiration and commitment to achieving a level of safety comparable with the best in class. The Board actively monitors days lost to work-related injuries, a key performance indicator relating to corporate responsibility. See page 27 for more details.

### Relationships with customers

The Group regards the relationship with its customers as a key discriminator in a competitive industry. Its core businesses are mostly defence related, selling products and services primarily in our home markets and to other national governments, both directly and indirectly through other defence and aerospace companies. In many cases these relationships extend over decades and span the full product and service lifecycle from initial concept definition, through the system development phase, into production and then on to support for the system in service.

This lifecycle approach is used as the basis for Lifecycle Management (LCM), which is a mandated core process under the Operational Framework. LCM provides a structured approach to managing the Group's commitments and investments throughout product and project lifecycles, promoting the application of best practice management and facilitating continuous improvement. Under LCM, programme margin variation and schedule adherence are regularly reviewed to monitor the Group's performance in relation to contract profitability and milestone achievement. These are key performance indicators relating to programme execution. See page 26 for more information.

Throughout this lifecycle, the Group engages extensively with its customers and undertakes customer satisfaction surveys as part of its drive for continuous performance improvement. The Group targets year-on-year improvement in customer satisfaction. This is a key performance indicator relating to programme execution. See page 26 for more information.

Increasingly contracts are being awarded for the delivery of a capability, rather than just a product. Reflecting this new approach, traditional customer relationships are evolving into long-term partnerships with governments and their armed forces.

### Subcontractors and other suppliers

Managing major subcontracts is a key strategic capability. Expenditure on subcontractors often represents a significant portion of project cost and effective management of this expenditure is a key value driver for our Group. The benefits of capability-based contracting, combined with ongoing budget pressures, are leading many customers to demand a more integrated partnering approach to meeting their requirements. Transforming relationships with suppliers is an essential part of developing systems integration and through-life management capabilities. The Group is committed to improving supply chain relationships and working together with other companies, large and small, in each of the Group's home markets to deliver better value and innovation for its customers.

The Group's Centre for Performance Excellence has identified best practices in managing major subcontracts from across BAE Systems and industry. Best practice in managing major subcontracts is embedded in the Group's processes, guidance and training to help deliver on commitments to customers. This directly aligns with the Group's strategic objectives of enhancing programme execution capabilities, sharing of best practice between the Group's global businesses and embedding a high-performance culture.

### Research and Development (R&D)

The Group is engaged in significant R&D programmes in support of the platforms, systems, services and capabilities that it provides to its customers. These cover a wide range of work and include performance innovations, improvements to manufacturing techniques and technology to improve the through-life support of products. Long-term research is undertaken through partnerships with the academic sector and in the Group's Advanced Technology Centre and Systems Engineering Innovation Centre.

Application of this research is managed through business-focused R&D programmes. Customers fund directly much of the near-term product development work undertaken by the Group. Total R&D expenditure for the Group amounted to £1,044m (2007 £1,460m), of which £211m (2007 £176m) was funded by the Group.

### Intellectual property

Intellectual property is created every day, taking many forms, both in tangible products and 'know how' developed over the years. The Operational Framework mandates a policy to protect the Group's intellectual property through appropriate use and observance of intellectual property law, so that returns made from the investment in R&D and technological innovation are protected, and valuable commercial and business innovations, all of which contribute to the Group's competitive advantage, are adequately safeguarded.

The Group filed patent applications covering over 200 new inventions in 2008 in support of its global businesses, and has a total portfolio of patents and patent applications covering more than 1,700 inventions worldwide.

## Innovation and technology

**Developing new technology is vital to the future of BAE Systems. The Group's HybriDrive® propulsion system powers New York's hybrid electric bus fleet, the world's largest, and growing hybrid fleets in Toronto, San Francisco, Houston, Ottawa and London.**

# Performance

## "Delivering global performance"

Performance contents **3**

BAE Systems drives a culture of service excellence, working in partnership with the Royal Air Force to provide through-life support for Typhoon. We will meet our customers' needs by delivering a comprehensive and flexible capability throughout the life of the aircraft.

# Monitoring our performance

The Board uses a range of financial and non-financial performance indicators, reported on a periodic basis, to monitor the Group's performance over time. Directors' remuneration is linked to certain of these measures.

## Financial

Link to strategy

**Financial KPIs are used to measure financial performance which underpins the Group's Strategic Objectives, Business Portfolio Actions and Integrated Business Plans.**

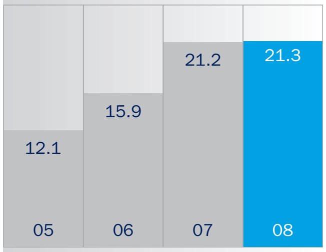
Link to 2008 Executive Committee top ten objectives

**1. Meet 2008 financial targets 5. Progress development of security business 6. Grow our US business, including through investments 7. Progress the business in the Kingdom of Saudi Arabia 8. Continue to implement the UK Defence Industrial Strategy 9. Progress export opportunities**

### Measure: Order intake (£bn)

Description: Order intake represents the value of funded orders received from customers in the year. It is a measure of in-year performance and supports future years' sales performance.

Performance: **2008: £21.3bn +0.5%**
2007: £21.2bn

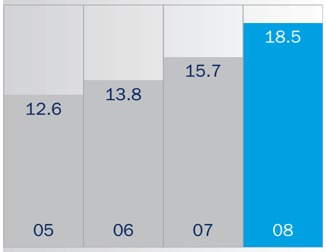



Comment: The year's intake has benefited from high demand for armoured wheeled vehicles in the US, awards for the new 15-year UK munitions capability contract and Saudi Tornado Sustainment Programme, and the Group's share of the Future Carrier award. Prior year intake included the Saudi Typhoon contract.

### Measure: Sales (£bn)

Description: Sales represents the amounts derived from the provision of goods and services, and includes the Group's share of sales of its equity accounted investments.

Performance: **2008: £18.5bn +18%**
2007: £15.7bn

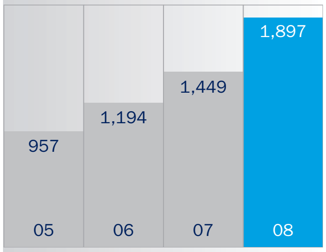



Comment: The significant increase in sales this year has primarily been driven by the Land & Armaments operating group due to high armoured wheeled vehicle volumes in the US and full-year impact of the Armor acquisition.

### Measure: Underlying EBITA[1] (restated) (£m)

Description: Underlying EBITA[1] is used by the Group for internal performance analysis as a measure of operating profitability that is comparable over time.

Performance: **2008: £1,897m +31%**
2007: £1,449m




Comment: Underlying EBITA[1] increased in line with the improved 2008 sales performance and a 1.0 percentage point improvement in return on sales.

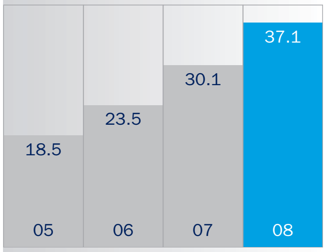
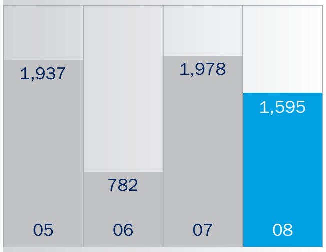
Links to further information

Further explanation of these Group financial KPIs for the years ended 31 December 2008 and 2007 are included within the Financial review on pages 28 to 32.

Individual operating group financial KPIs are included within the Operating group reviews on pages 36 to 44, and a reconciliation to the Group KPIs is presented on page 45.

Directors' remuneration is linked to certain of these measures. Further information is given within the Remuneration report on pages 75 to 93.

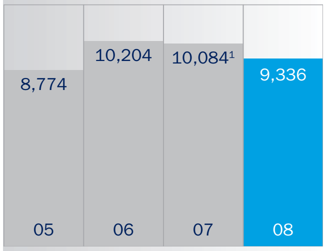
1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
2 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.

| | | |
|---|---|---|
| Measure | **Underlying earnings[2] per share (EPS) (restated) (p)** | **Operating business cash flow (£m)** |
| Description | Underlying earnings[2] represent profit for the year attributable to equity shareholders from continuing operations excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories (see note 10 to the Group accounts). Underlying EPS provides a measure of shareholder return that is comparable over time. | Operating business cash flow represents net cash flow from operating activities after capital expenditure (net) and financial investments, and dividends from equity accounted investments. |
| Performance | **2008: 37.1p +23%**<br>2007: 30.1p<br> | **2008: £1,595m -19%**<br>2007: £1,978m<br> |
| Comment | Underlying EPS has again increased mainly reflecting higher underlying EBITA[1]. | The 2008 reduction in operating business cash flow largely reflects utilisation of Saudi Typhoon advances received in 2007 and an agreed repayment to the UK Ministry of Defence in respect of the Astute programme. |

# Key Performance Indicators (KPIs) *continued*

## Programme execution

| | | | |
|---|---|---|---|
| Link to strategy | **Excellence in programme execution is at the core of the successful delivery of the Group's strategy. Partnering relationships with our customers are increasingly important to the long-term future and sustainability of the Group.** | | |
| Link to 2008 Executive Committee top ten objectives | **2. Develop our partnering approach 4. Further enhance programme execution through schedule and cost performance** | | |
| Measure | **Programme margin variation** | **Schedule adherence** | **Customer satisfaction** |
| Description | Programme margin variation measures outturn projections of and movements in margin of key customer-funded projects. It provides an indicator of our ability to effectively manage major programmes. | Schedule adherence measures the timing of achievement of key milestones. It shows how well we are performing against our stated key contract commitments. | Customer satisfaction surveys are used to collect customer opinions on key customer-funded projects. This provides an opportunity for customers to share information on perceived performance levels, and identify areas of strength and weakness. |
| Performance | The Group targets an aggregated year-on-year improvement in programme margin across its major contracts. The targeted improvement was achieved. | The Group targets an aggregated improvement in schedule adherence metrics relating to milestones across its major contracts. This targeted improvement was achieved. | The Group targets an aggregated year-on-year improvement in customer satisfaction across its major contracts. This targeted improvement was not achieved. |
| Comment | Contract management metrics are consistently used by the Board to provide oversight of contract performance. These metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented. | Contract management metrics are consistently used by the Board to provide oversight of contract performance. These metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented. | Plans to improve the performance on those contracts reporting a deterioration in customer satisfaction are being implemented on a contract-by-contract basis. |
| Links to further information | Programme margin variation, schedule adherence and customer satisfaction are regularly reviewed under Lifecycle Management (LCM), which is a mandated core business process under the Operational Framework. It provides a structured approach to managing commitments and investments throughout project and product lifecycles. Further information on LCM is given on pages 21 and 67. | | |

| | Mandated policies and processes | | Corporate responsibility |
|---|---|---|---|
| Link to strategy | **Having a high-performance culture underpins the Group's ability to achieve its strategy.** | | **High standards of corporate responsibility are essential to the Group's strategy of delivering sustainable growth.** |
| Link to 2008 Executive Committee top ten objectives | **3. Ensure continued application of business policies and processes** | | **10. Continue to drive performance in safety, ethics and diversity** |
| Measure | **Operational Assurance Statement (OAS)** | **Performance Centred Leadership (PCL)** | **Safety** |
| Description | The OAS requires that each part of the business completes a formal review of its compliance against the Operational Framework, including operational and financial controls, and risk management processes, every six months.<br>The level of application of mandated policies is assessed against defined scoring criteria. Where scores are below the minimum standard, action plans to achieve the minimum standard are implemented. | PCL addresses the setting of objectives and performance assessment, together with the determination of reward, development needs and potential, of the Group's employees. | Days lost to work-related injuries is monitored to minimise the risk to our employees and our operations, and drive continual performance improvement. |
| Performance | **47%**<br>**Improvement**<br>The Group targeted an improvement in scores below the minimum by 20% during 2008. The actual improvement in scores during 2008 was 47%. Newly acquired businesses are targeted to reach minimum standard in 75% of mandated policies within 12 months of acquisition. The ex-Armor Holdings business achieved 88% compliance. | **562**<br>**Additional employees**<br>The Group target was to increase the roll-out of PCL from 6,200 to 6,700 executives across the Group.<br>PCL was deployed to 6,762 employees across the Group. | <br>Days lost to work-related injuries (per 100,000 employees) |
| Comment | The Tenix, Detica and ex-VT Group businesses acquired during the year have been excluded from the analysis. The 2008 OAS submissions for these businesses will be used to measure achievement of this objective in 2009. | The 2008 target was exceeded. Roll-out of PCL to the newly acquired businesses will continue in 2009. | The Group targeted a 10% reduction in the gap between Group performance and the external benchmark of 2,000 days lost per 100,000 employees. The target was not met as the actual reduction was just over 9% during 2008. |
| Links to further information | OAS is a mandated policy under the Operational Framework. Further information on the Operational Framework is given on page 18. | PCL is a mandated core process under the Operational Framework. Further information on PCL is given on page 20 and in the Corporate governance section on page 67. | Further information on the Group's performance is given within the Corporate responsibility review on pages 48 to 55.<br>Directors' remuneration is linked to certain of these measures. Further information is given within the Remuneration report on pages 75 to 93. |

1 Restated.

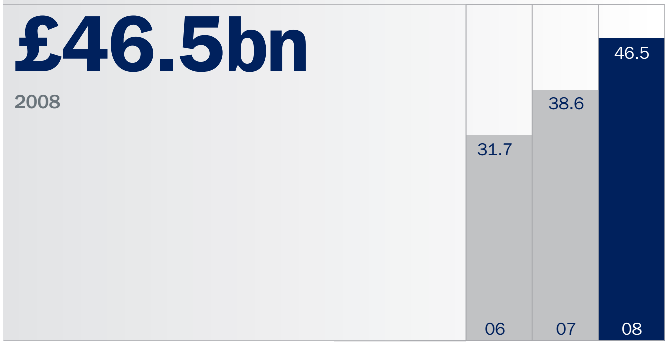
# Financial review

## "Another good year, with strong earnings growth and good cash flow generation"

**George Rose** Finance Director

- The £46.5bn (2007 £38.6bn) order book[1] continues to provide excellent forward visibility.
- Underlying earnings[3] per share has increased by 23% to 37.1p per share (2007 30.1p).
- The total dividend is 14.5p per share (2007 12.8p), an increase of 13.3%.

**Order book[1]** (£bn)




### Order book[1]

**Order book[1]** increased by 20% to £46.5bn (2007 £38.6bn). Exchange translation, primarily due to the weakening of sterling against the US dollar, accounted for £5.9bn of the increase. Awards for the new 15-year UK munitions capability contract, the UK Future Aircraft Carrier and US land vehicles, together with a net increase from acquisitions and disposals, delivered underlying order book growth.

### Income statement

**Summary income statement – continuing operations**

| | 2008 £m | 2007 £m |
|---|---|---|
| **Sales[1]** | **18,543** | 15,710 |
| **Underlying EBITA[2] (restated)** | **1,897** | 1,449 |
| Return on sales | **10.2%** | 9.2% |
| Profit on disposal of businesses | **238** | 40 |
| Uplift on acquired inventories | **–** | (12) |
| Amortisation of intangible assets | **(247)** | (149) |
| Impairment of intangible assets | **(177)** | (148) |
| Net financial income[1] | **697** | 93 |
| Taxation expense[1] | **(640)** | (373) |
| **Profit for the year** | **1,768** | 900 |

**Exchange rates**

| | | |
|---|---|---|
| £/$ – average | **1.853** | 2.002 |
| £/€ – average | **1.258** | 1.461 |

**Sales[1]** increased by 18% to £18.5bn (2007 £15.7bn). This includes contributions from the MTC, Tenix Defence and Detica businesses acquired during the year (£0.3bn) and a full year of sales from the Armor Holdings business, acquired in July 2007, of £2.3bn (2007 £0.7bn). Like-for-like growth, after adjusting for the impact of exchange translation, and acquisitions and disposals, was 3% primarily driven by high demand for armoured wheeled vehicles in the US, partially offset by a reduction in the UK businesses as the Typhoon programme transitions from Tranche 1 to Tranche 2 deliveries. US-led businesses accounted for 59% (2007 47%) of sales[1]. Sales[1] generated from the Group's six home markets represented 88% (2007 85%) of sales. The Group's sales[1] performance is illustrated in the bridge chart opposite.

**Underlying EBITA[2] (restated)** Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. This definition, which is referred to as underlying EBITA, has been amended to exclude profit/(loss) on disposal of businesses, which unlike in previous years, is material this year. It is also consistent with the profit measure disclosed in note 3 to the Group accounts on a segmental basis.

Underlying EBITA[2] increased by 31% to £1,897m (2007 £1,449m) giving a return on sales of 10.2%, up from last year's 9.2%. The contributions from the businesses acquired in the year totalled a £4m loss and a full year of trading from the ex-Armor Holdings business contributed a profit of £236m (2007 £89m). In the prior year, the Group's Regional Aircraft business recognised net charges of £76m against asset carrying values, although this was largely offset by a one-off gain of £52m on completion of the Brunei Offshore Patrol Vessel arbitration process. Exchange translation, primarily relating to US dollar-denominated businesses, generated £61m of the increase. US-led businesses delivered 57% (2007 53%) of the Group's underlying EBITA[2]. The increase in underlying EBITA[2] is illustrated in the bridge chart opposite.

**Profit on disposal of businesses** was £238m (2007 £40m). This includes the accounting gain on the disposal of the Group's interests in the businesses contributed to the BVT Surface Fleet joint venture (£121m), and profit on the disposal of the Surveillance & Attack business (£61m) and the Group's interest in Flagship Training (£56m).

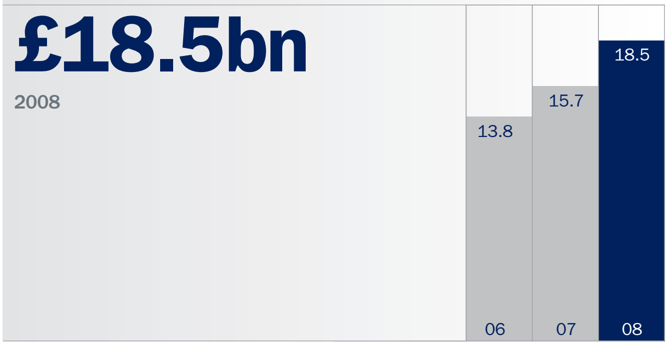
**Amortisation of intangible assets** is £98m higher at £247m reflecting a full year charge in respect of the ex-Armor Holdings business and £35m relating to the businesses acquired during the year.

**Impairment of intangible assets** totalled £177m (2007 £148m) largely reflecting a reduction in the market value of the Group's interest in Saab of Sweden (£120m) and lower sales volumes in the US-based Products Group business (£40m), which was acquired with Armor Holdings in 2007. The prior year charge included £145m in respect of the Insyte business.

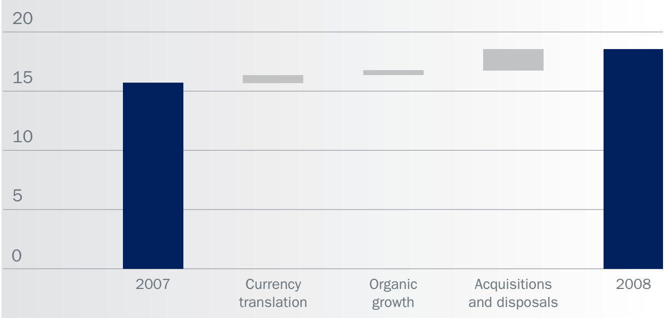
**Net financial income[1]** was £697m (2007 £93m). The underlying net interest charge was £102m (2007 £38m). A net credit of £799m (2007 £131m) arose from pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements. The underlying net interest charge has increased primarily as a result of the cash cost of business acquisitions. The net credit of £799m has increased mainly on the weakening of sterling against the US dollar during the second half of the year. Underlying interest cover was 19 times (2007 38 times).

**Taxation expense** reflects an effective tax rate of 26% (2007 26%), which is expected to increase to 28% in 2009.

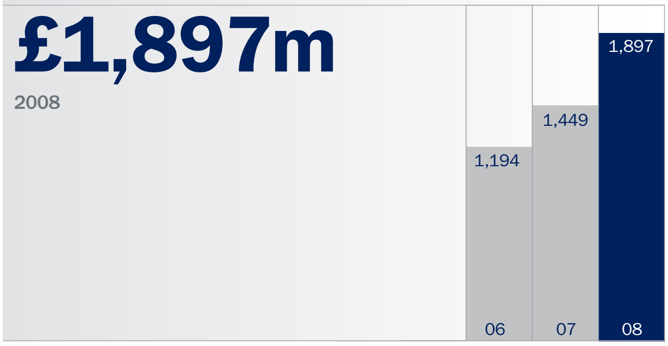
**Sales[1]** (£bn)



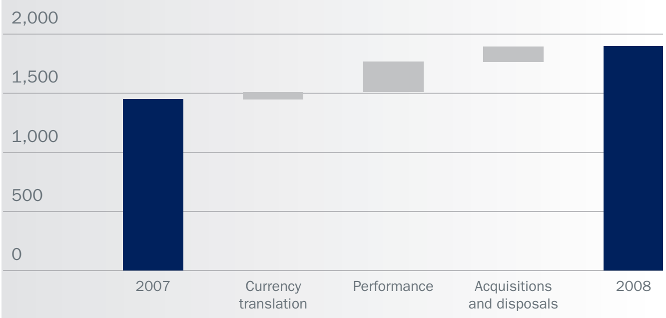

**Sales[1] bridge** (£bn)




**Underlying EBITA[2] (restated)** (£m)




**Underlying EBITA[2] (restated) bridge** (£m)




1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses.
3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses.

# Financial review *continued*

## Earnings per share

Basic earnings per share, in accordance with IAS 33 *Earnings per Share*, from continuing operations, increased by 91% to 49.6p (2007 26.0p).

**Reconciliation from underlying EBITA[2] to underlying earnings[3] – continuing operations**

| | 2008 £m | 2007 £m |
|---|---|---|
| **Underlying EBITA[2]** | **1,897** | 1,449 |
| Net financial expense excluding non-cash finance movements on pensions and financial derivatives, and interest on the debt instrument of the convertible preference shares | **(102)** | (25) |
| | **1,795** | 1,424 |
| Taxation | **(467)** | (371) |
| Interest on the debt instrument of the convertible preference shares | **–** | (13) |
| Minority interests | **(23)** | (21) |
| **Underlying earnings[3]** | **1,305** | 1,019 |
| Weighted average number of shares | **3,519m** | 3,386m |
| **Underlying earnings[3] per share** | **37.1p** | 30.1p |

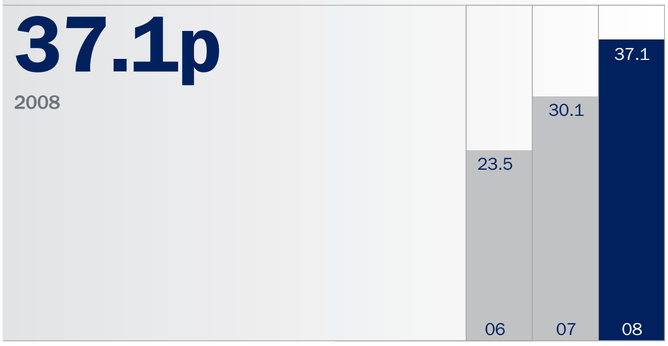
Underlying earnings[3] per share from continuing operations was 37.1p (2007 30.1p), an increase of 23%. The increase in underlying earnings[3] per share is illustrated in the bridge chart opposite.

## Dividends

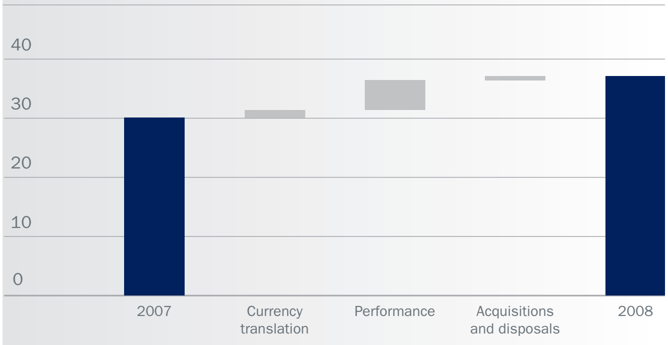
The Board is recommending a final dividend of 8.7p per share (2007 7.8p), bringing the total dividend for the year to 14.5p per share (2007 12.8p), an increase of 13.3%.

The proposed dividend is covered 2.6 times by underlying earnings[3] from continuing operations (2007 2.4 times), which is consistent with the Group's policy of growing the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

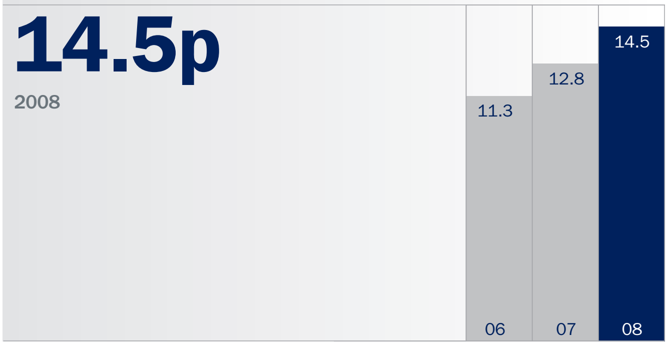
**Underlying earnings[3] per share (restated)** (pence)




**Underlying earnings[3] per share (restated) bridge** (pence)




**Dividend** (pence per share)




1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses.
3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses.

## Balance sheet

### Summary balance sheet

| | 2008 £m | 2007 £m |
|---|---|---|
| Intangible assets | **12,306** | 9,559 |
| Property, plant and equipment, and investment property | **2,558** | 1,887 |
| Equity accounted investments and other investments | **1,040** | 787 |
| Other financial assets and liabilities (net) | **240** | 52 |
| Tax assets and liabilities (net) | **256** | 63 |
| Assets held for resale | **–** | 64 |
| Retirement benefit obligations | **(3,325)** | (1,570) |
| Working capital | **(5,825)** | (5,540) |
| Net cash as defined by the Group[4] | **39** | 700 |
| **Net assets** | **7,289** | 6,002 |

### Exchange rates

| | | |
|---|---|---|
| £/$ – year end | **1.451** | 1.988 |
| £/€ – year end | **1.042** | 1.361 |

Favourable exchange translation, principally in respect of the Group's US-dollar denominated businesses, increased net assets by £1,004m (2007 £42m).

The £2.7bn increase in **intangible assets** to £12.3bn (2007 £9.6bn) mainly reflects goodwill on the acquisition of MTC (£0.1bn), Tenix Defence (£0.3bn) and Detica (£0.4bn), plus US dollar exchange translation of £2.1bn.

The movement in **retirement benefit obligations** during the year was as follows:

| | £m |
|---|---|
| Deficit in defined benefit pension plans at 1 January 2008 | (1,999) |
| Decrease in liabilities due to changes in assumptions | 1,433 |
| Actual return on assets below expected returns | (3,724) |
| Contributions over service cost | 321 |
| Transfers arising on acquisitions | (8) |
| Exchange translation | (240) |
| Other movements | 62 |
| Deficit in defined benefit pension plans at 31 December 2008 | (4,155) |
| US healthcare plans | (61) |
| Total IAS 19 deficit | (4,216) |
| Allocated to equity accounted investments and other participating employers | 891 |
| **Group's share of IAS 19 deficit at 31 December 2008** | **(3,325)** |

The net effect of worse than expected investment returns, an increase in real discount rates and the inclusion of an allowance for a minimum rate of future annual improvements in the mortality assumption has resulted in the Group's share of the pre-tax pension deficit increasing to £3,325m from £1,570m at 31 December 2007.

Further disclosure on the above is provided in note 22 to the Group accounts.

A net deferred tax asset of £1,115m (2007 £522m) relating to the deficit above is included within net tax assets and liabilities and disclosed in note 8 to the Group accounts.

## Cash flow

### Reconciliation of cash inflow from operating activities to net cash

| | 2008 £m | 2007 £m |
|---|---|---|
| Cash inflow from operating activities | **2,009** | 2,162 |
| Capital expenditure (net) and financial investment | **(503)** | (262) |
| Dividends received from equity accounted investments | **89** | 78 |
| Operating business cash flow | **1,595** | 1,978 |
| Interest and preference dividends | **(98)** | (65) |
| Taxation | **(261)** | (112) |
| Free cash flow | **1,236** | 1,801 |
| Acquisitions and disposals | **(1,001)** | (1,574) |
| Debt acquired on acquisition of subsidiary | **(37)** | (538) |
| (Purchase)/issue of equity shares | **(27)** | 603 |
| Equity dividends paid | **(478)** | (396) |
| Dividends paid to minority interests | **(11)** | (1) |
| Preference share conversion | **–** | 245 |
| Cash outflow from matured derivative financial instruments | **(440)** | (14) |
| Movement in cash collateral | **106** | 9 |
| Other non-cash movements | **339** | 62 |
| Foreign exchange | **(374)** | 36 |
| Movement in cash on customers' account[5] | **26** | 32 |
| | **(661)** | 265 |
| Opening net cash as defined by the Group[4] | **700** | 435 |
| **Closing net cash as defined by the Group[4]** | **39** | 700 |

The components of net cash as defined by the Group[4] are as follows:

| | 2008 £m | 2007 £m |
|---|---|---|
| Debt-related derivative financial assets | **203** | – |
| Term deposits – current | **–** | 164 |
| Cash and cash equivalents | **2,624** | 3,062 |
| Loans – non-current | **(2,608)** | (2,197) |
| *Loans – current* | **(154)** | (283) |
| *Overdrafts – current* | **(19)** | (16) |
| Loans and overdrafts – current | **(173)** | (299) |
| Cash on customers' account[5] (included within trade and other payables) | **(7)** | (30) |
| **Closing net cash as defined by the Group[4]** | **39** | 700 |

There was an outflow from **net capital expenditure and financial investment** of £503m (2007 £262m), which included £183m (2007 £52m) in respect of new residential and office facilities in Saudi Arabia.

**Dividends received from equity accounted investments**, primarily BVT, MBDA, Saab and Eurofighter, totalled £89m (2007 £78m).

4 See note 29 to the Group accounts.
5 Cash on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance.

# Financial review *continued*

**Interest and preference dividends** increased to £98m (2007 £65m) largely reflecting the cash cost of business acquisitions.

**Taxation payments** increased by £149m to £261m (2007 £112m) mainly as a result of the higher profits generated by the Group.

During the year, the Group acquired MTC, Tenix Defence and Detica for cash consideration totalling £1.1bn. The cash outflow for **acquisitions and disposals** of £1.0bn is shown net of the proceeds from the disposal of the Group's Surveillance & Attack business and its 50% interest in Flagship Training, which amounted to £134m. Net cash outflow relating to other acquisitions and disposals was £74m. In 2007, the Group acquired Armor Holdings for $4.5bn (£2.2bn).

The Group has financed part of its investment in the US through an intercompany loan. As at 31 December 2008, $2.1bn of a total of $6.6bn was hedged using a rolling programme of short-term foreign exchange hedges. As a consequence of the strengthening of the US dollar, there has been a **cash outflow from matured derivative financial instruments** of £440m in the second half of 2008 from rolling these hedges into 2009.

**Foreign exchange** translation during the year, primarily in respect of the Group's US dollar-denominated borrowing, decreased reported cash by £374m (2007 increased reported cash by £36m).

## Treasury policy

The Group's treasury activities are overseen by the Treasury Review Management Committee (TRMC). Two executive directors are members of the TRMC, including the Group Finance Director who chairs the Committee. The TRMC also has representatives with legal and taxation expertise.

The Group operates a centralised treasury department that is accountable to the TRMC for managing treasury activities in accordance with the framework of treasury policies and guidelines approved by the Board. It is an overriding policy that trading in financial instruments for the purpose of profit generation is prohibited, with all financial instruments being used solely for risk management purposes.

Other key policies are:

– to maintain a balance between continuity of funding and flexibility through the use of borrowings with a range of maturities, currencies and fixed/floating rates of interest reflecting the Group risk profile;

– to maintain adequate undrawn committed borrowing facilities;

– to mitigate the exposure to interest rate fluctuations on borrowings and deposits by utilising interest rate hedging products; and

– to hedge all material firm transactional exposures, unless otherwise approved as an exception by the TRMC, as well as to manage anticipated economic cash flows over the medium term.

Within this policy framework the treasury department's principal responsibilities are:

– to manage the Group's core funding and liquidity;

– to manage exposure to interest rate movements;

– to manage exposure to foreign currency movements;

– to control and monitor bank credit risk and credit capacity utilisation; and

– to manage the Group's relationship with debt capital market investors, banks and rating agencies.

All treasury policies are being kept under close review given the volatility in the financial markets.

The treasury department transacts with a number of counterparty banks and financial institutions, and adopts a systematic approach to the control and monitoring of counterparty credit risk. A credit limit is allocated to each counterparty, with reference to its relevant credit rating. For internal credit risk purposes, all transactions are marked-to-market and the resultant exposure is allocated against the credit limit.

The Group, through its internal audit department, monitors compliance against the principal policies and guidelines (including the utilisation of credit) and any exceptions found are reported to the TRMC.

Further disclosure on financial instruments is set out in note 32 to the Group accounts.

## Capital structure

The Group funds its operations through a mixture of shareholders' funds and borrowing facilities, including bank and capital market borrowings. All the Group's material borrowings are arranged by the central treasury function and funds raised are lent onward to operating subsidiaries as required. The Group's objective is to ensure the continuity of competitively priced funding by borrowing from a range of markets and spreading the maturity dates of the various facilities.

Details of the Group's debt are included in note 20 to the Group accounts. During 2008, the £150m Euro-Sterling bond was repaid. No new long-term or medium-term debt was raised during the year. It remains the Group's intention to ensure the business is funded conservatively and to be pro-active in accessing the bank and capital markets in achieving this aim.

### Liquidity

Strong cash generation in recent years and a prudent financing strategy have resulted in the Group currently being adequately positioned to withstand the credit crisis in the bank and capital markets. The Group had cash and short-term investments at 31 December 2008 of £2,624m (2007 £3,226m). This, together with an undrawn committed Revolving Credit Facility (RCF) of £1.5bn (which is syndicated amongst the Group's core relationship banks), is available to meet expected general corporate funding requirements. Of the £1.5bn undrawn facility,

£45m is with Lehman Brothers Commercial Paper Inc. The RCF provides standby funding for the Group's US Commercial Paper programme. The RCF was contracted originally for five years until 2010. However, it has been extended by two one-year extension agreements until 2012, although the available amount for the final year has been reduced from £1.5bn to £1.3bn. The RCF remained undrawn throughout the year.

Since the start of the credit crisis in the summer of 2007, the Group has adopted a more conservative approach to the investment of its surplus cash, with money market deposits being placed with relatively stronger financial institutions for shorter periods. Bank counterparty credit risk has been, and continues to be, monitored closely on a systematic and ongoing basis, taking account of the size of the institution, its credit rating and its credit default swap price.

Generally, excluding the impact of acquisition or disposal financing, the net cash/debt of the Group is driven by operational performance, the level of receipts on the major contracts and the performance of the equity accounted investments. Historically, the net cash/debt position of the Group is usually at its best at the year end.

The maturity of the Group's borrowings is as follows:

| | **2008 £m** | 2007 £m |
|---|---|---|
| Less than one year | **173** | 299 |
| Between one and five years | **1,557** | 1,157 |
| More than five years | **848** | 1,040 |
| **Loans and overdrafts – current and non-current[6]** | **2,578** | 2,496 |

A more detailed analysis of the Group's loans and overdrafts is provided in note 20 to the Group accounts.

## Insurance

The Group operates a policy of partial self-insurance, with the majority of cover placed in the external market. The Group continues to monitor its insurance arrangements to ensure the quality and adequacy of cover.

## Credit rating

Three credit rating agencies, Moody's Investors Service, Standard and Poor's Ratings Services and Fitch's Investors Service, publish credit ratings for the Group. During the year, all three maintained the outlook for their ratings as stable.

As at 31 December 2008, the Group's long-term credit ratings provided by these agencies were as follows:

| Rating agency | Rating | Outlook | Category |
|---|---|---|---|
| Moody's | Baa2 | Stable | Investment grade |
| Standard & Poor's | BBB+ | Stable | Investment grade |
| Fitch's | BBB | Stable | Investment grade |

The Board continues to view the maintenance of an investment grade credit rating as important to the efficient operation of the Group's activities.

## Critical accounting policies

The Group's significant accounting policies are outlined in note 1 to the Group accounts (page 110). Not all of these significant accounting policies require management to make difficult, subjective or complex judgements or estimates.

The following is intended to provide an understanding of those policies that management considers critical because of the level of complexity, judgement or estimation involved in their application and their impact on the consolidated financial statements. These judgements involve assumptions or estimates in respect of future events, which can vary from what is anticipated. However, the directors believe that the consolidated financial statements reflect appropriate judgements and estimations and provide a true and fair view of our financial performance and position over the relevant period.

### Contract revenue and profit recognition

The majority of the Group's defence activities are conducted under long-term contract arrangements and are accounted for in accordance with IAS 11 *Construction Contracts*.

Revenue is recognised on such contracts when performance milestones have been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved.

Owing to the complexity of many of the contracts undertaken by the Group, the cost estimation process requires significant judgement. It is based upon the knowledge and experience of the Group's project managers, engineers, finance and commercial professionals, and uses the Group's contract management processes. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the contract include the nature and complexity of the work to be performed, availability and productivity of labour, the effect of change orders, the availability of materials, performance of subcontractors, and availability of and access to government-furnished equipment.

Cost and revenue estimates and judgements are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense. Contract costs comprise directly attributable costs, including an allocation of direct overheads. Indirect overheads are only regarded as contract costs when their recovery is explicitly allowed for under the terms of the contract. Indirect costs are otherwise treated as a period cost and are expensed as incurred. Material changes in one or more of these estimates, whilst not anticipated, would affect the profitability of individual contracts.

Where goods are supplied under arrangements not considered to represent construction contracts, as defined by IAS 11, sales are recognised when the significant risks and rewards of ownership have been transferred to the buyer, recovery of consideration is probable, there is no continuing management involvement with the goods and the amount of revenue and costs can be measured reliably.

6 Includes £203m (2007 £nil) of debt-related derivative financial assets presented within other financial assets in the Group's balance sheet.

Where services are rendered, sales are recognised in proportion to the stage of completion when the stage of completion of the services, and the related revenue and costs, can be measured reliably.

Additional details concerning the Group's revenue recognition policy are in note 1 to the Group accounts.

**Retirement benefit plans**
The Group accounts for post-retirement pension and healthcare plans in accordance with IAS 19 *Employee Benefits*.

For defined benefit retirement plans, the cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of recognised income and expense. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period until the benefits become vested.

The retirement benefit obligations recognised in the balance sheet represent the present value of the defined benefit obligations as adjusted for unrecognised past service cost and as reduced by the fair value of scheme assets.

The main assumptions made in accounting for the Group's post-retirement plans relate to the expected return on investments within the Group's plans, the rate of increase in pensionable salaries, the rate of increase in the retail price index, the mortality rate of plan members and the discount rate applied in discounting liabilities. For each of these assumptions there is a range of possible values and, in consultation with our actuaries, management decides the point within that range that most appropriately reflects the Group's circumstances. Small changes in these assumptions can have a significant impact on the size of the deficit calculated under IAS 19.

The Group has allocated an appropriate share of the pension deficit to its equity accounted investments and other participating employers using a consistent and reasonable method of allocation which represents, based on current circumstances, the directors' best estimate of the proportion of the deficit anticipated to be funded by these entities. The Group's share of the pension deficit allocated to equity accounted investments is included on the balance sheet within equity accounted investments.

The valuing of assets and liabilities at a point in time rather than matching expectations of assets and liabilities over time has no impact on short-term cash contributions to the pension plans. These funding requirements are derived from separate independent actuarial valuations.

Additional details concerning the Group's retirement benefit plans are given in note 1 and note 22 to the Group accounts.

**Intangible assets**
In accordance with IFRS 3 *Business Combinations*, goodwill arising on acquisition of subsidiaries is capitalised and included in intangible assets. Goodwill on acquisition of joint ventures and associates is included in equity accounted investments. IFRS 3 also requires the identification of other acquired intangible assets. The techniques used to value these intangible assets are in line with internationally used models, but do require the use of estimates which may differ from actual outcomes. Future results are impacted by the amortisation period adopted for these items and, potentially, any differences between estimated and actual circumstances related to individual intangible assets.

Goodwill is not amortised, but is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment review calculations require the use of estimates related to the future profitability and cash-generating ability of the acquired business. Additional details concerning the Group's treatment of intangible assets and impairment reviews are given in note 1 to the Group accounts.

# Our operating structure

The Group has four principal operating groups organised around a combination of the different products and services they provide, and the geographical area in which they operate.

**Ian King**
Chief Executive,
BAE Systems plc

**Walt Havenstein**
Chief Operating Officer,
President and CEO,
BAE Systems, Inc.

## Electronics, Intelligence & Support

**Mike Heffron**
President, Electronics,
Intelligence & Support

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## Land & Armaments

**Linda Hudson**
President,
Land & Armaments

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## Programmes & Support

**Nigel Whitehead**
Group Managing Director,
Programmes & Support

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## International

**Guy Griffiths**
Group Managing Director,
International

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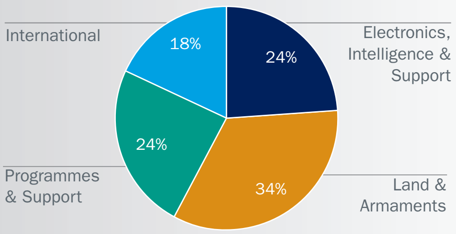
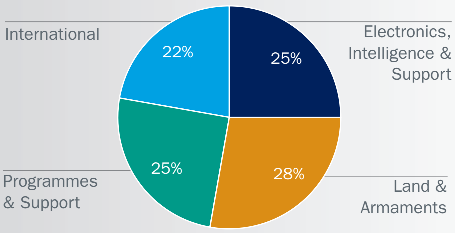
## 2008 operating group performance

The charts below illustrate the contribution of each of the four operating groups to the Group's sales[1,3] and underlying EBITA[2] in the year:

**Sales[1,3] by operating group[4]** (%)




**Underlying EBITA[2] (restated) by operating group[4]** (%)




A reconciliation of the performance of the individual operating groups to the Group's results, discussed in the Financial review on pages 28 to 32, is given on page 45.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Before elimination of intra-group sales.
4 Excluding HQ & Other Businesses.

# Electronics, Intelligence & Support

The Electronics, Intelligence & Support operating group, with 33,900 employees[1] and headquartered in the US, designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications. The operating group comprises four lines of business: Electronic Solutions, Information Solutions, Platform Solutions and Support Solutions.

## Financial highlights

- Like-for-like organic sales[1] growth of 6% over 2007
- Underlying EBITA[2] includes a credit of £23m from share scheme mark-to-market accounting
- Order book[1] increased

## Performance

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Sales[1] | **£4,459m** | £3,916m | £4,007m |
| Underlying EBITA[2] (restated) | **£506m** | £437m | £429m |
| Return on sales | **11.3%** | 11.2% | 10.7% |
| Cash inflow[3] | **£380m** | £302m | £273m |
| Order intake[1] | **£4,904m** | £4,178m | £4,311m |
| Order book[1] | **£5.2bn** | £3.5bn | £3.4bn |

## Key points

- Maintained leadership in electronic warfare systems
- Won key IT, situational awareness and aviation sustainment contracts
- Addressing market for vehicle power management systems
- Sustained leadership in US non-nuclear ship repair
- Increased research and development investment

## Looking forward

BAE Systems projects further growth as it delivers on its record order book and builds on existing enterprise capabilities, and continued research and development expenditure, to meet expected customer demand in cyber-space activity, and through-life product support of defence and aerospace electronics programmes. Growth in services, mission support and sustainment markets is expected to continue.

In 2008, Electronics, Intelligence & Support (EI&S) achieved underlying EBITA[2] of £506m (2007 £437m) on sales[1] of £4,459m (2007 £3,916m) and generated operating cash inflow[3] of £380m (2007 £302m).

On a like-for-like basis, sales[1] growth was 6% over 2007.

In June, BAE Systems completed the acquisition of MTC Technologies which contributed post-acquisition sales[1] of $181m (£98m) and underlying EBITA[2] of $2m (£1m).

### Electronic Solutions

The low-rate initial production contract for the US Navy's decoy system on the F/A-18 E/F Super Hornet was received. The system provides aircraft defence against radar-guided missiles.

The F-35 Lightning II low-rate initial production (LRIP) of two electronic warfare suites continues, with existing funding providing deliveries through to 2012.

BAE Systems was selected as a partner in developing and producing the Airborne Maritime Fixed Station Joint Tactical Radio Systems (JTRS), which will consist of software-defined radios that enable commanders to share information across ships, enhance decision-making, and increase mission capability. With this award, BAE Systems is now a partner on all five programmes that comprise JTRS, the family of software-programmable tactical radios that will permit combat personnel to communicate at every level of command.

Deliveries commenced under a five-year contract to provide thermal imaging modules for the US Army's Common Remotely Operated Weapon System that allows soldiers to detect and identify targets while remaining protected in their vehicles. To date, orders received under this contract total $110m (£76m). A $169m (£116m) extension from the US Army for continued production of thermal weapon sights was received. This programme has a production rate of 1,500 units per month, with more than 37,000 delivered by the end of 2008.

In support of homeland security and safety, JETEYE®, the infrared aircraft missile defence system, began its nine-month evaluation aboard civilian passenger aircraft in July and First InterComm™, an interoperable communications and data solution system for first responders, has been deployed in seven US states.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments.

US defence research and development programmes launched in 2008 included bio-inspired, miniature, intelligence-gathering robots, tactical ultra-low visibility communications, advanced night vision technology, and all-weather advanced persistent surveillance systems. These programmes represent the strengthening of core business areas as well as advances into new market areas.

**Information Solutions**
Our Information Technology business continues to be ranked in the top 25 by Computer World Magazine as a Best Place to Work in IT.

Five multiple and one single-award indefinite delivery/indefinite quantity contracts were received in the year, including a position on the Defense Information Systems Agency's Encore II contract.

**Platform Solutions**
Following the launch of its improved HybriDrive® propulsion system, BAE Systems' partner, Alexander Dennis, delivered its first double-deck hybrid electric bus to Transport for London with the buses scheduled to enter revenue-service testing in 2009. BAE Systems also expanded the global reach of the HybriDrive® programme by entering into agreements with Japan's ISUZU and North America's New Flyer Industries.

Collaborating with Land & Armaments, the business will provide power management components on board the Warrior demonstration vehicle supporting the UK Ministry of Defence programme to create an architecture that allows vehicles to power systems such as communications and electronic warfare suites. The same architecture will allow future upgrades to add more accessories and convert hydraulic systems to electrically powered systems.

## Capability

**EI&S's UK site became an Authorised Economic Operator and the first multinational organisation to attain this industry standard for supply chain security. The European Union certification gives priority customs clearance and increased security for shipments entering or leaving the European Union, helping drive integration of the EI&S global supply base.**

## Innovation

**BAE Systems is leading a team of scientists to develop miniature robots to improve military situational awareness. The business signed a $38m (£26m) contract with the US Army Research Laboratory to develop autonomous, multi-functional intelligence-gathering robots that can operate in places too inaccessible or dangerous for humans.**

**Support Solutions**
The US Air Force named BAE Systems one of 12 prime contractors on the Future Flexible Acquisition and Sustainment Tool contract. This indefinite delivery/indefinite quantity contract, under which prime contractors compete for task orders, has a total potential value of $6.9bn (£4.8bn). The contract will address future US Air Force requirements for modifications, development, and maintenance of weapon systems managed by the US Air Force and Air Force Special Operations Command.

BAE Systems received a US Air Force contract to support the Tactical Air Control Party (TACP) Modernisation Vehicular Communications System programme. With an initial value of $120m (£83m) and a maximum potential value of $233m (£161m), BAE Systems will design, produce and install state-of-the-art communications for up to 400 TACP ground vehicles.

In the ship repair business, work continues at the San Diego shipyard to maintain, repair, and modernise the guided missile cruiser USS Bunker Hill, and efforts are progressing on a five-year multi-ship, multi-option contract to maintain and repair all Arleigh Burke-class destroyers. The US Navy awarded BAE Systems a post-shakedown availability contract for destroyers and a multi-ship multi-option award for repairs to mine countermeasures ships.

In June, the acquisition of MTC Technologies provided the business with increased technical and professional service capabilities, and equipment integration and modernisation capabilities for the US military and intelligence customers.

In 2008, the Technology Solutions and Services business won all of its major recompetes.

# Land & Armaments

The Land & Armaments operating group, with 21,300 employees[1] and headquartered in the US, is a global leader in the design, development, production, through-life support and upgrade of armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems and munitions.

## Financial highlights

- Like-for-like organic sales[1] growth of 38% over 2007
- UK business secured a 15-year munitions partnering agreement with growth potential to £3bn
- Ex-Armor Holdings business performing ahead of expectations

## Performance

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Sales[1] | **£6,407m** | £3,538m | £2,115m |
| Underlying EBITA[2] (restated) | **£566m** | £324m | £168m |
| Return on sales | **8.8%** | 9.2% | 7.9% |
| Cash inflow[3] | **£467m** | £10m | £137m |
| Order intake[1] | **£8,568m** | £4,535m | £2,964m |
| Order book[1] | **£11.5bn** | £7.3bn | £4.9bn |

## Key points

- High volume of vehicle reset and upgrade activity
- Successfully addressed US mine protected vehicle requirements
- 15-year UK munitions partnering agreement secured
- Wheeled armoured vehicle successes
- Joint Light Tactical Vehicle down select

## Looking forward

After a period of significant growth primarily driven by deliveries on the short-term Mine Resistant Ambush Protected programme, demand in the medium term is expected to be influenced by the tempo of operations in Iraq and Afghanistan.

Land & Armaments will continue to pursue opportunities globally leveraging leadership positions in Tracked Combat Systems, Medium Tactical Vehicles, Mine Resistant Vehicles, Armour and Survivability Technologies and Artillery Systems.

In 2008, Land & Armaments achieved underlying EBITA[2] of £566m (2007 £324m) on sales[1] of £6,407m (2007 £3,538m) and generated operating cash inflow[3] of £467m (2007 £10m). The 2008 results included sales[1] of $3.1bn (£1.7bn) from the largely completed Mine Resistant Ambush Protected (MRAP) programme. The results include a full year of operations from the former Armor Holdings, Inc. business acquired in July 2007.

### United States

The MRAP vehicle programme was largely completed in 2008, with global production of 4,714 mine protected vehicles.

In addition to the MRAP programmes, continued growth was secured in the area of vehicle armour protection, most notably for the High Mobility Multi-purpose Wheeled Vehicles (HMMWV) and individual soldier protection. The business was also awarded a $3.7bn (£2.6bn) contract for the production of 20,000 Family of Medium Tactical Vehicles (FMTVs).

The sole-sourced Medium Mine Protected Vehicle (MMPV) programme was awarded with orders in 2008 totalling $110m (£76m). The MMPV contract envisions production of up to 2,500 vehicles at a potential value of $2.2bn (£1.5bn) through to 2015.

BAE Systems continued to serve as the premier support agency for the US Army Heavy Brigade Combat Team, providing remanufacturing and reset for key brigade components, including the Bradley Fighting Vehicle, as well as unveiling mortar and ambulance variants of the Bradley.

BAE Systems secured two technology development contracts for the US multi-service Joint Light Tactical Vehicle (JLTV). These 27-month contracts are the next step in selecting a new generation of tactical vehicles.

In the year, BAE Systems unveiled the first Non-Line-of-Sight Cannon (NLOS-C) for the US Army's Future Combat Systems Manned Ground Vehicles programme. Two vehicles are undergoing firing and mobility tests at Army testing facilities, with four additional vehicles undergoing integration. Along with the NLOS-C deliveries, successful test firing continued for the NLOS-C mortar platform.

BAE Systems' 57mm Mk 110 Naval Gun System was selected for the National Security Cutter and Littoral Combat Ship programmes, the gun systems entering into service in August and November, respectively.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments.

### United Kingdom
The munitions business secured a 15-year partnering agreement with growth potential to £3bn from the UK Ministry of Defence (MoD) in August covering the supply of approximately 80% of general munitions consumed by UK Armed Forces, including small arms and medium-calibre ammunition, mortar bombs, tank ammunition and artillery shells. Under the contract, BAE Systems will invest over £120m in new, highly-automated facilities.

The Weapons & Vehicles business secured significant work supporting operations in Iraq and Afghanistan, particularly in carrying out urgent upgrades to vehicles such as Bulldog, CVR(T), Warrior and Panther to protect against rapidly-evolving threats. The commitment and support given by the business to finding innovative solutions for Urgent Operational Requirements (UORs) in very tight timescales has been recognised by the customer on several occasions and 15 employees were awarded campaign medals by the MoD for their support in theatre.

Production of the M777 155mm lightweight howitzer programme continues, with 168 guns delivered in 2008 and a total of 737 guns ordered to date, to the US and Canadian armed forces. The M777 system has been deployed in operations in both Iraq and Afghanistan.

Requirements and schedule changes on the challenging Terrier armoured tractor programme have now been agreed with the customer. The programme has been rebaselined, and includes further improvements to protection levels and the robustness of the vehicle. Pre-production and proving of the Terrier will commence in 2009.

### Sweden
The Swedish business underwent two restructuring measures in the year in order to better position the business to match future strategic demands.

A contract for 20 BvS10 VIKING amphibious armoured all-terrain vehicles was received from the UK MoD, bringing the total number of vehicles ordered by the MoD to 149.

BAE Systems is partnered with Raytheon on the Excalibur artillery programme, the next generation family of guided projectiles for the US Army and Marine Corps artillery.

The 155mm Archer self-propelled Artillery System has been selected by Sweden and Norway with contracts to be awarded for up to 48 systems.

### South Africa
The South African business benefited significantly in the year from support to the US MRAP programme as well as the growing international requirement for mine-protected wheeled vehicles. A total of 475 RG31s were delivered to customers worldwide in 2008 bringing the total of RG31s sold to over 2,200. The business acquired IST Dynamics in August 2008, building on its systems integration capability, particularly in the areas of Turret Systems and Fire-Control Systems.

## Non-Line-of-Sight Cannon (NLOS-C)

**The NLOS-C is an indirect fire support component of the Manned Ground Vehicle family. It is a self-propelled howitzer with a two-man crew. It will provide networked, extended-range, responsive and sustained precision attack of point and area targets in support of the Future Combat System programme. The first NLOS-C prototype debuted on Capitol Hill during the summer of 2008.**

## Family of Medium Tactical Vehicles (FMTV)

**FMTV provides the US Army's backbone for tactical unit mobility and logistics support throughout the battlefield. More than 48,000 FMTV trucks and trailers are in service with the US Army. An added measure of success in 2008 was the award of a contract and the exercise of an option for a total of 20,000 FMTV vehicles by the US Department of Defense.**

# Programmes & Support

The Programmes & Support operating group, with 30,200 employees[1], comprises the Group's UK-based air and naval activities, the activities of the acquired Detica security business and the Integrated System Technologies business.

## Financial highlights

- Sales[1] reduced over 2007 on Brunei OPV completion and transition to Typhoon Tranche 2 deliveries
- Return on sales[1] improved to 10.6%
- Typhoon Tranche 2 pricing agreed

## Performance

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Sales[1] | **£4,638m** | £5,327m | £4,615m |
| Underlying EBITA[2] (restated) | **£491m** | £456m | £331m |
| Return on sales | **10.6%** | 8.6% | 7.2% |
| Cash inflow[3] | **£651m** | £807m | £449m |
| Order intake[1] | **£4,195m** | £9,091m | £5,178m |
| Order book[1] | **£19.8bn** | £20.9bn | £17.0bn |

## Key points

- Successful transition to start of Typhoon Tranche 2 deliveries
- BVT naval joint venture formed
- Manufacturing contract for Future Carriers secured
- Detica acquisition completed
- First Type 45 successfully delivered off contract

## Looking forward

Programmes & Support is driven by its existing order book and the level of future UK MoD funding to meet current UK armed forces operational requirements and delivery of the Defence Industrial Strategy.

The BVT joint venture is underpinned by the six ship Type 45 programme, the manufacturing phase of the Future Aircraft Carrier (CVF) programme and export contracts.

Detica's position in the UK market means that it is well-positioned to benefit from increasing government focus on intelligence, security and resilience.

During 2008, Programmes & Support achieved underlying EBITA[2] of £491m (2007 £456m) on sales[1] of £4,638m (2007 £5,327m) and generated an operating cash inflow[3] of £651m (2007 £807m). The lower sales[1] in 2008 reflect the transition from Typhoon Tranche 1 deliveries to Tranche 2 and completion in 2007 of the Brunei Offshore Patrol Vessel (OPV) contract. The acquisition of Detica in September contributed sales[1] and underlying EBITA[2] of £55m and £9m, respectively.

### Military Air Solutions

Military Air Solutions is responsible for delivering a range of military programmes including Typhoon, Hawk, Nimrod MRA4, F-35 Lightning II and autonomous air vehicles. In addition, it is responsible for through-life support to Harrier, Hawk, Tornado, Nimrod MR2, E-3D Sentry and VC-10 aircraft.

The business made good progress during 2008 in delivering on its programme commitments. Work continues with the UK MoD to explore whether a long-term partnering agreement (LTPA) in the air sector may provide mutual value to both parties.

Delivery of Typhoon aircraft to the four partner nations continues with a cumulative total of 57 aircraft delivered to the UK and 97 to the other European partner nations. All Tranche 1 aircraft have now been delivered and Tranche 2 deliveries commenced. In October, the first flight of a Typhoon aircraft for the Saudi customer took place marking the start of the flight test programme.

In the UK, Royal Air Force (RAF) Typhoons are operational in Air Defence and Quick Reaction Alert roles, and have a full multi-role capability. Discussions to establish a long-term, availability-based support contract are progressing. Work has also commenced on further air-to-ground capability enhancements. Discussions regarding the Tranche 3 requirements of each of the four partner nations are ongoing.

On the Hawk contract for India, 23 of the UK-built aircraft have been accepted by the customer and have been inducted to the Indian Air Force. Customer acceptance of the last of the 24 Hawk aircraft for South Africa took place in November.

The first five South African Gripen aircraft have been accepted by the customer to plan.

Aircraft acceptances of the Hawk Mk128 Advanced Jet Trainer for the RAF are expected to commence in early 2009, with RAF pilots then starting their Mk128 conversion flying programme. Support under the Hawk Integrated Operational Support programme, and provision of synthetic training to RAF fast jet pilots, continues at RAF Valley.

The current Nimrod MRA4 aircraft development programme is progressing with completion of the flight test programme and qualification of the aircraft systems expected during 2009. All nine production standard aircraft are in manufacture.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments.

The contracts for VC-10, Sentry and Nimrod MR2 aircraft support continue, and a contract expansion for much of the on-base engineering, logistics and technical support for the VC-10 has been secured.

The Tornado availability programme, ATTAC, is in full service and continues to perform in line with contractual milestones.

The Harrier GR9 upgrade programme is on schedule. The Harrier aircraft is currently providing close air support to UK military operations overseas. Discussions are progressing on contracting for a Harrier availability service.

All three F-35 Lightning II aircraft variants, Carrier, Conventional Take-Off and Landing, and Short Take-Off and Vertical Landing (STOVL), are now in various stages of manufacture and assembly. The STOVL variant had its maiden flight in June. Low-rate initial production continues under contract from Lockheed Martin.

BAE Systems continues to leverage its expertise in Unmanned Aircraft Systems (UAS) and position itself in this growth market. In addition to the existing Taranis programme, which is a key enabler to the UK MoD's evaluation of future requirements, BAE Systems has entered into a jointly funded UK MoD Mantis advanced technology demonstrator programme. The aim of this programme is to demonstrate the potential of a large unmanned system to support future operational needs. The UAS portfolio also includes the HERTI surveillance system. The pre-production HERTI unmanned air system has been operating at fully active overseas customer airbases integrated with manned platform operations.

The redundancy programme announced in April affecting over 600 jobs at the Brough and Woodford sites is progressing towards its 2010 completion.

**BVT Surface Fleet Limited (BVT) (55% interest)**
The joint venture between BAE Systems and VT Group (VT) was formed on 1 July 2008, creating the UK's leading provider of surface warship building and through-life support operations. Following formation, BVT signed the manufacturing contract for the Future Aircraft Carrier (CVF) and has assumed overall responsibility for delivery of the programme, including project management, engineering, shipbuild and integration. BVT is also responsible for the engineering and build of blocks 2 and 4. The cutting of steel for the first ship is planned for spring 2009.

The programme to build six Type 45 Destroyers has progressed well during the year with all key milestones being achieved, including the successful completion of sea trials and acceptance off contract by the customer of the first of class ship, HMS Daring.

Both contracts to build three Ocean Patrol Vessels for the Royal Navy of Oman and three Offshore Patrol Vessels for the Trinidad and Tobago Coastguard are projected to incur significant losses. Consistent with estimates provided by BVT management, loss provisions of £96m (£53m at our 55% share) have been recorded through fair value accounting. As a result of a review of these export contracts, which were contributed by VT into BVT, BAE Systems is in negotiation with VT regarding a possible injection of capital by VT into the BVT business.

In September 2008, a contract was received to support the construction of two further Fast Attack Craft for the Hellenic Navy, building on the successful contract for the previous five vessels.

The last of the three ex-Royal Navy Type 23 frigates for the Chilean Navy completed its reactivation and was handed over to the customer.

In January 2009, VT announced that it has decided to exercise its put option to sell its interest in BVT to BAE Systems and that it expects to be in a position to exercise that option by 1 July 2009.

**Submarine Solutions**
In a challenging year for the Astute programme, HMS Astute, the first of class, is now scheduled for delivery to the customer at the end of 2009. Orders have been received to continue the build of boat 4 and for long lead items on boat 5.

**Detica**
BAE Systems acquired Detica, a leading UK consultancy servicing the counter-threat agenda, in September 2008. Detica employs 1,400 staff. Detica helps its clients tackle terrorism and serious crime by helping them collect, manage and exploit information to reveal actionable intelligence. Services range from business and technology consulting, system integration and support to the sale of proprietary hardware and software.

Detica assists clients with initiatives in areas such as counter-terrorism, serious and organised crime, and immigration and border control, as well as fraud detection and identity management through its sales of Detica NetReveal® software. Its financial services business remains challenged by current market conditions.

Detica's sales for the full year increased by 20% on 2007 reflecting higher sales to the UK government and, in particular, growth in sales of Detica NetReveal® software.

**Integrated System Technologies (Insyte)**
Following the successful sea trials of the first of class Type 45 destroyer, HMS Daring, during 2008, the Sampson Radar, Combat Management System and Long Range Radar are all now fitted to the next three ships.

The Seawolf Mid-Life Update system has now passed successful system harbour trials and is undertaking sea trials on the Type 23 HMS Sutherland.

The establishment of the Maritime Composite Training Systems, state-of-the-art training facilities at HMS Collingwood and Royal Naval Base Devonport, will be achieved in 2009.

The Sting Ray lightweight torpedo programme remains ahead of schedule with the fourth batch of production weapons accepted by the customer in November 2008. Progress on securing an export order for this torpedo is well advanced.

## Autonomous systems

**The need to avoid exposing individuals to dangerous or difficult environments has driven the development of unmanned and autonomous systems. The pre-production HERTI unmanned air system has been operating at fully active overseas customer airbases integrated with manned platform operations.**

# International

The International operating group, with 19,200 employees[1], comprises the Group's businesses in Saudi Arabia and Australia, together with a 37.5% interest in the pan-European MBDA joint venture, a 20.5% shareholding in Saab of Sweden and a 49% shareholding in Air Astana.

### Financial highlights

- Aggregate return on sales[1] maintained at 13% for the sector
- Cash inflow[3] reflects utilisation of advances received in 2007 on the Salam Typhoon programme
- Post-acquisition sales[1] of £130m from Tenix Defence

### Performance

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Sales[1] | **£3,333m** | £3,359m | £3,428m |
| Underlying EBITA[2] (restated) | **£435m** | £435m | £412m |
| Return on sales | **13.1%** | 13.0% | 12.0% |
| Cash inflow[3] | **£163m** | £678m | £171m |
| Order intake[1] | **£4,065m** | £3,876m | £3,854m |
| Order book[1] | **£11.0bn** | £7.9bn | £7.1bn |

### Key points

- Saudi Typhoon programme (Salam) progressing to schedule
- Tenix Defence acquisition completed; price adjustments in negotiation
- Impairment taken of £120m on Saab carrying value

### Looking forward

The Group seeks to sustain its long-term presence in the Kingdom of Saudi Arabia through delivering on current programme and industrialisation commitments, and developing new business. In Australia, the acquisition of Tenix Defence and reinforcement of the business as through-life capability partner to the Australian Defence Force across all domains, are expected to provide growth in the near term.

During 2008, the International operating group achieved underlying EBITA[2] of £435m (2007 £435m) on sales[1] of £3,333m (2007 £3,359m) and generated an operating cash inflow[3] of £163m (2007 £678m) as advances received in 2007 on the Salam Typhoon programme were utilised. In June 2008, BAE Systems completed the acquisition of Tenix Defence, which contributed sales[1] of £130m and a £12m post-acquisition loss[2] after including integration costs.

**CS&S International**

BAE Systems has a major presence in the Kingdom of Saudi Arabia where it acts as prime contractor for the UK government-to-government defence agreement. Progress continues to be made to modernise the Saudi armed forces in line with the Understanding Document signed in December 2005 between the UK and Saudi Arabian governments.

Under the 2007 contract for the supply of 72 Typhoon aircraft, the first aircraft remains on schedule for delivery in June 2009. Discussions continue with the Royal Saudi Air Force (RSAF) to agree the support and training solutions for the aircraft to enable their entry into service during 2009.

The support provided under the Saudi British Defence Co-operation Programme continues to provide operational capability to both the RSAF and Royal Saudi Naval Forces operations. In particular, work is ongoing in partnership with the RSAF to maintain and enhance the capability of the Tornado aircraft while extending its operational life.

In addition to some 1,500 employees in the UK, around 4,400 people are employed by the Group in the Kingdom of Saudi Arabia of whom approximately half are Saudi nationals. The business continues to develop its presence in Saudi Arabia and remains committed to developing a greater indigenous capability in the Kingdom.

The security of employees is the highest priority and new residential and office facilities were completed in 2008, incorporating increased security measures and a greater range of pastoral and recreational facilities for the workforce. Further facilities will be completed in 2010.

Work is ongoing at a senior level to refine the strategy for securing a greater proportion of business in the land sector. The Royal Saudi Land Forces are anticipated to require upgrades and capability enhancements in future years.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments.

**Australia**

Following the acquisition of Tenix Defence during 2008, including 100% of the former joint venture company Tenix Toll Defence Logistics, BAE Systems is now the largest defence contractor in Australia. This acquisition has ensured that BAE Systems Australia can offer capability across the aerospace, land, maritime and joint domains.

BAE Systems Australia is a subcontractor to Boeing to deliver the ground and air subsystems of the Wedgetail Airborne Early Warning and Control programme. Wedgetail has experienced significant schedule delays and cost overruns. An agreement was reached with Boeing that defines and concludes the Group's role in delivering the ground subsystem by June 2009.

The Australian government has re-evaluated its requirements under the Land 121 contract for the supply of medium and heavy tactical trucks and is issuing a revised Request for Tender. BAE Systems Australia remains in the competition with responsibility for tendering (and carrying out the project) transferred from BAE Systems, Inc. to BAE Systems Australia.

Major programmes now in BAE Systems Australia's portfolio following the Tenix Defence acquisition include the prime contract for the supply of two Landing Helicopter Dock (LHD) ships to the Royal Australian Navy, and the supply of one multi-role, two offshore and four inshore patrol vessels to the New Zealand Ministry of Defence. The LHD programme is in the early stages of a fixed price development programme that will need continued focus to deliver the contracted outcomes. The multi-role vessel under the New Zealand contract has been accepted by the customer, but a number of warranty claims have subsequently been made. The remaining vessels will be progressively presented for acceptance in 2009. The completion accounting process for the Tenix Defence acquisition is ongoing.

## Australia

**The acquisition of Tenix Defence in Australia is a clear reflection of BAE Systems' home market strategy, developing the Group's position as the premier global defence, security and aerospace company. The Group will expand and develop in Australia with through-life support solutions and services activities, continuing to support the Australian customer base with an even broader capability.**


## Saudi Arabia

**The latest development in a long-standing relationship with Saudi Arabia will see the provision of 72 Typhoons and associated training to around 300 Royal Saudi Air Force technicians in the UK. The training programme has been designed by BAE Systems to produce multi-skilled aircraft technicians.**

**Saab (20.5% shareholding)**

Saab's sales were SEK23.8bn (£2.0bn), with export sales accounting for 68%. Operating income was SEK166m (£14m), producing an operating margin of 0.7%.

The Group has taken an impairment of £120m against the carrying value of its shareholding in Saab, reflecting a significant reduction in Saab's share price during the year.

**MBDA (37.5% interest)**

MBDA's performance in 2008 delivered an increasing return on sales on broadly unchanged sales volume.

Key domestic production deliveries included Mica air-to-air missiles, Aster surface-to-air missiles, Seawolf naval air defence missiles and Taurus cruise missiles. 2008 saw the completion of deliveries on the UK MoD's Brimstone air-to-ground missile programme and export deliveries of an air weapons package to Greece. MBDA delivered over 2,500 missiles in 2008.

Development programmes continue to progress well. 2008 saw a number of successful development firings on key programmes, including the Meteor and Aster weapon systems.

As the UK MoD's designated lead contractor in managing its complex weapons sector under the Defence Industrial Strategy, MBDA secured a series of important Assessment Phase contracts for new programmes, including the Fire Shadow loitering munition which was successfully fired early in 2008, completing a rapid development demonstrator programme lasting just 15 months. An important contract amendment has also been received on the Meteor (air-to-air missiles) development contract to re-align the programme to a revised customer timetable. A 15-year availability contract to support the Seawolf missile system was secured.

A key export contract win was for the £398m Spada air-to-surface weapon system to Pakistan.

# HQ & Other Businesses

HQ & Other Businesses, with 1,800 employees[1], comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

## Financial highlights

– FRIP dispute settled with all major reinsurers

## Performance

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Sales[1] | **£235m** | £243m | £295m |
| Underlying EBITA[2] (restated) | **£(101)m** | £(203)m | £(146)m |
| Cash (outflow)/inflow[3] | **£(66)m** | £181m | £(225)m |
| Order intake[1] | **£212m** | £345m | £267m |
| Order book[1] | **£0.4bn** | £0.4bn | £0.3bn |

## Looking forward

Market conditions in the aircraft asset management business are increasingly challenging given the economic downturn and restrictions on available credit to higher risk customers which is an increasing feature of new markets. Losses are expected to continue at levels comparable to 2008.

During 2008, HQ & Other Businesses reported a loss[2] of £101m (2007 loss[2] £203m) on sales[1] of £235m (2007 £243m) and had an operating cash outflow[3] of £66m (2007 inflow[3] £181m). Of this, the reported loss[2] for Regional Aircraft was £17m (2007 £105m) with operating cash outflow[3] of £3m (2007 inflow[3] £175m).

The commercial aircraft market has become increasingly challenging with the tightened availability of funding to aircraft operators due to the global credit issues and economic slowdown. Oil prices have been high over the year impacting operator profitability and their operational cash flows. Discussions are ongoing with operators as to their future fleet requirements and marketing activity is focused on both uncontracted idle and returning aircraft. During 2008, the Regional Aircraft business placed 75 aircraft through new leases, extensions with existing customers and sales. Support revenues have fallen on lower demand for aircraft components and services. Power-by-the-hour contracts worth £43m in 2008 were secured.

Historically, much of the leasing business has been underpinned by the Group's Financial Risk Insurance Programme (FRIP) which made good shortfalls in actual lease income against originally estimated future income for a 15-year period from 1998 to 2013. Since 2006, the Group and certain reinsurers have been in dispute over several areas of the policy. During 2007 and 2008, agreements were reached with all major reinsurers and settlements paid by them.

The balance sheet carrying value of aircraft (£240m) is based on the net present value of forecast future net leasing or disposal income and reflects the current adverse economic climate.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Net cash (outflow)/inflow from operating activities after capital expenditure (net) and financial investment, and dividends from equity accounted investments.

# Operating group performance summary

The Board monitors the financial performance of the Group at an operating group level. Certain of the financial measures are regarded as Key Performance Indicators (KPIs).

### Operating group performance summary 2008

| | Sales[1] £m | Underlying EBITA[2] (restated) £m | Return on sales % | Cash flow[3] £m | Order intake[1] £m | Order book[1] £bn |
|---|---|---|---|---|---|---|
| Electronics, Intelligence & Support | **4,459** | **506** | **11.3** | **380** | **4,904** | **5.2** |
| Land & Armaments | **6,407** | **566** | **8.8** | **467** | **8,568** | **11.5** |
| Programmes & Support | **4,638** | **491** | **10.6** | **651** | **4,195** | **19.8** |
| International | **3,333** | **435** | **13.1** | **163** | **4,065** | **11.0** |
| HQ & Other Businesses | **235** | **(101)** | | **(66)** | **212** | **0.4** |
| | **19,072** | **1,897** | | **1,595** | **21,944** | **47.9** |
| Intra-group | **(529)** | **–** | | **–** | **(635)** | **(1.4)** |
| | **18,543** | **1,897** | **10.2** | **1,595** | **21,309** | **46.5** |

### Operating group performance summary 2007

| | Sales[1] £m | Underlying EBITA[2] (restated) £m | Return on sales % | Cash flow[3] £m | Order intake[1] £m | Order book[1] £bn |
|---|---|---|---|---|---|---|
| Electronics, Intelligence & Support | 3,916 | 437 | 11.2 | 302 | 4,178 | 3.5 |
| Land & Armaments | 3,538 | 324 | 9.2 | 10 | 4,535 | 7.3 |
| Programmes & Support | 5,327 | 456 | 8.6 | 807 | 9,091 | 20.9 |
| International | 3,359 | 435 | 13.0 | 678 | 3,876 | 7.9 |
| HQ & Other Businesses | 243 | (203) | | 181 | 345 | 0.4 |
| | 16,383 | 1,449 | | 1,978 | 22,025 | 40.0 |
| Intra-group | (673) | – | | – | (851) | (1.4) |
| | 15,710 | 1,449 | 9.2 | 1,978 | 21,174 | 38.6 |

Sales[1], underlying EBITA[2], cash flow[3] and order intake[1] are Group KPIs. See pages 24 and 25 for a review of these KPIs on a Group basis.

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
3 Net cash inflow/(outflow) from operating activities after capital expenditure (net) and financial investment and dividends from equity accounted investments.

# Responsibility

## "Leadership in standards of global business conduct"

We are continuing to embed a high performance culture at the heart of our Company by developing global leadership in standards of business conduct, a total commitment to safety, support for skills development and by embracing inclusiveness throughout our organisation.

## Responsibility contents

4

# "Ethics is fundamental to our reputation"

**Raj Rajagopal** Managing Director, Corporate Responsibility

The Group is determined that it should be recognised as a leader in responsible business worldwide, and we continue to strive for ways to improve our business and its reputation.

## Our approach

Delivery of our Corporate Responsibility agenda is now firmly embedded as a Group Strategic Objective within the Group's strategy (see page 10). This reflects the increased emphasis and importance placed on ensuring that the Group's commitment to total performance includes every aspect of business, not only financial and programme performance, but also business conduct and the Corporate Responsibility agenda. This is reflected in the new organisation structure.

The Group's Corporate Responsibility agenda and activity have matured considerably over recent years. To continue to deliver on the Group's commitment to achieving a leadership position in responsible business worldwide will require a sustained and focused effort particularly in embedding the necessary behaviours and an inclusive culture across all of our businesses. A key part of this will be delivering on the recommendations of the Woolf Committee to ensure high standards of business conduct (see page 50).

Key to the delivery of our strategy are leadership and role model behaviours at the most senior level. Our 2008 objectives on ethics, safety and diversity required both a demonstration of leadership, as well as measures of progress towards our stated goals. To confirm the importance of these objectives, 12% of the available executive bonus allocation was set against performance on safety and ethics objectives.

We continue to develop other aspects of our Corporate Responsibility agenda, in particular environment and sustainability.

### Governance of corporate responsibility

Our objectives are delivered through our business operations and managed through the Executive Committee. The Corporate Responsibility Committee evolved its role in 2008 to provide independent oversight, advice and strategic direction on social, ethical and environmental issues that face the Group. The Committee's report on its 2008 activity can be found on page 72.

During 2008, the Committee undertook a number of activities which included:

- oversight of health and safety performance;
- review and oversight of the development of the Global Code of Conduct;
- ongoing review of performance against the Group's objectives; and
- site visit to our Submarine Solutions site in Barrow-in-Furness to review and understand how Corporate Responsibility has been embedded within the business.

## Corporate responsibility objectives

| 2008 objectives | Progress | 2009 objectives[1] |
|---|---|---|
| **Ethics** | | |
| Establish global leadership standards of business conduct: | | |
| – Senior leadership to communicate and demonstrate commitment to high ethical standards through employee engagement. Number of engagement events and employees reached to be measured. | – Senior leadership used opportunities of team meetings and conferences to emphasise importance of ethical business conduct. | **– Senior leadership to lead two employee focus/engagement sessions to discuss the Global Code of Conduct and ethical issues.** |
| – Develop and roll out a Group-wide Code of Conduct. | – Roll-out of the Global Code of Conduct to employees across the Group commenced in January 2009 (see page 51). | **– Deliver the 2009 Woolf Committee implementation plan milestones and obtain independent external assurance of this.** |
| – Implement the response to the Woolf Committee recommendations. | – Detailed programme in place to implement Woolf recommendations, with a number of actions already addressed (see page 50). | **– Employee sample survey on selected ethics questions to be carried out in the fourth quarter of 2009. Results to show an improvement relative to the 2008 survey results.** |
| **Safety** | | |
| Continue to drive performance in safety to a level comparable with leading performers: | | |
| – Days lost to work-related injuries: Reduce the gap between 2007 Group performance and external benchmark by 10% in 2008 (benchmark is 2,000 days lost per 100,000 employees). | – The gap between Group performance and the external benchmark was reduced by just over 9% during 2008. | **– Senior leaders each to undertake three safety audits, and flow-down training and requirement to conduct safety reviews to two levels below the Executive Committee.** |
| – Senior leadership to demonstrate commitment to safety by undertaking formal training and conducting safety audits across our operations. Number of safety audits conducted to be measured. | – Training sessions held between May and August. Safety audits conducted by senior leaders (see page 52). | **– Minimum of Level 3 on the SMM, with 60% of sites progressed to Level 4 by the end of 2009.** **– Incident rate targets to be set by business at a level reflecting the progress required to achieve the 2011 target of best in class.** |
| – Progress to benchmark safety performance against a five level Safety Maturity Matrix (SMM) – all businesses to achieve Level 3 by the end of 2008 and have a plan in place to attain Level 5 by the end of 2011 (Level 5 has been benchmarked against leading companies). | – All BAE Systems' major operational sites (other than those acquired during the year) achieved Level 3 by the end of 2008. All businesses submitted Level 5 plans by the end of 2008. | **– Incident rate in 2009 to show at least a 10% improvement over 2008 and, for sites with significantly worse than best in class statistics, improvement targets to be set consistent with achieving best in class in 2011.** |
| **Diversity and inclusion** | | |
| Create an environment that values and respects the contribution, based on merit, of all members of the communities in which we operate: | | |
| – Senior leadership to demonstrate commitment to such an environment by attending a diversity awareness training programme by mid-year. | – A workshop on the role of leadership in establishing a diverse and inclusive culture was held in June at a senior leaders' forum. Many of the attendees led similar events with their management teams. | **– Senior leadership to participate in a workshop to develop the inclusion agenda for their business. Senior leaders to lead two events with employee groups to develop action plans to address culture, barriers and improvements.** |
| – Establish a Group-wide Women's Forum. | – Inaugural virtual global Women's Forum was held in June with 70 participants across seven locations from three countries. Eighteen locations in three countries participated in the second forum in October. | **– Executive Committee to review the Operational Framework and supporting policies and processes to identify potential improvements required to develop a more inclusive culture. Any changes to be included in the updated July 2009 version of the Operational Framework.** |
| – Develop an action plan to enhance diversity and inclusion by mid-year. | – Each business set an action plan to address specific diversity and inclusion issues identified in the Employee Opinion Survey. A summary of the 2008 survey results is set out on page 53. | **– Senior leadership to develop one personal objective on inclusion during the first half of 2009 for implementation in the second half of the year.** |

1 Ethics and safety objectives are two of the Executive Committee's top ten objectives for 2009. Diversity and inclusion objectives have been set within the individual performance objectives for the senior leadership.

## Implementing the Woolf Committee recommendations

The Woolf Committee Report was published in May 2008. It made 23 recommendations for further improvement. These will provide a route map for the Group to establish a global reputation for ethical business conduct. The Committee's full report is available on our website at www.baesystems.com/woolfcommittee

We have committed to act on all of its recommendations and have put in place a comprehensive implementation programme of up to three years to achieve this. The outputs of the implementation programme will not be dealt with in isolation; in order for us to deliver this programme successfully, the outputs must quickly become part of how the Group conducts its day-to-day business as a key part of its performance culture.

The Executive Committee has appointed the Group General Counsel as sponsor of a programme to implement the Woolf Committee findings and reinforce high standards of business conduct as a sustainable way of working across the Group. The programme, which is led by a full-time Programme Director and a central team of 14 people, applies project management disciplines and processes to the programme similar to those applied to the Group's projects. A Steering Committee, drawn from members of the Executive Committee and other senior leaders, has been established to provide strategic oversight to the programme and to monitor progress regularly.

As part of the Implementation Programme, the Programme Team has divided each of the 23 recommendations into six key areas of operational activity, with each area being addressed by a Working Group. These six Working Groups consist of approximately 60 senior managers drawn from across the global BAE Systems business. External professional advisers have also been engaged to support the focus of the Programme. The scope of work being carried out in the Working Groups is as follows:

(i) Customer Contracting – developing procedures to assess the ethical and reputational risks involved with the selling of defence equipment and capability by BAE Systems. Such assessments are planned to form part of our consideration of what equipment and capabilities we sell, to whom we sell it, and what contractual obligations we will accept.

(ii) Anti-Corruption and Compliance – assessing and recommending changes to our anti-corruption policies, procedures and guidelines. This work includes codifying and integrating the existing policies on Business Development Adviser appointments, and recommending further enhancements to anti-bribery policies and procedures. Other policies under review include those relating to facilitation payments, gifts, hospitality and donations, Group giving, sponsorship, conflicts of interest together with internal investigations and disciplinary policy concerning breaches of ethical policies.

(iii) Board and Management Operations – recommending enhancements to corporate governance arrangements with respect to the management of non-financial risk. This Working Group is also responsible for recommending the establishment of a new role of Managing Director of Corporate Responsibility as well as developing procedures to embed further the explicit consideration of ethical and reputational risk in the Group's decision-making.

(iv) Leadership in Business Ethics – defining and articulating the strategic aspiration and intent of the Group to be a leader in standards of business conduct among global companies. This Working Group is also defining the role and performance management assessment (including remuneration) of BAE Systems' senior executives, the development of an ethics and compliance training strategy, and the drive for openness and transparency.

(v) External engagement – recommending actions to support the Group's leadership in the defence industry on key matters of ethical and reputational risk. This covers a wide range of external stakeholders such as governments, non-governmental organisations, customers and competitors.

(vi) Establishing a Global Code of Conduct – focusing on the delivery and implementation of a new Global Code of Conduct to communicate the required principles of business conduct and the standards expected of all employees, regardless of location or role, consistent with the Group's aspiration and intention to be a leader in standards of business conduct among global companies.

### Business Development Advisers

In 2007, the Group undertook an extensive programme to revise its policies, processes and procedures with regard to the appointment, management and payment of Business Development Advisers. Central to this process is the creation of a Business Development Adviser Compliance Panel. The Panel is chaired by independent third parties. The revised process was described by the Woolf Committee as representing leading-edge practice.

During 2007 and 2008, whilst the new process for the appointment, management and payment of advisers was being designed and implemented, the Group also undertook a review of current contracts with existing Business Development Advisers and of expired contracts with outstanding obligations; this exercise included a review of these arrangements by the Panel. As a result of the review, and the Group's stated strategy to focus on the development of home markets, many Business Development Adviser contracts were either terminated or expired without renewal. As defined in the revised process, decisions by the Group to re-appoint, or maintain the contract and services, of a Business Development Adviser are subject to the Group receiving from the Panel prior affirmative advice to do so. As a result of the actions described above, the number of Business Development Advisers has been substantially reduced.

### Looking forward

With the exception of the Global Code of Conduct, which is at a very advanced stage, the first phase of the work for the Working Groups is nearing completion. This phase involves identification of the actions necessary to implement each of the recommendations in the Woolf Committee Report, exploring options for change and proposing solutions. The status of these proposed solutions was reviewed, in detail, by the Steering Committee in December 2008.

The next planned phase, to be undertaken in the first half of 2009, is a consultation process both inside and outside the Group on these proposed solutions. We then plan that the feedback from this consultation will be fully considered in formulating the final design of the changes to be implemented.

The programme to implement the recommendations of the Woolf Committee is an extensive and thorough undertaking over a programme of up to three years during which changes will be progressively implemented across the Group. As stated above, we already have a revised policy relating to the engagement of Business Development Advisers. In addition, we have reinforced our training in standards of business conduct and have taken initial steps to include a greater emphasis on assessing non-financial risk in the assessment of customer bid proposals.

Once we have fully implemented the necessary changes, our intention is that BAE Systems will be recognised as a global leader in standards of business conduct.

Our progress in implementing each recommendation will be monitored regularly by our Corporate Responsibility Committee. Independent external auditors, Deloitte, have been appointed to assure our progress annually.

## Ethics

We are determined to be recognised as a leader in responsible business conduct worldwide, and we continue to strive for ways to improve our business and its reputation. Maintaining high standards of ethical conduct is essential to enhance our overall business performance, build trust and improve our reputation with stakeholders. Our licence to operate depends on this.

We aim to build on our employees' pride and integrity by equipping them with the capability, accountability and confidence to ensure high ethical standards are maintained. To do this, we must make sure that all employees understand what we expect of them. Our Global Code of Conduct sets this out clearly.

### Global Code of Conduct

The Code, which builds on working practices already in place in various parts of the business, was launched in January 2009. It improves awareness of our policies and aims to ensure a consistent approach is taken across all our operations. The Code provides guidance on the principles and standards of behaviour we expect of all employees, regardless of location or role. It encourages employees to ask for help and emphasises that they can raise concerns without fear of reprisal.

The Code is being rolled out to all employees during the first half of 2009 through face-to-face briefings. Every employee will be asked to confirm that they have understood, and will comply with, the Code. The roll-out of the Code will be supported by mandatory training to raise awareness, either online or face to face.

### Ethics Helpline

Our Ethics Helpline exists so that employees can report ethical concerns arising from our business, confidentially, wherever they operate and whatever their role.

## Visible leadership in safety

**We recognise the critical role that leadership plays in ensuring high safety standards. During 2008, 60 senior executives underwent safety training and conducted safety reviews across our sites. For the safety reviews, the executives were given a detailed briefing on a site or operation, then walked through the area talking to employees.**

### Visible leadership

Our senior leaders must promote a collective and individual sense of responsibility for ethical conduct, and are committed to lead by example. They are responsible for ensuring that our new Code becomes the core tenet for how business gets done at BAE Systems.

Continuous improvement in ethical business conduct is included in the objectives for all Executive Committee members and linked to their remuneration (see page 79).

## Safety

We firmly believe that ensuring the safety of our employees and those who work on our sites is a pre-condition of our operations. We recognise the risks associated with both manufacturing and daily office working, and seek to ensure that these risks are managed and mitigated as far as is reasonably possible. In 2007, we declared our aspiration and commitment to achieving a level of safety comparable with the best in class. This section provides an update on our progress towards this goal.

Many of our employees are involved in manufacturing, often using heavy equipment and sometimes handling explosive or nuclear materials. In addition, a number of BAE Systems employees are based at customer sites providing maintenance and support services. These include military bases in combat zones, such as Iraq and Afghanistan.

Our goal is to achieve leadership safety performance, compared with the best performing companies worldwide. This requires a significant reduction in workplace accidents and injuries. Our target, based on the performance of leading companies, is to reach 2,000 days lost to work-related injuries per 100,000 employees. Our performance in 2007 was 10,084[1] days and in 2008 this was reduced to 9,336 days (see page 27).

In 2007, we launched a four-year plan with safety targets for every BAE Systems business. We are focusing on sharing best practice and embedding a safety culture across the Group. We are also working closely with our customers in aiming to ensure the safety of employees based off-site where we do not have operational control.

### Fatalities

This year, we are saddened to report the deaths of five employees. These include two fatalities at our sites – one during a crane operation at our shipyards in San Diego, US and one during a maintenance procedure at our aircraft facility in Brough, UK. We are reviewing the causes of these accidents and co-operating fully with regulatory investigations. Our shipyards have made a number of management changes as a result and our Brough site is implementing a 15-point remedial action plan.

Three fatalities occurred among our employees deployed on active service with the US armed forces in Iraq and Afghanistan. These are subject to ongoing military procedures and investigation. We recognise the bravery of these individuals in being prepared to enter dangerous territories to support the work of our armed forces.

### A clear safety strategy

In 2007, we launched our four-year plan to achieve a leadership position in safety across BAE Systems. Our goal is to ensure a consistent level of good safety management in the short term and drive safety performance to a level comparable with leading performers over a four-year period.

1 Restated.

# Corporate responsibility review *continued*

We developed a five-level Safety Maturity Matrix (SMM) to help us progress towards recognised best practice and continue to improve performance across our sites. Our target is for all our businesses to achieve level 5 (benchmark) by the end of 2011.

During 2008, each business provided a rating against the SMM. Initial ratings ranged from Levels 1 to 4 and plans were set in place to achieve Level 3 across all BAE Systems' businesses by the end of 2008. This was achieved across all BAE Systems' major operational sites, other than those acquired during the year. Further benefit was gained from our safety professionals supporting audits of other sites across our operations. This delivered cross-site learning, improved networking and exchange of good practice.

We recognise that 'best in class' is a continually improving target and will annually review the criteria we are aiming for. This will be supplemented by ongoing benchmark visits with other companies to understand how we can keep raising our standards of safety.

Continuous improvement in safety performance is included in the objectives for all senior executives and linked to their remuneration (see page 79). Our Corporate Responsibility Committee has reviewed performance in 2008 and allocated the bonus accordingly.

### Visible leadership

In 2008, senior leaders demonstrated their commitment to safety by undertaking formal training and personally conducting site safety audits. The initiative was designed to inspire employees and give senior managers an insight into safety issues affecting employees on the shop floor.

We plan to make senior manager-led safety audits a regular feature of our approach to safety management. In 2009, we will involve the next two levels of management from across BAE Systems.

### Sharing best practice

Leadership in safety performance requires a consistent approach across our different sites and businesses. The exchange of ideas, policies and best practices is essential.

Safety experts from our UK and US businesses conducted audits of our sites against our SMM during 2008. These allowed the experts to share best practice with other BAE Systems' businesses, and to learn from examples of excellence in different regions and sites.

## Diversity and inclusion

Our workplace is changing. A growing number of our employees are based at customer sites, providing maintenance and support services on military bases and for troops on the front line. This requires new skills and capabilities, and a different approach to people management. At the same time, our business is expanding internationally as we increase our presence in key markets. We need to create a mobile workforce, and use skills and capabilities from across BAE Systems to service customers wherever they are based.

These changes are taking place against the backdrop of a skills shortage, and increased competition for science and engineering graduates in many of our home markets.

## Education and skills

**Helping to inspire the next generation of engineers and inventors is central to BAE Systems' commitment to education and training. The Group is a major supporter of the US-based FIRST programme (For Inspiration and Recognition of Science & Technology), including the FIRST Robotics Competition in which teams of young people design and build robots.**


We must anticipate and respond to these trends. Our approach includes:

- expanding our recruitment pool to include talented people from all genders and backgrounds;
- creating an inclusive work environment that supports the retention of skilled employees, and encourages collaboration between employees in different markets;
- providing training to help employees keep abreast of changing customer requirements; and
- good communication that keeps all employees involved and motivated regardless of location.

### Inclusion

We aim to establish a diverse workforce. The main challenges are increasing the percentage of women in our workforce and increasing ethnic diversity in the UK.

Our senior leaders are responsible for creating an inclusive work environment. This is included in the objectives for all Executive Committee members.

Senior leaders received inclusion awareness training in 2008 to help them understand their role in creating an inclusive culture.

### Gender

Increasing gender diversity is very challenging. Today, the percentage of female engineering and technology graduates remains low in many countries and at only 15% in the UK (2005-2007 Higher Education Statistics Agency).

Our approach to increasing gender diversity includes:

– education – our schools programme challenges perceptions that engineering is a male career choice;

– recruitment – we have reviewed our graduate recruitment brochures and websites to ensure they appeal to a diverse audience and include case studies of female graduates;

– leadership development – we have identified female employees in each business who have the potential to become senior leaders. They have been appointed a senior mentor to help identify development needs and provide guidance on career planning;

– flexible working – many of our businesses enable flexible working, including part-time working; and

– women's networks – these provide female employees with a wider network of contacts and support, and act as a source of expertise to help the business identify barriers and enablers to the inclusion of women at all levels within the Group. In 2008, we held two Women's Forums, uniting more than 70 employees at a number of sites globally, to raise awareness of women's networks. These were led by senior executives. We have also launched a 'Women at BAE Systems' online forum and held awareness sessions on women's networks across the business.

**Ethnicity**
Our approach to ethnic diversity is tailored to local culture and heritage in each of our home markets subject to compliance with local laws. For example, in South Africa we are increasing the number of black Africans in the workforce, in line with the South African Government's Black Economic Empowerment Agenda. In Saudi Arabia, we are focusing on increasing the proportion of Saudi nationals in the workforce.

**Age**
We already have succession planning in place to prepare the Group for changes to the age profile of our workforce as a result of employees retiring. Business initiatives include identifying high-potential employees and ensuring they work closely with those who are about to retire. Retirees are encouraged to share their knowledge using documentation and coaching sessions. Where practicable, we offer flexible working for employees who would like to reduce their hours without retiring completely.

## Other areas of Corporate Responsibility
We continue to further our understanding of other aspects of our Corporate Responsibility agenda and have initiated a number of programmes to embed them throughout the Group.

**Training and development**
We must ensure that employees develop their skills and keep up with changing technology and customer requirements. In addition, we support apprenticeships and other initiatives that increase the number of qualified engineers, technicians and project managers.

We employed 347 new apprentices in the UK and 712 graduates joined our graduate recruitment programmes across the US and UK. We also employed 410 summer interns and 31 students in industrial placements in the US and UK, respectively.

**Employee communications**
Good communication helps keep our workforce engaged and motivated. Our approach includes regular employee surveys, global, regional and departmental newsletters, and a global intranet site. We also engage with our people through employee representative bodies and trade unions. These relationships are important in helping us resolve issues and improve our employment policies.

This year, our biennial employee opinion survey was completed by more than 58,000 employees.

Highlights from this year's survey results include an increase in the level of overall job satisfaction (three percentage points higher at 71%), satisfaction with career and training opportunities (four percentage points higher at 56%), and an increase in the proportion of employees believing that the Group demonstrates clear ethical standards (seven percentage points higher at 73%).

The results also reflect strong awareness and understanding in the areas of safety, ethics and diversity.

Feedback from employees has also indicated areas for improvement. Compared with 2006, satisfaction levels were reduced for acting on customer feedback (three percentage points lower at 70%), having clear and measurable personal objectives (three percentage points lower at 67%), and ensuring that employees receive regular updates on performance against the business plan and strategy (three percentage points lower at 58%).

In response to the survey results, the Executive Committee has agreed four performance improvement priorities:

– personal performance objectives should be clear and measurable;

– properly recognise people for doing a good job;

– business changes that affect us should be communicated in a timely manner; and

– our working culture should enable everyone to demonstrate high standards of business conduct, and to speak up and challenge inappropriate behaviour.

Businesses have developed action plans to address their survey results. All businesses will include measures to address these four priority areas as part of their improvement action plans and the Executive Committee will regularly review progress made.

# Corporate responsibility review *continued*

### Education and community

We give time and money to support education and charities in our key markets.

Recruiting and retaining people with the necessary skills and ability is extremely important to our business. Our education programmes are designed to interest young people in science and engineering, and help combat the skills shortage affecting our industry.

Our businesses support local charities through corporate donations, and employee fundraising and volunteering. This helps us develop good relationships with the communities near our sites, and motivate and engage our employees.

### Environment

We recognise that our day-to-day operations, our products, and their use and disposal have the potential to damage the environment. To keep our impact to a minimum, we must manage our resources efficiently and minimise waste. We also need to consider the lifecycle of our products including how they are maintained and disposed of.

Reducing these impacts helps us to cut costs, improve efficiency and comply with the growing volume of environmental regulation. Concerns around climate change and rising energy costs mean that our environmental performance is of growing interest to all of our stakeholders.

#### Our environment policy

We published our new environment policy in January 2009. This states our commitment to reducing resource use, minimising the through-life impacts of our products and establishing environmental performance targets. It is included in our Global Code of Conduct that is being distributed to all employees (see page 51).

We work in partnership with customers and suppliers on environmental issues. In 2008, we were the first signatory to the UK Ministry of Defence's (MoD) Sustainable Procurement Charter.

#### Climate change

Our primary environmental impacts and contribution to $CO_2$ levels are through the use of energy for heating and lighting, and the travel footprint of our employees. In 2008, we commissioned the Coefficient Company to provide an estimate of our total carbon footprint for 2007, including business travel, to give us a view of our global emissions. Including the travel footprint of our employees, our $CO_2$ levels were estimated at around 920,000 tonnes in 2007. We reported in 2007 that 550,000 tonnes related to energy use.

Our businesses are looking into initiatives to help reduce our carbon footprint, including implementing energy saving measures and sharing best practice. We are also identifying ways to reduce business travel.

To support our customers, BAE Systems has developed HybriDrive® technology for buses which helps increase fuel economy, whilst reducing emissions (see page 21). This was developed from hybrid electric drive systems for vehicles in our military portfolio.

In 2009, we plan to extend our data collection to include $CO_2$ emissions from product trials and key suppliers. We are also working with the UK MoD to calculate the carbon footprint of the lifecycle of defence equipment.

## Company giving

**BAE Systems is committed to working effectively with sponsorship and charitable partners to benefit our customers and the communities near our operations. The Group focuses on supporting the armed forces and their families as well as education projects with a science, engineering and technology focus.**

## Corporate responsibility performance summary

We collect data on ethics, safety, diversity and environment to help us monitor performance and identify areas for improvement. The data is recorded by the businesses and collated centrally for review. Days recorded lost to work-related injuries is a key performance indicator (see page 27 for details). Specific notes are recorded below.

| | 2006 | 2007 | **2008** |
|---|---|---|---|
| **Ethics** | | | |
| Ethics enquiries from employees | 410 | 327 | **507** |

The increase in the number of enquiries reflects the Group's continued focus on awareness and training relating to business conduct.

| **Safety** (per 100,000 employees) | 2006 | 2007 | **2008** |
|---|---|---|---|
| Days recorded lost to work-related injuries | 10,204 | 10,084[1] | **9,336** |
| Total recorded injuries to all employees | 4,788 | 4,454 | **4,089** |

The gap between Group performance and the external benchmark of 2,000 days lost per 100,000 employees was reduced by just over 9% during 2008.

| **Diversity** | 2006 | 2007 | **2008** |
|---|---|---|---|
| **Gender diversity:** | | | |
| Male employees | 80% | 79% | **80%** |
| Female employees | 20% | 21% | **20%** |
| **Ethnic diversity:** | | | |
| White | 87% | 82% | **85%** |
| Non-white | 13% | 18% | **15%** |
| **Age diversity:** | | | |
| Under 25 | 7% | 8% | **10%** |
| 26 to 35 | 18% | 17% | **17%** |
| 36 to 49 | 42% | 39% | **38%** |
| 50 to 59 | 26% | 27% | **27%** |
| 60 + | 7% | 9% | **8%** |

The focus of our diversity agenda is creating an inclusive environment where our employees, regardless of gender, ethnicity or age, can realise their full potential.

Ethnic diversity figures are based on South Africa, UK and US data only.

| **Environment** | 2006 | 2007 | **2008** |
|---|---|---|---|
| Energy use (Gwh) | 1,742 | 1,706 | **1,655** |
| $CO_2$ emissions relating to energy use (million tonnes) | 0.57 | 0.55 | **0.66** |
| Volatile organic compound emissions (tonnes) | 742 | 642 | **519** |

Our environmental data reflects the emphasis on the minimisation of the use of resources within the Group's businesses. This reduction has been achieved even with an increase in throughput at a number of our sites.

1 Restated.

# Risk management within BAE Systems

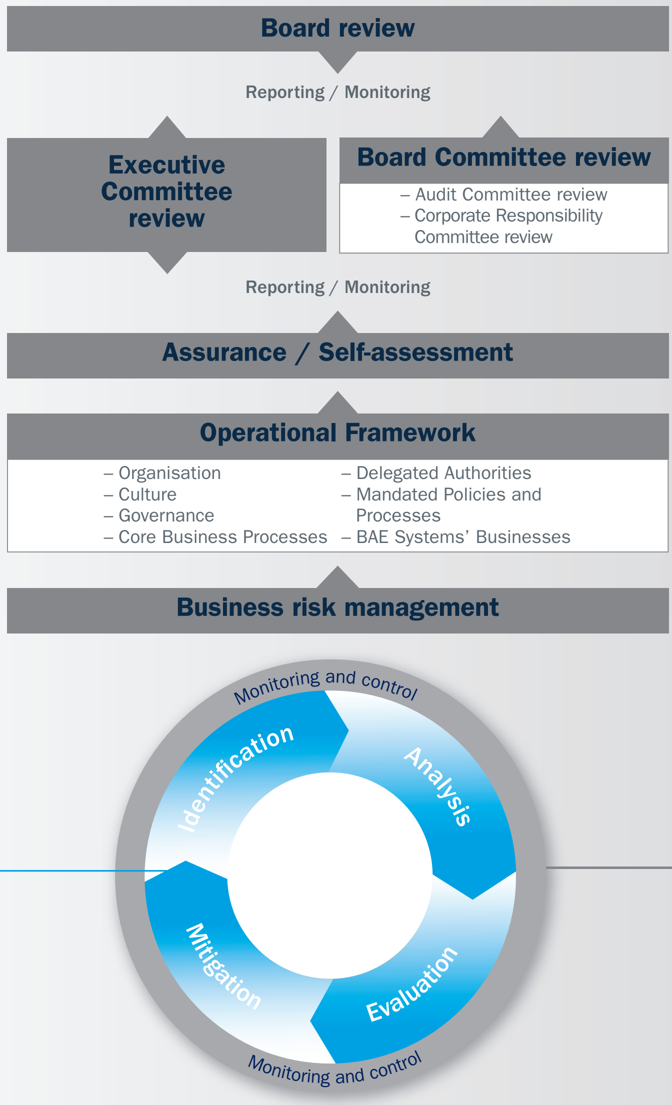
Effective management of risk and opportunity is essential to the delivery of the Group's objectives, achievement of sustainable shareholder value and protection of its reputation.

**Identification**
- At least six monthly, each business and function undertakes a full review of potential risks
- Risks are recorded in registers explaining the event(s) with cause and effect statements prompting effective mitigation strategies
- Risk owners are allocated who have authority and responsibility for assessing and managing the risk

**Analysis**
- Risks are analysed for impact and probability to determine exposure to the business

**Evaluation**
- Risk exposure is comprehensively reviewed and risks prioritised in relation to the achievement of business objectives
- Risk evaluation is documented in controlled risk registers showing:
  - the risks that have been identified
  - characteristics of the risk
  - the basis for determining mitigation strategy
  - necessary review and monitoring

**Mitigation**
- Implementation of action plans to manage, or respond to, the risks
- Robust mitigation strategy subject to regular and rigorous review




**Monitoring and control**
- Risks and plans are monitored and regularly and rigorously reviewed with significant risks immediately notified through the business reporting systems
- Key risks are reported through the Integrated Business Plan, twice yearly through the Operational Assurance Statement self-assessment, and at Quarterly Business Reviews
- The Executive Committee conducts risk workshops to analyse and allocate management responsibility for the management of the most significant non-financial risks to the Group
- The Board and the Audit and Corporate Responsibility committees review risk on a regular basis

Effective management of risk and opportunity is essential to the delivery of the Group's objectives, achievement of sustainable shareholder value and protection of its reputation. The Group's approach to risk management is aimed at the early identification of key risks and then removing or reducing the likelihood and effect of risks before they occur, and dealing effectively with them if they crystallise. The Group is committed to the protection of its assets, which include human, property and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

The management of risk is linked into the Group's strategy, the environment in which it operates, the Group's appetite for risk and the delivery of the Group's business objectives. The underlying principles are that risks are continuously monitored, associated action plans reviewed, appropriate contingencies are provisioned and this information is reported through established management control procedures.

The Board has overall responsibility for ensuring that risk is effectively managed across the Group and has delegated to the Audit Committee the responsibility for reviewing in detail the effectiveness of the Group's system of internal controls. The Executive Committee remains committed to the effective management of material non-financial risks including those arising in connection with safety and ethical issues. The Executive Committee advises the Corporate Responsibility Committee of all matters within the latter's remit.

In order to assist the Committees and the Board in their review, the Group has the self-assessment Operational Assurance Statement (OAS) process, which is mandated by the Operational Framework. The OAS is in two parts: a self-assessment of compliance with appropriate parts of the Operational Framework; and a report showing the key risks for the relevant business. Together with independent reviews undertaken by Internal Audit, and the work of the external auditors, the OAS forms the Group's process for reviewing the effectiveness of the system of internal controls.

Reporting within the Group is structured so that key issues are escalated through the management team, ultimately to the Board if appropriate. The responsibility for risk identification, analysis, evaluation, mitigation, reporting and monitoring rests with line management. Both the Audit Committee and the Corporate Responsibility Committee report the findings of their reviews to the Board so that the Board can form a view. Further information on the activities of the Board and its Committees is given in the Corporate governance section on pages 66 to 76.

## Non-financial risk management assessment

**In 2007, we introduced an overlay to our existing risk assessment and assurance process to more rigorously identify potential issues of non-financial and reputational risk. The output from the existing risk assessment processes is collated and reviewed by the Executive Committee, along with inputs and consideration of external factors, to identify those issues where the cumulative risk, or possible reputational impacts, could be significant. The Non-Financial Risk register is reviewed regularly by the Executive and Corporate Responsibility Committees to monitor the ongoing status and progression of mitigation plans.**

As with any system of internal control, the policies and processes that are mandated in the Operational Framework are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable, and not absolute, assurance against material mis-statement or loss.

Further detail of these business processes and mandated policies is given on page 18 and in the Corporate governance section on pages 67 and 68.

# Principal risks

## Defence spending

**The Group is dependent on defence spending and reductions in such spending could adversely affect the Group.**

**Description:** The Group's core businesses are primarily defence-related, selling products and services directly and indirectly primarily to the US, the UK, the Saudi Arabian and other national governments. In any single market, defence spending depends on a complex mix of political considerations, budgetary constraints and the ability of the armed forces to meet specific threats and perform certain missions. Because of these factors, defence spending may be subject to significant fluctuations from year to year.

Although the Group expects growth in US defence spending to slow, it believes it is well placed to support the US Department of Defense's likely emphasis on force sustainment, readiness and affordable transformation. The UK defence equipment budget is expected to continue to be constrained, having potential implications for the sustainability of long-term funding for future defence technologies and engineering capabilities in the UK. Saudi Arabia is expected to remain one of the heaviest defence spenders in the world.

**Impact:** A decrease in defence purchases by the Group's major customers could have a material adverse effect on the Group's future results of operations and financial condition.

**Mitigation:** The Group's business is geographically spread across six home markets and its products are marketed across a range of sectors within the defence arena. In addition, the Group uses realistic assumptions to underpin its financial and operational planning.

## Large contracts

**Certain parts of the Group's business are dependent on a small number of large contracts.**

**Description:** A significant proportion of the Group's revenue comes from a small number of large contracts. These contracts individually are typically worth or potentially worth £1bn or more including, but not limited to, those contracts in the Programmes & Support operating group.

**Impact:** The loss, expiration, suspension, cancellation or termination of any one of these contracts, for any reason, could have a material adverse effect on the Group's future results of operations and financial condition.

**Mitigation:** The Board regularly reviews the Group's performance in these markets, and the Executive Committee continues to work closely with its customers to ensure the Group strategy is aligned with theirs (refer to Strategy section on page 10).

## Government contracts

**The Group's largest customer contracts are government contracts.**

**Description:** The governments of the United Kingdom, the United States and the Kingdom of Saudi Arabia are the Group's three largest end customers. Any significant disruption or deterioration in the relationship with these governments and a corresponding reduction in government contracts would significantly reduce the Group's revenues. Moreover, companies engaged in the supply of defence-related equipment and services to government agencies are subject to certain business risks particular to the defence industry. These governments could unilaterally cancel, suspend or amend their contractors' funding under existing contracts or eligibility for new contracts potentially at short notice. Terms and risk sharing agreements can also be amended. In addition, the Group, as a government contractor, is subject to financial audits and other reviews by some of its governmental customers with respect to the performance of, and the accounting and general practices relating to, government contracts. As a result of these audits and reviews, costs and prices under these contracts may be subject to adjustment.

**Impact:** The termination of one or more of the contracts for the Group's programmes by governments, or the failure of the relevant agencies to obtain expected funding appropriations for the Group's programmes, could have a material adverse effect on the Group's future results of operations and financial condition.

**Mitigation:** The Board regularly reviews the Group's performance in these markets, and the Executive Committee continues to work closely with its customers to ensure the Group strategy is aligned with theirs (refer to Strategy section on page 10).

## Contract timing

**The timing of contracts could materially affect the Group's future results of operations and financial condition.**

**Description:** The Group's operating performance and cash flows are dependent, to a significant extent, on the award of defence contracts.

**Impact:** Because the amounts payable under these contracts can be substantial, the timing of award or failure to receive anticipated orders could materially affect the Group's operating results and cash flow for the periods affected.

**Mitigation:** The Board regularly reviews the Group's performance with regard to contract awards, and the Executive Committee actively manages the assets and resources of the Group in line with the timing of awards.

## Fixed-price contracts

**The Group has fixed-price contracts.**

**Description:** A significant portion of the Group's revenue is derived from fixed-price contracts, although the Group has reduced its exposure to fixed-priced design and development activity which is in general more risk intensive than fixed-price production activity. An inherent risk in these fixed-price contracts is that actual performance costs may exceed the projected costs on which the fixed prices for such contracts are agreed.

**Impact:** The Group's failure to anticipate technical problems, estimate costs accurately or control costs during performance of a fixed-priced contract may reduce the profitability of such a contract or result in a loss.

**Mitigation:** To manage contract-related risks and uncertainties, contracts are managed through the application of the Lifecycle Management (LCM) business process mandated by the Group's Operational Framework at the operational level (refer to page 21 for further information on LCM). The consistent application of metrics is used to support the review of individual contract performance (refer to page 26 for KPIs relating to programme execution).

## Global market

**The Group is exposed to risks inherent in operating in a global market.**

**Description:** BAE Systems is a global company which conducts business in a number of regions, including the Middle East, and, as a result, assumes certain risks associated with businesses with a broad geographical reach. In some countries these risks include, and are not limited to, the following: government regulations and administrative policies could change quickly and restraints on the movement of capital could be imposed; governments could expropriate the Group's assets; burdensome taxes or tariffs could be introduced; political changes could lead to changes in the business environment in which the Group operates; and economic downturns, political instability and civil disturbances could disrupt the Group's business activities.

**Impact:** The occurrence of any such events could have a material adverse effect on the Group's future operational performance and financial condition.

**Mitigation:** The Group has a balanced portfolio with six home markets.

## Export controls and other restrictions

**The Group is subject to export controls and other restrictions.**

**Description:** A portion of the Group's sales is derived from the export of its products. Many of the products the Group designs and manufactures for military or dual use are considered to be of national strategic interest. The export of such products outside the jurisdictions in which they are produced is normally subject to licensing and export controls and other restrictions. No assurance can be given that the export controls to which the Group is subject will not become more restrictive, that new generations of the Group's products will not also be subject to similar or more stringent controls, or that political factors or changing international circumstances will not result in the Group being unable to obtain necessary export licences.

**Impact:** Reduced access to export markets could have a material adverse effect on the Group's future results of operations and financial condition. Failure to comply with export controls and wider regulations could expose the Group to fines and other penalties, including potential restrictions on trading.

**Mitigation:** The Group has formal systems and policies in place which are mandated under the Group's Operational Framework to ensure adherence to regulatory requirements and to identify any restrictions that could adversely impact the Group's future activities.

## Consortia and joint ventures

**The Group is involved in consortia, joint ventures and equity holdings where it does not have control.**

**Description:** The Group participates in various consortia, joint ventures and equity holdings, exercising varying and evolving degrees of control. While the Group seeks to participate only in ventures in which its interests are aligned with those of its partners, the risk of disagreement is inherent in any jointly controlled entity, and particularly in those entities that require the unanimous consent of all members with regard to major decisions, and that specify restricted rights.

**Impact:** In the event of disagreement within a consortium, joint venture or equity holding and the business arrangement failing to meet its strategic objectives or expected benefits, the Group's business and results of operations may be adversely affected.

**Mitigation:** The Group has formal systems and procedures in place to monitor the performance of such business arrangements and identify and manage any adverse scenario arising.

# Principal risks *continued*

## Competition

**The Group's business is subject to significant competition.**

**Description:** Most of the Group's businesses are focused on the defence industry and subject to competition from national and multi-national firms with substantial resources and capital, and many contracts are obtained through a competitive bidding process. The Group's ability to compete for contracts depends to a large extent on the effectiveness and innovation of its research and development programmes, its ability to offer better programme performance than its competitors at a lower cost to its customers, and the readiness of its facilities, equipment and personnel to undertake the programmes for which it competes.

Additionally, in some instances, governments direct to a single supplier all work for a particular programme, commonly known as a sole-source programme. Although governments have historically awarded certain programmes to the Group on a sole-source basis, they may in the future determine to open such programmes to a competitive bidding process. Government contracts for defence-related products can, in certain countries, be awarded on the basis of home country preference. Therefore, other defence companies may have an advantage over the Group for some defence-related contracts on the basis of the jurisdiction in which they are organised, where the majority of their assets are located or where their officers or directors are located.

**Impact:** In the event that the Group is unable adequately to compete in the markets in which it operates, the Group's business and results of operations may be adversely affected.

**Mitigation:** The Group's strong global market positioning, balanced portfolio, leading capabilities and performance continue to address this risk (refer to pages 15 to 17 for further information on the Group's positioning and portfolio).

## Pension funding

**The Group is exposed to funding risks in relation to the defined benefits under its pension schemes.**

**Description:** The Group operates certain defined benefit pension schemes. At present, in aggregate, there is an actuarial deficit between the value of projected liabilities of these schemes and the value of the assets they hold. The Group has put in place and is implementing deficit recovery plans in line with agreements reached with the respective scheme trustees based on actuarial advice and valuation results.

**Impact:** The amount of the deficits may be adversely affected by a number of factors, including lower than assumed investment returns, changes in long-term interest rate and price inflation expectations, and greater than anticipated improvements in members' longevity. An increase in pension scheme deficit may require the Group to increase the amount of cash contributions payable to these schemes, thereby reducing cash available to meet the Group's other obligations or business needs.

**Mitigation:** The performance of the Group's pension schemes and deficit recovery plans are regularly reviewed by both the Group and the Trustees of the schemes taking actuarial and investment advice as applicable. The results of these reviews are discussed with the Board and appropriate action taken (refer to page 136 for further details of the Group's retirement benefit plans).

## Acquisitions

**The Group has experienced growth through acquisitions. Anticipated benefits of acquisitions may not be realised.**

**Description:** The Group has experienced growth through acquisitions and continues to pursue acquisitions in order to meet its strategic objectives. Integrating the operations and personnel of acquired businesses is a complex process. The Group may not be able to integrate the operations of acquired businesses with existing operations rapidly or without encountering difficulties.

**Impact:** The diversion of management attention to integration efforts and any difficulties encountered in combining operations could adversely affect the Group's business. The failure to manage growth by acquisition while at the same time maintaining adequate focus on the existing assets of the Group could have a material adverse effect on the Group's business, future results of operations or financial condition. In addition, failure to integrate acquisitions appropriately creates the risk of impairments arising on goodwill and other intangible assets.

**Mitigation:** The Group has an established methodology in place to deliver the effective integration of acquisitions. The Group has an established policy for monitoring impairment risks. See note 1 to the Group accounts on page 110 for further information on the Group's approach to impairment testing.

## Laws and regulations

| | | |
|---|---|---|
| **The Group is subject to risk from a failure to comply with laws and regulations.** | **Description:** The Group's operations are subject to numerous domestic and international laws, regulations and restrictions. Non-compliance with these laws, regulations and restrictions could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group. The Group has contracts and operations in many parts of the world and operates in a highly regulated environment. The Group is subject to the laws and regulations of many jurisdictions, including those of the UK and US. These include, without limitation, regulations relating to import-export controls, money-laundering, false accounting, anti-bribery and anti-boycott provisions. From time to time, the Group is subject to government investigations relating to its operations.<br><br>**Impact:** Failure by the Group or its sales representatives, marketing advisers or others acting on its behalf to comply with these laws and regulations could result in administrative, civil or criminal liabilities resulting in significant fines and penalties and/or result in the suspension or debarment of the Group from government contracts for some period of time or suspension of the Group's export privileges. | **Mitigation:** During the year, the Group has continued to add to its resources dedicated to legal and regulatory compliance in order to further enhance its capability to identify and manage the risk of compliance failure. Internal and external market risk assessments form an important element of the ongoing corporate development process. Policies and procedures for the appointment of advisers engaged in business development have been further refined, and a uniform global policy and process has been established. The investigation announced in 2004 by the Serious Fraud Office into suspected false accounting and corruption is continuing. In June 2007, the Company was notified by the US Department of Justice that it had commenced an investigation relating to the Group's compliance with anti-corruption laws, including its business concerning the Kingdom of Saudi Arabia. |

## Exchange rates

| | | |
|---|---|---|
| **The Group is exposed to volatility in currency exchange rates.** | **Description:** The global nature of the Group's business means it is exposed to volatility in currency exchange rates in respect of foreign currency denominated transactions, and the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.<br><br>**Impact:** Significant fluctuations in exchange rates to which the Group is exposed could have a material adverse effect on the Group's future results of operations and financial condition.<br><br>**Mitigation:** In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures, unless otherwise approved | as an exception by the Treasury Review Management Committee, as well as to manage anticipated economic cash flow exposures over the medium term. The Group aims, where possible, to apply hedge accounting treatment for all derivatives that hedge material foreign currency exposures. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of overseas subsidiaries and equity accounted investments it regards as long-term investments. Hedges are, however, undertaken in respect of investments that are not considered long-term or core to the Group. |

Additional risks and uncertainties currently unknown to the Group, or which the Group currently deems immaterial, may also have an adverse effect on the financial condition or business of the Group.

# Governance

## "Committed to the effective management of our business"

### Governance contents

**5**


Our Operational Framework is a key document for all our employees. It sets out the way we do business and what it means to be part of BAE Systems. It is based on principles of good governance, a set of definitions, values, policies and processes that guide our work and behaviour, and a clear system of delegated authority.

# Board of directors

## Chairman

**1. Dick Olver FREng**[3, 4]
Dick Olver was appointed as Chairman in 2004. A civil engineer, Dick Olver joined BP in 1973 where he held a variety of senior positions culminating in his appointment to the board of BP p.l.c. as CEO of Exploration and Production in 1998. He was subsequently appointed deputy group chief executive of BP in 2003, stepping down from that position when he assumed the chairmanship of BAE Systems. Dick Olver chairs the Board's Nominations Committee and the Non-Executive Directors' Fees Committee. He is a Business Ambassador for UK Trade & Investment, a Fellow of the Royal Academy of Engineering, and a member of the Royal Academy Council and the Trilateral Commission. He is a former non-executive director of Thomson Reuters plc.
Appointed: 2004 Age: 62

## Executive directors

**2. Ian King**[4]
**Chief Executive**
Ian King was appointed as Chief Executive on 1 September 2008, having originally been appointed to the Board as Chief Operating Officer, UK and Rest of the World, at the beginning of 2007. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Immediately prior to the BAe/MES merger he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems. He is a non-executive director of Rotork plc.
Appointed: 2007 Age: 52

**3. Walt Havenstein**[4]
**Chief Operating Officer, President and CEO, BAE Systems, Inc.**
Walt Havenstein was appointed to the Board in 2007 as Chief Operating Officer, US, and is also President and CEO of BAE Systems, Inc. He was previously President of the Company's US-based Electronics & Integrated Solutions business. He was President of the Sanders defence electronics business prior to it being acquired by the Company from Lockheed Martin in 2000. A graduate of the US Naval Academy, he served 12 years in the US Marine Corps.
Appointed: 2007 Age: 59

**4. George Rose**
**Group Finance Director**
George Rose was appointed Group Finance Director in 1998. Prior to joining the Company in 1992, he held senior positions in the Rover Group and Leyland DAF. He is a non-executive director of Saab AB and National Grid plc, and a member of the Industrial Development Advisory Board. He is a Fellow of the Chartered Institute of Management Accountants.
Appointed: 1998 Age: 56

## Non-executive directors

**5. Phil Carroll**[3]
Phil Carroll is a former chairman and chief executive of Fluor Corporation and a former president and chief executive of Shell Oil Company Inc. He was appointed by the US Department of Defense in 2003 to serve as the first Senior Adviser to the Iraqi Ministry of Oil. He is a former non-executive director of Scottish Power plc.
Appointed: 2005 Age: 71

**6. Michael Hartnall**[1]
Michael Hartnall is a former finance director of Rexam plc, prior to which he held senior positions with a number of manufacturing companies. He is a non-executive director of Lonmin plc and a former non-executive director of Elementis plc. Michael Hartnall chairs the Board's Audit Committee. He is a Fellow of the Institute of Chartered Accountants in England and Wales.
Appointed: 2003 Age: 66

1 2 3 4 5 6

**7. Andy Inglis**[2]
Andy Inglis is a director of BP p.l.c. He is a member of the BP executive management team, and is also chief executive of BP's Exploration & Production business. He is a Fellow of the Royal Academy of Engineering and a Fellow of the Institute of Mechanical Engineers.
Andy Inglis chairs the Board's Corporate Responsibility Committee.
Appointed: 2007 Age: 49

**8. Sir Peter Mason KBE**[1, 3]
Sir Peter Mason is the non-executive chairman of Thames Water and a non-executive director of Acergy S.A. He was formerly chief executive of AMEC plc, executive director of BICC plc, chairman and chief executive of Balfour Beatty Limited and chief executive of Norwest Holst Group PLC. Sir Peter has been appointed the Board's Senior Independent Director.
Appointed: 2003 Age: 62

**9. Roberto Quarta**[1, 5]
Roberto Quarta is a partner in the private equity firm Clayton, Dubilier & Rice, in connection with which he serves as chairman of Rexel SA and Italtel. He was previously chairman and chief executive of BBA Group plc, an executive director of BTR plc and a non-executive director of PowerGen plc and Equant NV.
Appointed: 2005 Age: 59

**10. Sir Nigel Rudd**[2, 5]
Sir Nigel Rudd is currently chairman of BAA Limited and Pendragon plc, and deputy chairman of Barclays PLC and Invensys plc. He was formerly chairman of Alliance Boots Group PLC and Pilkington plc. He also holds a number of other public appointments, including chairman of the CBI's Boardroom Issues Group.
Sir Nigel chairs the Board's Remuneration Committee.
He is a Fellow of the Institute of Chartered Accountants in England and Wales.
Appointed: 2006 Age: 62

**11. Carl Symon**[5]
Appointed to the Board on 11 June 2008, Carl Symon retired from IBM in 2001 having held a number of senior positions in the US, Europe, Latin America and Asia, including serving as chairman and chief executive of IBM UK Limited. He is a non-executive director of BT Group plc and Rexam PLC, and a former non-executive director of Rolls-Royce Group plc and former chairman of HMV Group plc.
Appointed: 2008 Age: 62

**12. Ravi Uppal**[2]
Appointed to the Board on 2 April 2008, Ravi Uppal is managing director and chief executive officer of L&T Power Limited, a member of the Larsen & Toubro group which operates in the technical, engineering, construction and manufacturing sector and is one of the largest companies in India's private sector. He was previously President, Global Markets for the power and automation technology group ABB Limited where he was responsible for ABB's marketing and business development on a worldwide basis. Prior to that he was managing director of Volvo India, establishing that corporation's business in India.
Appointed: 2008 Age: 56

Each of the eight non-executive directors listed above is considered to be independent for the purposes of the Combined Code on Corporate Governance.

## Company Secretary

**David Parkes**

1 Member of the Audit Committee.
2 Member of the Corporate Responsibility Committee.
3 Member of the Nominations Committee.
4 Member of the Non-Executive Directors' Fees Committee.
5 Member of the Remuneration Committee.

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# Corporate governance

## "The BAE Systems Board is always looking to move the Group forward"

**Dick Olver** Chairman

The events that shook financial markets last year have made many directors reflect on their governance responsibilities and particularly their role in ensuring that, in the words of the Combined Code, there is a 'framework of prudent and effective controls which enables risk to be assessed and managed'.

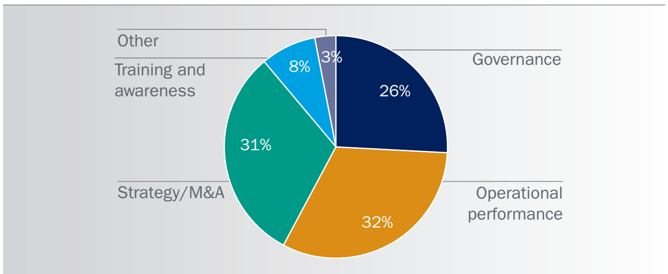
Much is demanded of directors of major companies – and rightly so given the impact that the fortunes of such companies can have on the global economy. As directors we need to continually challenge the way we operate and look to improve the effectiveness of how we as a board collectively discharge our duties and provide leadership. I hope that this report provides you with a wider understanding of aspects of our governance framework and practices, which together with the other reports in this section, details how we apply the Combined Code principles.

The BAE Systems Board is always looking to move the Group forward and is determined that it shall be recognised as a global leader in responsible business. Appointing the Woolf Committee was a good example of this and, as Lord Woolf wrote, this has provided "…a route map for the Company to establish a global reputation for ethical business conduct that matches its reputation for outstanding technical competence". In advance of its publication, the Board committed to act on any recommendations made in the Committee's report and these are being carefully addressed as part of a three-year programme. For its part, the Board will, amongst other things, undertake further ethics awareness training in 2009.

The board of a company stands at the apex of its governance structure and its effectiveness is critical to the governance of the company as a whole. There is no definitive guide as to what makes an effective board. The UK's Combined Code on corporate governance does provide clear principles of good governance practice. However, it is just a framework, and it is for individual boards to determine how they can maximise their effectiveness. A large part of this comes down to how use is made of the time and talents available to the board; and the annual performance evaluation required by the Code is an important tool in helping a board to collectively reflect on whether it is operating effectively and pointing out the areas where improvements can be made.

The BAE Systems Board has recently completed its annual performance evaluation. For the past four years we have engaged in the same process, using an external facilitator to undertake one-to-one interviews with all the directors. This provides a rich source of information not just on the Board's performance but also on that of individual directors and of myself as Chairman.

Through the evaluation we try to ensure that as a board we are spending the right amount of time on the right things. Last year, the BAE Systems Board held nine meetings plus a day spent conducting a strategy review. Looking back over the time we allocated to various matters at these meetings and analysing this under a few generic headings provides the following analysis:




This analysis is fairly basic but I think it fairly represents the work of the BAE Systems Board last year and hopefully will provide some insight into how it operates. As you can see, most time was spent on operational performance and Strategy/Mergers and Acquisitions (M&A), with the rest of the time spent largely dealing with governance matters. The detail of what was included in these categories is discussed in more detail below.

**Operational performance**

This principally covers the Board's role in setting performance targets and objectives for management and then monitoring and overseeing progress against these. Plans are agreed and objectives are set as part of the Group's core processes. These are contained in the Operational Framework, a document that details the way we do business and what it means to be part of BAE Systems. It is based on principles of good governance, a set of definitions, values, policies and processes that guide our work and behaviour, and a clear system of delegated authority. Through the Operational Framework the Board has mandated five core business management processes that have been developed by the Group over a number of years and are at the heart of our performance delivery.

In brief these processes are:

– Integrated Business Plan (IBP)
The purpose of the IBP process is to assess and monitor the Group's ability to maximise value in accordance with its strategy and objectives. It consists of a strategic plan, a financial forecast for the current year and financial projections for the following five years. Reflecting the long-term nature of much of the Group's business, part of the development of strategy involves analysing the business over the following ten years. The process is undertaken annually and culminates in the Board approving the Group strategy and financial five-year plan. At each scheduled meeting, the Board monitors performance against the agreed plan.

– Lifecycle Management (LCM)
The purpose of LCM is to provide a structured approach to managing the Group's commitments and investments throughout project and product lifecycles, facilitating continuous improvement. This includes the bidding process, including the authority required for the submission of contract bids and tenders, most of which are managed on a delegated basis. However, the larger bids require Board approval and, during 2008, it considered and authorised a number of major contract bids. The LCM process is essential for the management of long-term contracts and mandates that key risks are identified and managed at different stages through the life of a project or product, which can run into tens of years. Importantly, LCM also covers the period before a contract is awarded, or even bid for. This helps to ensure that risks are understood, enabling informed decisions to be made to either commit to a business opportunity or decline to bid if risks do not align to the reward potential. The risks identified by the LCM process are also used as the basis for recognising profit on long-term contracts, ensuring that profit is only taken when risks on the contract are retired.

– Mergers, Acquisitions and Disposals Process (M&A)
The purpose of the M&A process is to provide a structured approach to managing the Group's acquisitions, joint ventures and disposals (see page 68).

– Performance Centred Leadership (PCL)
The purpose of the PCL framework is to provide an integrated approach to management, resourcing and people development. This process addresses objective setting and performance assessment; making sure that the targets used to reward executive performance are set as part of the strategic and financial planning processes that are part of the routine management of the whole Group. The process for the setting of objectives for executives is initiated firstly by the Chairman developing non-financial objectives with the Chief Executive. These are then forwarded to the Remuneration Committee for its consideration. The Remuneration Committee (in consultation with the Corporate Responsibility Committee for corporate responsibility-related matters) agrees appropriate non-financial objectives for the executive directors and also financial objectives

based on the output from the IBP process. The Remuneration Committee monitors performance against the objectives throughout the year.

– Performance Management Process (PMP)
The purpose of the PMP is to provide a structured approach and clear framework for the evaluation and management of performance in accordance with the Group's strategy and objectives. The IBP provides agreed business objectives and measures for the following year. Performance against these is then monitored during the year using three levels of review; individual executive, project and business. At each Board meeting, the Chief Executive and Chief Operating Officer BAE Systems, Inc. report to the Board on operational performance based on the information they receive through the PMP.

As reported in the Performance section of this Annual Report, the Board uses a range of financial and non-financial performance indicators when reviewing operational performance. The financial KPIs shown on pages 24 and 25 are reviewed at all scheduled board meetings, with the non-financial KPIs (see pages 26 and 27) reviewed on a quarterly basis. The non-financial KPI reporting is managed by a central department, the Centre for Performance Excellence, which in consultation with the Board has developed the metrics to meet its performance reporting needs and is tasked with ensuring that the information is accurate and timely.

**Strategy/M&A**
This covers the Board's involvement in developing and agreeing the Group's future strategy, and the implementation of that strategy where it involves major M&A activity.

The Group has developed an annual strategy review process that has been effective in driving the strategic transformation of the Group over the last few years and delivering strong financial performance. You will see on pages 10 and 11 of this report details of the Group Strategic Framework that captures the top-level output from the IBP process. This process is undertaken over a nine-month period each year and culminates in the Board approving the changes to the framework and agreeing the five-year financial plan. Integrating financial planning with the development of strategy ensures that business plans reflect the evolution of our strategy, and resources are available and aligned with the implementation of the strategic objectives and actions that are identified in the Group Strategic Framework.

The IBP and the development of strategy are managed by the Chief Executive but the Board ultimately approves the financial plan and strategy each year, and has an important role to play in constructively challenging the plans based on the wider perspective and different skills and knowledge that the non-executive directors bring to the Board. At a number of its meetings held through the year the Board has specific agenda items covering the development of strategy. It also spends a whole day each year undertaking a detailed review of strategy, which coincides with its review of the financial plan for the next five years. From this, the Board has an awareness of the growth profile of the Group's existing businesses over this period and how different strategic options can be overlaid on the plan. This helps the Board to plan the evolution of the strategic shape of the Group and thereby establish the foundations for long-term growth.

Setting strategy is an important element of total risk management. Certain risks facing a company will be structural in nature and such risks need to be recognised and mitigated by long-term strategic planning. Also, strategic change itself usually involves risk and it is for the Board to exercise its judgement as to what is the appropriate level of risk to take. The quality of judgement exercised by a board is heavily dependent on its awareness of the business. A significant element of the time that we as a board spend on strategy involves developing a collective awareness of the strategic landscape. At four of the eight scheduled board meetings last year (excluding our whole day strategy review) we dedicated time to understanding different geographical markets, sectors adjacent to our traditional markets, new and developing technologies and capabilities, and revisiting strategic decisions we made in the past to check that there had not been changes of which we needed to be aware.

One area identified through the annual strategy planning process as being of strategic importance to the Group was establishing security businesses in our home markets. This provides a good example of the Board's involvement in M&A activity. Having developed an awareness of the global security market, and from that agreeing a strategic objective of growing this related market segment, the Board was able to respond quickly when the Chief Executive proposed that a bid should be made for the prime UK company operating in this sector, Detica. Having made the decision to approach the Detica board with a view to acquiring the company, the Board thereafter managed the acquisition through a committee of the Board that met on four occasions during the summer of 2008.

**Governance**
This covers the role of the Board in setting the Group's values and standards, ensuring that the appropriate governance structures and controls are in place and operating effectively, and reporting on these matters to shareholders.

The Board agrees the structure of the Group's internal controls and this includes setting the standards and values that govern all that we do. It looks to the Audit Committee and Corporate Responsibility Committee to undertake most of the work involved in monitoring and seeking assurance as to compliance with the controls within this framework. These committees are formed of independent non-executive directors and are therefore appropriately structured to undertake the role. However, the Board as a whole must maintain oversight of such important matters and after each committee meeting the chairmen of each of the Board's committees report on the matters they have dealt with.

Reviewing the effectiveness of internal controls is part of the Board's governance responsibilities. The Audit and Corporate Responsibility committees have been tasked with reviewing and seeking assurance as to the effectiveness of internal controls. The chairmen of the committees report regularly to the Board on this and other activities they undertake, thereby ensuring that all directors have visibility and the opportunity to discuss such matters (see pages 70 and 73).

One of the most important decisions that the Board took last year was to appoint a new Chief Executive. In last year's report I outlined the process that the Board had adopted in seeking a new Chief Executive, which began with the invaluable work the Nominations Committee had undertaken in the last few years in overseeing the development of our succession and management resource planning processes. This meant that from day one of our search our internal succession planning processes were indicating that in Ian King we had an excellent internal candidate. However, given the importance of this position, the Committee worked through a thorough process, undertaking a global search looking at various external candidates. Having completed the search process the Committee concluded that Ian King was the strongest candidate and nominated him for appointment. The Board duly appointed him Chief Executive with effect from the beginning of September 2008.

I began by commenting on the value of performance evaluation and using that as the basis for continually improving on how we discharge our responsibilities as a board. In the table below we have summarised how the Board performed against the objectives set for 2008 and those we have set for this year.

The performance evaluation process also looks at how individual directors and the Board's committees have performed. I meet with all directors individually and provide them with an appraisal of their performance based on feedback from the process. Where a director chairs a committee I also provide him with feedback on his performance in chairing it and how effective the committee has been in performing its duties. Finally, the Senior Independent Director receives feedback on my performance as Chairman so that he can meet with the non-executive directors and discuss my performance before discussing this with me.

**Shareholder communications**

The Board recognises the importance of ensuring that there is a dialogue with shareholders so that it understands issues or concerns they may have. A comprehensive investor relations programme has been in place for many years. This is managed by the Chief Executive and Group Finance Director who meet with the Company's largest shareholders on a regular basis. I also maintain a dialogue with our larger shareholders and their representative bodies. For example, last year I held meetings with investors to explain how we will be implementing the recommendations in the Woolf Report, and answering questions they had.

To assist the Board in its understanding of any issues and concerns investors may have, each year it is presented with the results of a survey undertaken across our twenty largest shareholders (who together control more than 25% of the Company). The survey is undertaken by a third party consultant who interviews the shareholders and delivers his findings directly to the Board.

The Annual General Meeting (AGM) provides all shareholders with the opportunity to meet with the Company, ask questions and give their views on its performance. We recognise that not all shareholders can attend the AGM and last year a number of shareholders took advantage of our new Frequently Asked Questions (FAQ) facility. This facility enables shareholders to e-mail or post questions to us and for the Company to provide answers to the most frequently asked questions at the meeting and also post these on our website. The FAQ facility will be available again this year. The Company tries to make attendance at our AGM rewarding in terms of participating in this essential governance process and in developing a better understanding of the business. I urge as many shareholders as possible to attend the meeting on 6 May 2009.

**Dick Olver** Chairman

## Board performance evaluation – objectives

| 2008 Objectives | 2008 Achievements | 2009 Objectives |
|---|---|---|
| – Engage non-executive and executive directors in dialogue to ensure smooth and transparent selection and transition of the new Chief Executive. | – The Nominations Committee engaged with all directors and managed the Chief Executive appointment process. The Board then appointed an internal candidate and has supported a smooth and seamless transition. | **– Maximise the effectiveness of the strategy planning process and continue to visit operational sites to develop further the Board's awareness and understanding of the Group.** |
| – Board to conduct additional site visits as part of its meeting programmes. Use the visits as an opportunity to meet with senior management to support succession planning. | – Board members visited Oman and Saudi Arabia in 2008. In addition, non-executive directors visited the Submarine Solutions and Insyte businesses in the UK. | **– Continue to engage with management in studying and developing the actions needed to exploit global markets.** |
| – Understand and review the competencies, processes and culture required to support the Company's increasingly global position. | – The Board studied globalisation opportunities in the defence sector before and during the annual strategy session and approved four global initiatives. | **– Support the Chief Executive in ensuring the Woolf Report recommendations are implemented across the Group, ensuring all staff and external stakeholders are engaged.** |
| – Ensure that ethical and reputational implications of strategic growth options are explored and understood. Plan for and commence embedding the Woolf Committee recommendations. | – The Board committed to implementing all the Woolf Committee's recommendations before the final report was delivered in May 2008. The Company subsequently set up teams to create and act upon plans for implementation. | **– Provide support to the new Chief Executive to ensure his success.** |
| – Keep attention focused on programme KPIs. | – Directors regularly reviewed the Programme Margin Variation and Schedule Adherence metrics that are used to provide oversight of contract performance. | **– Focus on KPIs, ensuring they continue to provide the right level of performance oversight, and periodically take a more in-depth look at specific programmes.** |
| | | **– Ensure attention remains focused on near-term and long-term succession planning for the Board.** |

## Audit Committee Report

**Michael Hartnall**
Audit Committee
Chairman

**Members**
Michael Hartnall (Chairman)
Sir Peter Mason
Roberto Quarta

**Responsibilities**
– Reviewing the effectiveness of the Group's financial reporting, internal control policies and procedures for the identification, assessment and reporting of risk.
– Monitoring the role and effectiveness of the Internal Audit function including approving the appointment or removal of the Director of Internal Audit.
– Considering and making recommendations to the Board on the appointment of the Auditors.
– Keeping the relationship with the Auditors under review, including the terms of their engagement and fees, their independence and expertise, resources and qualification.
– Monitoring the integrity of the Group's financial statements.
– Reviewing significant financial reporting issues and judgements.

The full terms of reference of the Audit Committee can be found on the Company's website or can be obtained from the Company Secretary.

### Governance
The Audit Committee was in place throughout 2008 and all its members were independent in accordance with provision A.3.1 of the Combined Code.

Mr Hartnall has been chairman of the Committee since 2003. He was formerly the finance director of a FTSE 100 company and is a Fellow of the Institute of Chartered Accountants in England and Wales.

The Committee has asked that the Chief Executive, Group Finance Director, Director Financial Control, Reporting and Treasury and the Director of Internal Audit normally attend its meetings. However, during the year, the Committee held individual meetings without Group executives present, without the Director of Internal Audit present and also with only the external auditors present.

The Committee met six times in 2008.

### Activities
One of the Committee's principal responsibilities is to monitor the integrity of the Group's financial statements and any significant judgements that need to be made in their production.

A sound system of internal controls is essential for reliable financial reporting and also for the effective management of the Group. In assessing the quality of the control environment the Committee received reports during the year from the Group's Auditors, KPMG Audit Plc, and the Group's Internal Audit function on the work they had undertaken in reviewing and auditing the control environment. The Group has a well defined controls framework based on a set of core processes that have been developed over a number of years. This is documented in the Operational Framework. Twice during the year the Committee reviewed the results of the Group's Operational Assurance Statements (OAS) process, through which senior managers across the Group report on the quality of their businesses' implementation and compliance with the policies mandated in the Operational Framework. The Committee also reviewed the output from the OAS process that requires managers to report on significant risks to the delivery of their business plans and the status of plans to mitigate such risks.

As part of its review of the Group's financial reporting, the Committee reviews significant financial reporting judgements. The areas in which such judgements are required change over time, and to assist the Committee in understanding these it reviewed with the Group's Auditors their assessment of the Group's principal financial reporting and control risks. As well as indicating where significant accounting judgements are required, this risk assessment was also used to direct the audit work undertaken by the Auditors.

To gain a greater awareness of the Group's operations and, in particular, to understand in more detail the implementation of core control processes, the Committee has for a number of years met with the management of different businesses. During 2008, the Committee met with senior executives from the Group's Electronics & Integrated Solutions business based in Nashua, New Hampshire and also with the management of the Insyte business at its New Malden site near London.

Last year, the regulations in the UK concerning periodic financial reporting for listed companies were revised. As a result of this the Company was required to publish Interim Management Statements in the periods between the publication of its full and half-yearly reports. The Committee reviewed these statements prior to their publication in May and October 2008.

To discharge its responsibility for reviewing the effectiveness of the Group's Internal Audit function, the Committee reviewed the results of an evaluation of the function's performance across the Group. This covered different aspects of the function's remit and reported on work planning, access to skills and knowledge, quality of reporting, implementation of audit recommendations and its independence.

With regard to the Auditors, the Committee evaluated their effectiveness and reviewed and agreed the fees they were paid in respect of their audit work. In 2008 this formed part of a wider review of external audit performance and effectiveness undertaken by the Committee on a triennial basis. On the basis of this review the Committee recommended to the Board that it recommend that shareholders support the re-appointment of the Auditors at the 2009 Annual General Meeting.

The Committee accepts that certain work of a non-audit nature is best undertaken by the Auditors. The Committee reviews regularly the amount and nature of non-audit work they perform and did so in 2008. It believes that it is not appropriate to limit the level of such work by reference to a set percentage of the audit work fee, as this does not take into account important judgements that need to be made concerning the nature of work undertaken. However, the Committee has agreed the following rules with regard to non-audit work undertaken by the Auditors:

– any non-audit work to be undertaken by the Auditors in excess of £250,000 must be authorised by both the Chairman of the Audit Committee and the Group Finance Director;

– no partner/director of the Auditor's worldwide audit team shall be employed by the Group within two years of the conclusion of a relevant audit;

– no qualified member of the worldwide audit team at manager level or below is to be employed by the Group within two years of the conclusion of a relevant audit; and

– no partner/director of the Auditors not associated with the audit is to be employed by the Group without the approval of the Group Finance Director and the Chairman of the Audit Committee.

During the year the committee chaired by Lord Woolf published its report on the Group's ethical policies and processes. One of the recommendations contained in the report was that the Corporate Responsibility and Audit committees should hold at least one joint meeting a year to decide on the preparation of the annual internal audit programme. The first such meeting was held last November, at which the Director of Internal Audit reported to the two committees on the work that was being undertaken reviewing the recommendation in the Woolf Report concerning ethical business conduct assurance activity. At the meeting, the committees agreed the approach that would be taken in agreeing the annual programme of activity to be undertaken by Internal Audit.

Summary of work undertaken by the Audit Committee in the last 12 months:

– reviewed the effectiveness of the Group's internal controls and the disclosures made in the Annual Report on this matter;

– reviewed the output from the Group-wide process used to identify, evaluate and mitigate risk;

– received a report from the Auditors on their review of the effectiveness of controls across the Group;

– reviewed half-yearly risk assessments detailing major financial and non-financial risks and the status of actions identified to mitigate such risks;

– reviewed the effectiveness of the Group's helpline procedures in respect of the reporting of possible accounting, financial control and other financial irregularities;

– reviewed the financial statements in the 2007 and 2008 Annual Report and the 2008 Half-Yearly Report, and received a report from the Auditors on the statements;

– reviewed the basis for preparing the Group accounts on a going concern basis, and strengthened the process for reviewing the analysis supporting the going concern judgement and disclosures in the financial statements;

– reviewed the Interim Management Statements issued by the Company in May and October 2008;

– agreed the approach and scope of the audit work to be undertaken by the Auditors;

– agreed the fees to be paid to the Auditors in respect of the 2008 audit;

– reviewed the fees paid to the Auditors in respect of non-audit work undertaken during the year;

– received assurances from the Auditors regarding their independence;

– undertook a comprehensive review of the Auditors' performance, including fee benchmarking, management performance evaluation, client service review and future audit strategy;

– undertook an evaluation of the Group's Internal Audit function;

– received a report from the Director of Internal Audit on the work undertaken by the Internal Audit function;

– received a presentation on the Group's tax affairs;

– reviewed the Group's processes for disclosing information to the Auditors and the statement concerning such disclosure in the Annual Report; and

– reviewed the Committee's terms of reference.

On behalf of the Audit Committee

**Michael Hartnall** Audit Committee Chairman

## Corporate Responsibility Committee Report

**Andy Inglis**
Corporate Responsibility Committee Chairman

### Members
Andy Inglis (Chairman)
Sir Nigel Rudd
Ravi Uppal

Mr Weinberg was a member of the Committee and its Chairman for the period up to 7 May 2008. Mr Inglis was appointed Chairman of the Committee with effect from that date.

Mr Carroll stood down from the Committee on 7 May 2008 and Mr Uppal joined the Committee with effect from that date.

### Responsibilities
- Assisting the Board in overseeing the development of strategy and policy on social, environmental and ethical matters.
- Monitoring and reviewing the Group's performance in managing social, environmental, ethical and reputational risk.
- Overseeing and supporting key stakeholder engagement on social, environmental and ethical issues.

The full terms of reference of the Corporate Responsibility Committee can be found on the Company's website or can be obtained from the Company Secretary.

### Governance
The Corporate Responsibility Committee was in place throughout 2008 and all its members were independent in accordance with provision A.3.1 of the Combined Code.

During the year, the Nominations Committee reviewed the membership of the Committee and nominated Mr Uppal as a member and nominated Mr Inglis to chair the Committee following Mr Weinberg's retirement from the Board.

The Committee has asked that the Chief Executive, Group General Counsel, Group Human Resources Director, Managing Director Corporate Responsibility and the Director of Internal Audit normally attend its meetings.

The Committee met five times in 2008.

### Activities
During 2008 the Corporate Responsibility Committee evolved further its role in providing oversight and strategic direction to social, ethical and environmental matters within BAE Systems. All members of the Committee are independent non-executive directors and as such are able to exercise independent oversight and provide advice based on the experience and knowledge of its members. The primary focus of the Committee in 2008 was providing review and oversight of the Group's performance against its corporate responsibility objectives.

When the Woolf Committee issued its report following its review of the Company's ethics policies and processes it recognised the value of the Committee's governance structure. The Woolf Report recommended that the Corporate Responsibility Committee should have a key role in providing oversight and reporting on standards of ethical business conduct and reputational risk, and in performing this duty its role would be analogous to that of the Group's Audit Committee. To assist the Committee in undertaking the role recommended by Woolf, we agreed that the Committee should engage an external party to undertake assurance work – similar in some ways to the role of the Group's Auditors and its relationship with the Audit Committee. The Committee ran the process for the selection of an assurance provider and approved the appointment of Deloitte to undertake this role.

Deloitte will provide assurance over aspects of the programme for the implementation of the recommendations in the Woolf Report and assurance over selected subject matter in the separate 2008 Corporate Responsibility Report to be published by the Group. In managing the relationship with Deloitte we will be introducing similar practices to those adopted by the Audit Committee to manage its relationship with the Group's Auditors. This will include agreeing on a regular basis the annual assurance strategy, the scope of work and the fee payable for this. In addition, the Committee will agree their terms of engagement and also review their independence and effectiveness.

The Woolf Committee recommended that the Group adopt a Global Code of Conduct. The Corporate Responsibility Committee was closely involved in overseeing the production of the Code. The Global Code of Conduct was launched across the Group at the beginning of 2009 and one of the Committee's priorities for this year will be to monitor the quality of the roll-out process that is aimed at ensuring that a common language and set of expectations regarding business conduct are embedded throughout the Group.

The Committee met with Ian King, the Group's Chief Executive, to discuss priorities in this area. We agreed with his view that ethics, health and safety and diversity should be the prime focus for the Group and therefore for the Committee's activities. However, the Committee will continue to monitor the Group's performance in other important corporate responsibility areas, such as the environment and our social and community responsibilities.

During 2008, the Committee continued its activity in overseeing and monitoring the Group's performance in protecting the health and safety of our employees, and everyone working at or near our sites. This included looking at how health and safety is managed and led throughout the Group, the development of standards and the indicators used to monitor performance. To assist members of the Committee in their understanding of the management of health and safety, and other corporate responsibility matters, the Committee will be holding certain of its future meetings at

Group sites. The first such meeting was held in 2008, when the Committee visited the Barrow-in-Furness Submarine Solutions site.

Since its formation four years ago, the Committee has had access to the audit and assurance services provided by the Group's Internal Audit function, and that function will continue to provide valuable services to the Committee that complement the independent assurance activities that Deloitte will provide.

The Director of Internal Audit attends all of the Committee's meetings and presents the findings from audits involving areas covered by its terms of reference. He also provides details of the output from the Group's Operational Assurance Statement process that provides assurance as to compliance with the Group's core control polices. In his report on the activity of the Audit Committee (see page 70), Michael Hartnall has reported on the joint meeting held between the Audit and Corporate Responsibility committees last year at which we agreed the approach we will take in approving the annual programme of work to be undertaken by the Internal Audit function. We have agreed that the committees should hold two joint meetings in 2009 to ensure that audit and assurance work is co-ordinated effectively.

To be effective the Committee needs be aware of what the key risks are to the value of the Group. Therefore, during the year the Committee regularly reviewed the Non-Financial Risk register that is used by the Executive Committee to identify and manage reputational and non-financial risks and the impact they could have on the Group's value and reputation. This risk analysis is used to help set the Committee's priorities.

It is important that executive remuneration reflects not just basic financial performance but performance in areas such as those that are within the remit of the Corporate Responsibility Committee. To achieve this, the Committee has agreed that it will be consulted by the Remuneration Committee when agreeing the non-financial objectives for the executive directors' bonus scheme. In 2008 the Committee recommended objectives relating to ethics, and health and safety. These were agreed by the Remuneration Committee and the Committee will oversee performance against these during 2009 and, in line with the process adopted with regard to the 2008 objectives, will make a recommendation as to the level of achievement against them.

Summary of work undertaken by the Corporate Responsibility Committee in the last 12 months:

– recommended to the Remuneration Committee corporate responsibility-related leadership objectives for the executive directors' annual bonus plan;

– reviewed the output from the Non-Financial Risk process that identifies and seeks to mitigate significant non-financial and reputational risks that could impact the Group;

– reviewed the Group's health and safety performance;

– reviewed the operation of the Ethics Helpline and the nature of the matters reported;

– agreed the corporate responsibility sections in the 2007 and 2008 Annual Reports and the separate Corporate Responsibility Reviews for those years;

– considered the recommendations from the Woolf Committee as they relate to the Committee;

– reviewed the plans for the implementation of the recommendations in the Woolf Report;

– agreed the process for the creation of the Global Code of Conduct and agreed the final draft of the Code;

– received reports on the plans for the roll-out of the Global Code of Conduct across the Group;

– met with the Group's then two Chief Operating Officers and reviewed with them the management of health and safety across the Group;

– oversaw the search for a third-party provider of corporate responsibility assurance services and approved the appointment of Deloitte to perform this role;

– received reports from the Director of Internal Audit on corporate responsibility-related work undertaken by the Group's Internal Audit function in 2008;

– held a joint meeting with the Audit Committee to agree the approach to be taken with regard to agreeing the annual programme of work to be undertaken by the Internal Audit function; and

– reviewed the Committee's terms of reference.

On behalf of the Corporate Responsibility Committee

**Andy Inglis** Corporate Responsibility Committee Chairman

## Nominations Committee Report

**Dick Olver**
Nominations Committee Chairman

**Members**
Dick Olver (Chairman)
Phil Carroll
Sir Peter Mason

**Responsibilities**
- Reviewing regularly the structure, size and composition of the Board and making recommendations to the Board on any desired changes.
- Identifying and nominating for the Board's approval suitable candidates to fill all vacancies for non-executive and, with the assistance of the Chief Executive, executive directors.
- Planning for the orderly succession of new directors to the Board.
- Recommending to the Board the membership and chairmanship of the Audit, Corporate Responsibility and Remuneration committees.

The full terms of reference of the Nominations Committee can be found on the Company's website or can be obtained from the Company Secretary.

**Governance**
The Nominations Committee was in place throughout 2008. It is chaired by the Chairman of the Company. Whilst he is not deemed to be independent, the other two members of the Committee are independent non-executive directors in accordance with provision A.3.1 of the Combined Code.

When dealing with any matters concerning the Chairmanship of the Board, the Chairman of the Committee will absent himself from meetings as required and Sir Peter Mason, the Board's Senior Independent Director, will take the chair.

The Committee normally asks the Chief Executive and Group HR Director to attend its meetings. During the year, the Committee did meet without Group executives present.

The Committee met six times in 2008.

**Activities**
In the first half of 2008, the Committee's main focus was on managing the search for a new Chief Executive to succeed Mike Turner who retired at the end of August 2008. The search process was initiated towards the end of 2007 and began with the Committee considering the succession plans that the Committee has assisted in developing over a number of years. Under the heading of Chief Executive, these plans identified Ian King in the 'Ready Now' category. However, recognising the time available in which to conduct a search and the vital importance of this particular appointment, the Committee agreed that it should engage search consultants to review suitable candidates in the external global market. Egon Zehnder International were selected by the Committee to conduct this search, and all directors were consulted by them and the Chairman as part of the search process. Having completed the process, the Committee nominated Ian King for appointment to the position of Chief Executive with effect from 1 September 2008.

The Committee was also active in 2008 in the appointment of new non-executive directors. The Zygos Partnership was engaged to assist the Committee in searching for suitable candidates for nomination. The search resulted in Carl Symon and Ravi Uppal being nominated and duly appointed to the Board. These individuals broaden the global business experience available to the Board.

In past years the Nominations Committee has reported on the succession planning processes that have been introduced across the Group in recent years. The management resource planning and development processes that are the basis of these plans are reviewed annually by the Committee. Last year the Committee reviewed the output from the succession and development process looking at individual succession plans and analysing the overall strength of the management resource, the development themes that apply to the global senior management cadre and how these are being addressed.

Finally, during 2008 the Nominations Committee reviewed the membership of Board committees following changes to the membership of the Board. Andy Inglis was nominated to succeed Peter Weinberg as chairman of the Corporate Responsibility Committee and changes were recommended to the membership of certain committees so as to ensure that full use was made of the time and expertise offered by our non-executive directors.

On behalf of the Nominations Committee

**Dick Olver** Nominations Committee Chairman

The Board has delegated authority to the Remuneration Committee for remuneration policy and determining the specific packages for the Chairman and executive directors, and has delegated authority to the Non-Executive Directors' Fees Committee to agree fees payable to the non-executive directors.

The reports from both these Committees are incorporated into this Remuneration report, together with a report on the remuneration or fees paid to directors and the policy underpinning this.

The Remuneration report is structured as follows:



## Remuneration Committee Report

**Sir Nigel Rudd**
Remuneration Committee Chairman

**Members**
Sir Nigel Rudd (Chairman)
Roberto Quarta
Carl Symon

During the year, Peter Weinberg served as a member of the Remuneration Committee until his retirement from the Board on 7 May 2008. Sir Peter Mason also served as a Committee member for part of 2008.

**Responsibilities**

- Agreeing a policy for the remuneration of the Chairman, executive directors, members of the Executive Committee, the Company Secretary and other senior executives.
- Within the agreed policy, determining individual remuneration packages for the Chairman and executive directors.
- Agreeing the policy on terms and conditions to be included in service agreements for the Chairman, executive directors, members of the Executive Committee, the Company Secretary and other senior executives, including termination payments and compensation commitments, where applicable.
- Approving any employee share-based incentive schemes and any performance conditions to be used for such schemes.
- Determining any share scheme performance targets.

The full terms of reference of the Remuneration Committee, which conform with the requirements of the Combined Code, can be found on the Company's website or can be obtained from the Company Secretary.

**Governance**

The Committee is chaired by Sir Nigel Rudd and all of its members are independent non-executive directors. The Company's Chairman and Chief Executive attend Committee meetings by invitation only. They do not attend where their individual remuneration is discussed and no director is involved in deciding his own remuneration.

In 2008 the Committee met seven times and details of attendance at these meetings are provided in the Corporate Governance Report on page 94.

The Committee appointed Kepler Associates as its Independent Adviser in 2007 to provide advice to the Committee and its individual members on all aspects of the Committee's remit. Kepler Associates will not undertake any work for the Company whilst they are retained as the Committee's Independent Adviser. Representatives from Kepler Associates have attended each of the Committee meetings during 2008, except the June meeting in the US, and will be in attendance at all meetings unless specifically requested otherwise by the Committee.

During the year the Committee also received material assistance and advice on remuneration policy from the Group's Human Resources Director, Alastair Imrie, and the Human Resources Director, Group Remuneration and Benefits, Graham Middleton. Dick Olver, Chairman, Mike Turner (prior to his retirement as Chief Executive at the end of August 2008), and Ian King (since his appointment as Chief Executive from 1 September 2008) also provided advice that was of material assistance to the Committee.

Legal advice to the Committee has been provided by Linklaters and Freshfields Bruckhaus Deringer, who are both appointed by the Company, and who also provided services to the Company during the year. The Committee is satisfied that the services provided to it by these firms were of a technical nature and did not create any conflict of interest. If a conflict of interest were to arise in the future, the Committee would appoint separate legal advisers from those used by the Company.

PricewaterhouseCoopers (PwC), who are appointed by the Company and also provided services to the Company during the year, provided detailed information on market trends and the competitive positioning of packages. Hewitt New Bridge Street, who are appointed by the Committee, provided advice on the total shareholder return figures for assessing the performance condition under the Performance Share Plan.

**Activities**

In discharging its responsibilities, the Committee has, during the year, reviewed the Company's reward strategy and agreed the:

- performance targets for the year and progress against those targets;
- operation of the long-term incentive plans and policy for executive share scheme grants including the level of individual grants and performance conditions;
- policy for the operation of the all-employee share schemes;
- award of annual incentives based on the prior year's performance;
- package for the new Chief Executive appointed during the year;
- discretionary elements of the executive share plans;
- payout on the special incentive awarded to Mike Turner which vested on his retirement at the end of August 2008; and
- review of the pensionability of annual incentives for US executives.

In addition, the Committee has:

- reviewed the Remuneration report; and
- consulted with major shareholders over aspects of remuneration policy.

The Company's remuneration strategy, policy and details of executive remuneration are set out on pages 77 to 93 of this Remuneration report.

On behalf of the Remuneration Committee

**Sir Nigel Rudd** Remuneration Committee Chairman

## Non-Executive Directors' Fees Committee Report

**Members**

Dick Olver (Chairman)
Philip Bramwell
Walt Havenstein
Ian King

During the year Mike Turner served as a member of the Non-Executive Directors' Fees Committee until his retirement at the end of August 2008.

**Responsibilities**

- Reviewing the fees payable to non-executive directors (excluding the Chairman) and making changes to such fees as deemed appropriate.

**Governance**

The Non-Executive Directors' Fees Committee has delegated authority from the Board to agree fees payable to non-executive directors on its behalf.

**Activities**

The Board has approved the following guidelines to be used by the Committee when discharging its responsibilities:

- fees shall be sufficient to attract and retain individuals with the necessary skills, experience and knowledge required to ensure that the Board is able to discharge its duties effectively;
- in setting fees the Committee shall have regard to the amount of time individual non-executive directors are required to devote to their duties and also the scale and complexity and international nature of the business and the responsibility involved;
- fees payable to non-executive directors shall be paid in cash and shall not be performance-related; and
- non-executive directors shall not participate in the Company's share-based incentive schemes or pension scheme.

The Committee meets each year to consider the fees paid to the non-executive directors. Having first reviewed the time commitments expected of non-executive directors and the market competitive positioning of existing fee levels, the Committee agreed the changes detailed on page 86.

On behalf of the Non-Executive Directors' Fees Committee

**Dick Olver** Non-Executive Directors' Fees Committee Chairman

## Remuneration strategy and policy for executive directors

This section of the report explains the Company's remuneration strategy and policy, the individual components of executive directors' remuneration and details of their service contracts as required by legislation.

**Remuneration strategy and 2008 review**
The Committee undertook a major review of the remuneration strategy in the second half of 2007 and as a result made a number of changes for 2008 which:

- brought the remuneration packages into line with market competitive levels;
- simplified the arrangements to improve line-of-sight between performance and reward;
- shifted the focus towards long-term sustainable growth in earnings per share (EPS);
- reinforced the key aspects of the Group's Corporate Responsibility agenda;
- directly aligned short-term and long-term reward through compulsory deferral of part of the annual incentive into the Share Matching Plan for all executive directors; and
- increased the gearing to drive for high performance as most of the improvement in the package is only delivered for achieving more stretching targets.

This review was set out in detail in last year's report. Following the annual review in November 2008, the Committee concluded that the current remuneration strategy remains appropriate, and intends to continue with the executive remuneration policy as detailed in this report in 2009 and subsequent years for executive directors, and this policy will be flowed down to the most senior executives within the Group globally (approximately 280) to create a consistent global approach to reward. The principles of the remuneration strategy are applied consistently across the Group below this level, taking account of seniority and local market practice.

The Committee will continue to consult on material changes with principal shareholders.

Summarised below is the Company's remuneration strategy and policy for executive directors, together with the individual elements of the package and their purpose.

**Strategy**
To provide a remuneration package that:

- helps to attract, retain and motivate
- is aligned to shareholders' interests
- is competitive against the appropriate market
- encourages and supports a high-performance culture
- is fair and transparent
- can be applied consistently throughout the Group

**Policy**

- Set base salary at around median of the relevant market competitive level
- Reward stretching superior performance with upper quartile reward
- Balance between:
  - short-term and long-term reward
  - fixed and variable reward
  - with balance becoming more long-term and more highly geared with seniority
- Directly align short-term and long-term reward through compulsory deferral of annual incentive into the Share Matching Plan
- Competitive package of benefits

| Package | Purpose |
|---|---|
| Base salary | Recognise market value of role and individual's skills, experience and performance |
| Annual Incentive | To drive and reward annual performance of individuals, teams and the Company on both financial and non-financial metrics, including behaviours |
| Share Matching Plan | Directly align short-term and long-term reward through compulsory deferral of annual incentive into shares, and drive and reward delivery of sustained long-term EPS performance through co-investment aligned to interests of shareholders |
| Performance Share Plan | Drive and reward delivery of sustained long-term EPS and Total Shareholder Return (TSR) performance aligned to interests of shareholders |
| Pension provision | Provide competitive retirement benefits which reward long-term performance through seniority, and loyalty through long service |
| Other benefits | Provide competitive cost effective benefits package through leveraging the Company's size and scale |
| Global all-employee incentive plan | Reward all employees globally for Group performance, encouraging employee share ownership aligned to interests of shareholders |

# Remuneration report *continued*

### Appointment of new Chief Executive

Prior to the annual review of remuneration strategy, the Company announced on 27 June 2008 the appointment of Ian King, previously Chief Operating Officer – UK/RoW, as Chief Executive with effect from 1 September 2008. The Committee agreed a package for Ian King which it considered to be competitive and appropriate to incentivise him to deliver the next phase of the Company's strategy. This comprised annual base salary of £850,000, maximum annual incentive opportunity for 2008 of 225% of base salary (pro-rated for the period from appointment) and total award of Performance Shares in 2008 of 250% of base salary.

The following sections describe in more detail the subsequent 2008 review and the specific arrangements for executive directors.

### Approach to the 2008 remuneration review

The 2008 review not only considered the Company's executive remuneration packages against the market but also the Company's performance to date and its corporate strategy for the next five years.

Information on the market for comparable management positions was provided by PwC so that the Committee could form a view as to where to position the various elements of the package relative to comparable companies.

The methodology used was to construct appropriate comparator groups for the individual positions, taking account of company size, scale of operations and breadth of role. The comparator group for the UK executive directors comprised the FTSE 50 companies (excluding financial services and retail) with market capitalisation nearest to that of BAE Systems. The Committee believes that using market capitalisation creates alignment between the value placed on the Company and the value placed on the executives who manage it. The six largest companies were also excluded as were several others to arrive at a comparator group of 23 companies (11 larger and 12 smaller) which the Committee believed appropriate for benchmarking UK executive directors' packages.

For the US Chief Operating Officer, regression analysis was used on US aerospace, defence and general industry sector data to produce appropriate market figures consistent with the size and scale of the US business, adjusting where necessary to reflect the extra responsibility for his plc board role.

The base salary, total cash reward (base salary plus annual incentive), total direct reward (total cash reward plus long-term incentives) and total reward (total direct reward plus pension) were analysed at the median and upper quartile for the relevant posts in the comparator group companies. This gives the Committee a view on the competitiveness of the individual elements of the package as well as the package as a whole.

The Committee also reviewed market trends around the individual elements of remuneration to ensure that the structure of the package stays in line with market practice. The remuneration structure overall also takes account of the performance of the individual, the Company as a whole and the pay and conditions of Group employees.

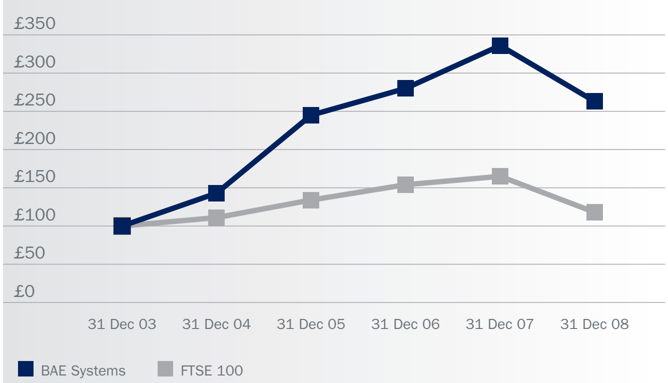
### Base salary

As a result of the above review and, having taken account of the competitive pay positioning, performance and general market trends, the Committee has increased the annual base salaries of executive directors with effect from 1 January 2009 as follows:

| Executive director | Base salary at 31 December 2008 | Base salary at 1 January 2009 | Percentage increase |
|---|---|---|---|
| **Ian King**[1]<br>Chief Executive | £850,000 | £900,000 | 5.9% |
| **George Rose**<br>Group Finance Director | £592,500 | £622,500 | 5.1% |
| **Walt Havenstein**<br>Chief Operating Officer – US | $900,000 | $960,000 | 6.7% |

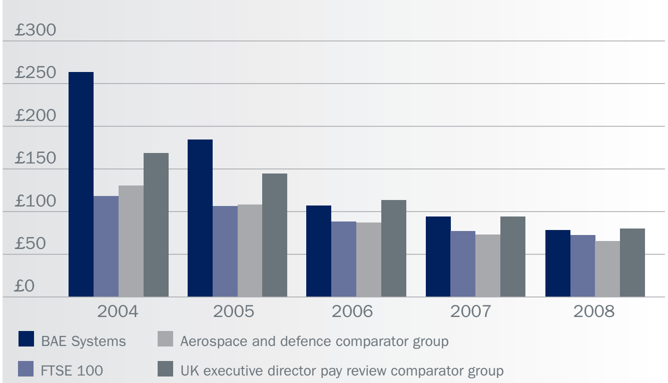
1 Ian King was an executive director at the beginning of 2008 in the role of Chief Operating Officer – UK/RoW on an annual base salary of £592,500, and was promoted to Chief Executive with effect from 1 September 2008.

**Value at 31 December 2008 of £100 investment at 31 December 2003**




This graph, which has been produced in accordance with the requirements of Schedule 7A to the Companies Act 1985, shows the value by 31 December 2008, on a total shareholder return basis, of £100 invested in BAE Systems on 31 December 2003 compared with the value of £100 invested in the FTSE 100 Index. The other points plotted are the values at intervening financial year ends. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity market index. As BAE Systems is a constituent member of the FTSE 100, it was deemed to be the most appropriate general UK equity index.

**Value at 31 December 2008 of £100 investment**




The graph above shows the value shareholders have achieved by their investment in BAE Systems over recent years as compared to (i) the FTSE 100 Index; (ii) the companies forming the sectoral peer group for the BAE Systems Performance Share Plan; and (iii) the companies forming the comparator group for the 2008 executive pay review. The graph depicts the value for BAE Systems and the comparators at the end of 2008 of a single £100 investment made at the beginning of each of the last five years.

### Incentives

The Group strategy is set out on page 10 along with the Group Strategic Framework. This explains how the Group strategy is delivered through the Group Strategic Objectives, which apply across all businesses and are championed by the Executive Committee, and the Business Portfolio Actions, which apply to the businesses individually or jointly and are championed by the relevant Executive Committee members. Both are underpinned by the Integrated Business Plan (IBP) which sets out the individual businesses' plans for the next five years in terms of strategy, actions and performance, making sure they are aligned to collectively deliver the Group strategy.

Each year, the Board agrees the Executive Committee's top ten objectives which are those key to delivering the Group's strategy. These are set out on page 9 and are used as the basis to set the individual objectives for the executive directors which are agreed by the Chairman, Dick Olver and the Committee. These then flow down to members of the Executive Committee and the senior leadership team to ensure that all businesses within the Group are aligned with the overall Group strategy.

The remuneration strategy incentivises and rewards executives to deliver their contribution to the achievement of the Group strategy through the combination of short-term incentives targeted at business performance, Group performance, personal performance and leadership behaviours, and long-term incentives targeted at Group performance. To directly align short-term and long-term reward, executive directors will be required to invest at least one-third of their net 2009 annual incentive into the Share Matching Plan (SMP) when the annual incentive is paid in 2010. Further investment can be made on a voluntary basis up to a maximum investment of half their net annual incentive.

### Annual Incentive Plan

The annual incentives for 2009 continue to focus on a combination of in-year financial performance and longer-term performance and risk management (both business risk and reputation risk). Two-thirds is driven off in-year financial performance and one-third based on driving performance and improvement in ethics and safety (reinforcing the importance of key aspects of the Group's Corporate Responsibility agenda) combined with the other objectives supporting the Group's strategy.

To remain competitive, the 2009 maximum annual incentive opportunity for the Group Finance Director increases from 125% to 150% of base salary but one-third will be compulsorily invested into the SMP (compared to one-quarter of the 2008 annual incentive). Table (i) below summarises the revised annual incentive structure and levels for the executive directors.

The financial targets are derived from the IBP and are based on earnings and cash targets as these are seen as the key indicators of both short-term and long-term financial performance and value creation, and are supported by the Company's major shareholders. At Group level, EPS is used whereas EBITA[2] is used to measure earnings performance at a business level. Previously cash targets have been based on net cash/debt at the year end. For 2009, to incentivise improved phasing of cash generation throughout the year, a combination of year end and average net cash/debt will be used. As last year, the payout for achieving on-target performance against the in-year financial targets remains at 40% of maximum.

The Committee believes that the annual incentive targets for the executive directors are stretching but achievable. The structure of the 2009 annual incentive plan for executive directors is summarised in table (ii) below.

| Table (i) – Maximum annual incentive as percentage of salary | Ian King | | | Walt Havenstein | | George Rose | |
|---|---|---|---|---|---|---|---|
| | 2009 | 2008[1] | | 2009 | 2008 | 2009 | 2008 |
| | CEO | CEO | COO – UK/RoW | US COO | | Group Finance Director | |
| In-year financial performance | 150% | 150% | 83% | 150% | 150% | 100% | 83% |
| Ethics and safety | 28.5% | 27% | 15% | 28.5% | 27% | 19.5% | 15% |
| Other objectives supporting the Group strategy | 46.5% | 48% | 27% | 46.5% | 48% | 30.5% | 27% |
| **Total** | **225%** | **225%** | **125%** | **225%** | **225%** | **150%** | **125%** |
| Annual incentive compulsorily invested into SMP | 75% | 75% | 31.25% | 75% | 75% | 50% | 31.25% |
| Maximum bonus payable in cash | 150% | 150% | 93.75% | 150% | 150% | 100% | 93.75% |

1 The 2008 annual incentive for Ian King will be pro-rated for his periods as Chief Executive (CEO) and Chief Operating Officer (COO) – UK/RoW.

| Table (ii) – Annual incentive as a percentage of base salary for 2009 | Ian King | | Walt Havenstein | | George Rose | |
|---|---|---|---|---|---|---|
| Measure | Base target | Stretch target | Base target | Stretch target | Base target | Stretch target |
| Group EPS | 30% | 75% | 10% | 25% | 20% | 50% |
| Group cash | 30% | 75% | 10% | 25% | 20% | 50% |
| Business EBITA[2] | – | – | 20% | 50% | – | – |
| Business cash | – | – | 20% | 50% | – | – |
| Ethics and safety | Up to 28.5% | | Up to 28.5% | | Up to 19.5% | |
| Other objectives supporting the Group's strategy | Up to 46.5% | | Up to 46.5% | | Up to 30.5% | |

2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

If performance is between the base and stretch targets, the bonus is pro-rated on a straight-line basis.

### Long-Term Incentive Plans (LTIPs)
The Company operates two LTIPs (having ceased awards of share options in 2008) – the Performance Share Plan (PSP) and the Share Matching Plan (SMP). At the May 2008 AGM, shareholders approved:

– an increase in the maximum annual award under the PSP to four times base salary;

– half the PSP awards to use a performance condition based on internal metrics (EPS for 2008), with the remaining half to continue to use Total Shareholder Return (TSR); and

– an improvement in the SMP match to 2:1 for improved performance.

Full details of the PSP and SMP are contained on pages 82 and 83.

To maintain a competitive package, the 2009 PSP awards for the Group Finance Director will be 250% of base salary so that all three executive directors will have the same level of awards in 2009.

### Pension provision
Following the changes made recently in the UK in response to pensions simplification legislation (as reported in 2006), no further changes to the pension arrangements for UK executive directors are required.

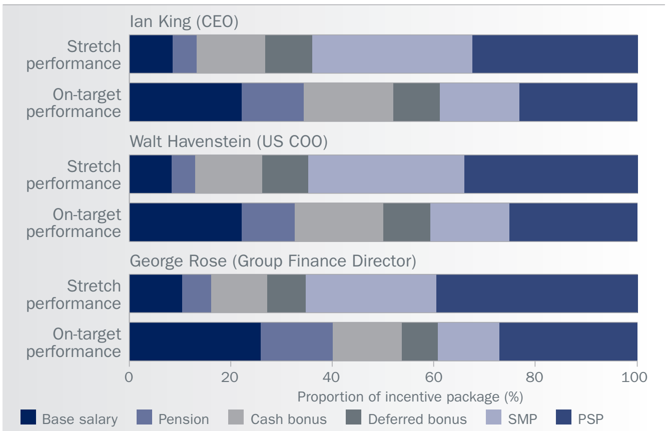
As reported last year, following the increases in US annual incentive levels, the Committee undertook a review of pensionability of annual incentives for US executives. Given the changes made in 2006 to increase the pay averaging period for existing US executives to ten years by 2015, the Committee decided that annual incentives should continue to be pensionable in line with normal US practice but to limit the maximum pensionability to 150% of base salary from 2008.

## Analysis of package

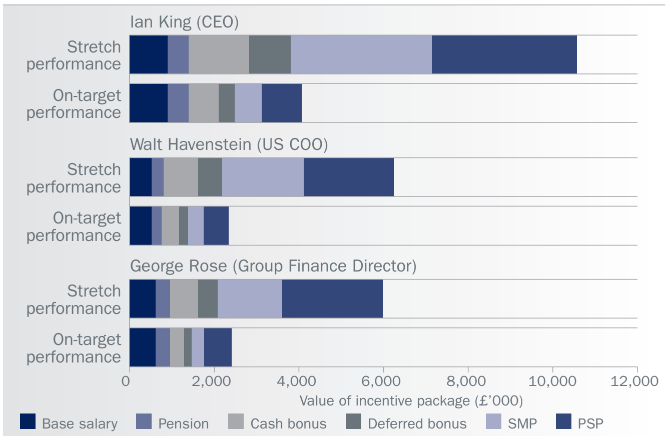
### Total value of incentives
The table below shows the incentive package for executive directors for 2009.

| Incentives as a percentage of base salary | Ian King and Walt Havenstein | George Rose |
|---|---|---|
| **Annual Incentive Plan**<br>– On-target<br>– Maximum | 110%<br>225% | 73%<br>150% |
| **Share Matching Plan**<br>– Match<br>– Compulsory deferral | 2:1<br>1/3 | |
| **PSP award**<br>– TSR<br>– EPS | 125%<br>125% | |
| Total | 250% | |

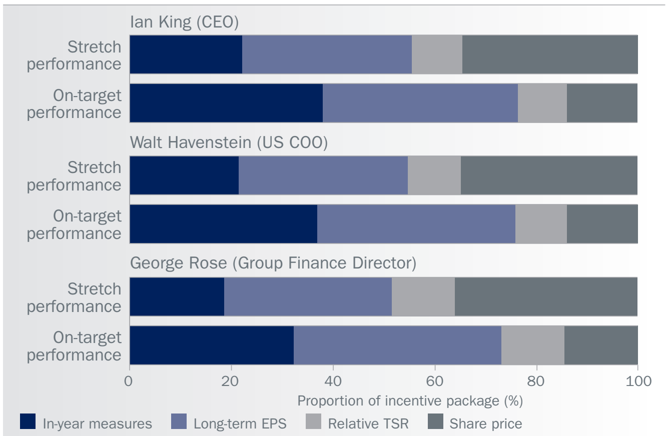
### Proportion of package value delivered through fixed and performance-related reward
The following chart re-expresses this as a proportion of the overall package and shows that, for the Group Finance Director, more than half the package is performance-related at on-target performance rising to over three quarters at stretch performance. For the Chief Executive and US Chief Operating Officer, these figures are even higher at two-thirds at on-target performance and 85% at stretch performance. It also demonstrates the importance of the SMP, which is the largest driver of gearing in the package and delivers a similar value to the PSP at stretch performance.




### Value of package
The chart below shows the total value of the package for the three executive directors at both on-target and stretch performance.




### Performance drivers of incentive package
The following chart shows the drivers of performance in the incentive package and demonstrates that long-term EPS is the dominant driver of performance reward.



## Performance in 2008

The structure of the 2008 Annual Incentive Plan was set out in last year's Remuneration report and summarised below.

**Financial performance**
2008 was another very successful year, building on the strong performance of recent years. Stretch performance targets on EPS, profit and cash were each achieved at the plc, UK/RoW and BAE Systems, Inc. levels. At the individual business level, the major businesses achieved stretch on most but not all their targets with notable performances in Land & Armaments and Military Air Solutions. Three of the smaller businesses did not meet their targets on one or other of the profit and cash elements.

**Non-financial performance**
The Executive Committee's Top Ten objectives for 2008 and the assessment of performance against these are set out on page 7, whilst page 49 provides more detailed information on Objective 10, which relates to the Corporate Responsibility agenda, and the performance against this.

Significant progress was made against the ethics objective, including developing the Global Code of Conduct and rolling this out to all employees from January 2009, and the Group is on plan with its programme to implement the Woolf Committee recommendations. The Committee awarded the full stretch payout to the executive directors in respect of that part of the annual incentive driven off ethics performance.

On safety, all major operational sites (other than those acquired during the year) achieved Level 3 against the five-level Safety Maturity Matrix and have submitted plans to achieve Level 5 by the end of 2011. Senior Leaders undertook formal training and completed safety audits. Regrettably, there were five employee fatalities during the year, two on company sites and three deployed on active service with the US armed forces. The gap between Group performance and external benchmarks on days lost to work-related injuries was closed by 9% during the year, falling short of the target of 10%. The Committee awarded only one-third of the potential payout on that part of the annual incentive driven off safety performance.

On other objectives supporting the Group Strategy, significant progress was made against all the eight remaining Top Ten objectives and the Committee agreed an overall assessment of 7 out of 8. The Committee also reviewed the individual directors' overall performance and their behavioural performance.

Accordingly, the Committee determined the payout under the 2008 Annual Incentive Plan as follows:

| 2008 annual incentive payout | Mike Turner | Ian King | Walt Havenstein | George Rose |
|---|---|---|---|---|
| % of stretch | 93.7% | 94.7% | 92.7% | 93.9% |
| % of base salary | 140.5% | 150.0% | 208.5% | 117.3% |
| Amount | £1,405,000 | £1,275,000 | $1,876,500 | £695,200 |

In addition:

– The real growth in EPS over the three years to 2008 exceeded 5% pa so that the awards of share options granted in 2006 vest in full.

– The Company's TSR for awards of shares made in June 2005 under the Performance Share Plan exceeded the upper quintile position when compared against the comparator group of 18 other defence and aerospace companies. The Committee has satisfied itself that there has been a sustainable improvement in the underlying performance of the Group over the three-year performance period and so this award has vested in full.

– The TSR for the PSP award made in December 2005 fell just short of the upper quintile position and accordingly 97.1% of the award vested.

The Committee also determined that the performance conditions attached to the special incentive awarded to Mike Turner in October 2007, which related to continuing the successful implementation of the Company's business strategy, satisfaction of leadership objectives set by the Committee, achieving an orderly handover of key external relationships, and facilitating an orderly succession to the Chief Executive role, had been met in full. Accordingly the whole of the award vested. This comprised an award of 231,618 shares and a cash payment of £1,181,250. Half the shares and cash were released on his retirement on 1 September 2008 with the remaining half due to be released a year later. The share award is included in Table B on page 91 and the cash award is included in Table C on page 92.

| Annual incentive as a percentage of base salary for 2008 | Mike Turner | | Ian King[2] | | Walt Havenstein | | George Rose | |
|---|---|---|---|---|---|---|---|---|
| Measure | Base target | Stretch target | Base target | Stretch target | Base target | Stretch target | Base target | Stretch target |
| Group EPS | 20% | 50% | 15.5% | 38.8% | 15% | 37.5% | 16.6% | 41.5% |
| Group cash | 20% | 50% | 15.5% | 38.8% | 15% | 37.5% | 16.6% | 41.5% |
| Business EBITA[1] | – | – | 5.5% | 13.8% | 15% | 37.5% | – | – |
| Business cash | – | – | 5.5% | 13.8% | 15% | 37.5% | – | – |
| Ethics and safety | Up to 18% | | Up to 19% | | Up to 27% | | Up to 15% | |
| Other objectives supporting the Group's strategy | Up to 32% | | Up to 34% | | Up to 48% | | Up to 27% | |

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
2 Ian King's figures represent the total arising from pro-rating his figures for his periods as Chief Executive and Chief Operating Officer – UK/RoW.

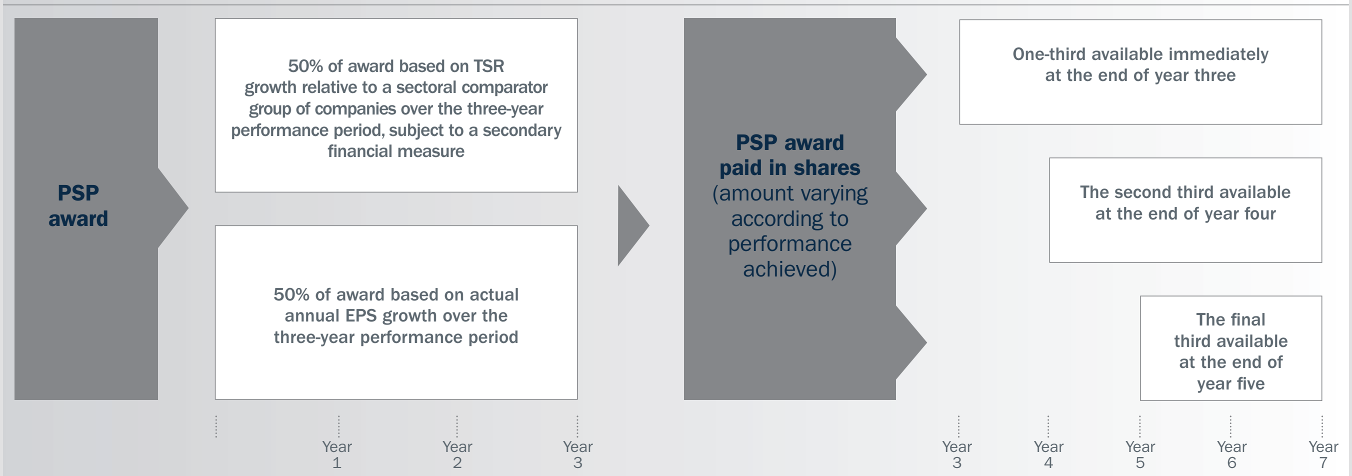
## Summary of Long-Term Incentive Plans

**Plan provisions**
Performance conditions for grants of awards to be made under the Performance Share Plan and the Share Matching Plan in 2009 are detailed below. Performance conditions for grants of awards made prior to 2009 are detailed on pages 88 and 89.

### Performance Share Plan (PSP)

**Key features for PSP awards in 2009:**
- half the PSP award will be based on a Total Shareholder Return performance condition (PSP$^{TSR}$) and the other half on an Earnings per Share (PSP$^{EPS}$) performance condition;
- length of period for performance condition: three years with any shares vesting paid out in three equal tranches on vesting at the end of years three, four and five; and
- shares under award attract dividends prior to vesting.

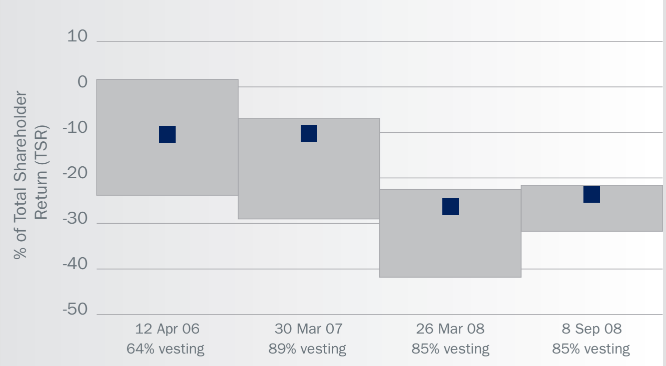
**How the PSP operates**




For the US executives, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition achieved.

The graph below summarises the current position on the TSR element for outstanding awards under the PSP as at 31 December 2008. The coloured box shows the range of TSR required for 25% vesting to full vesting, and the square shows BAE Systems' TSR.

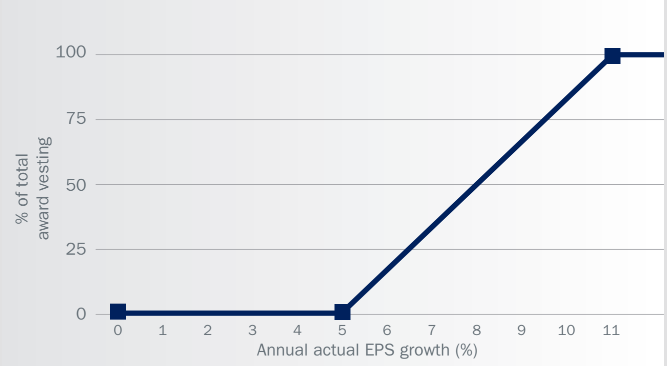
**Performance of outstanding PSP$^{TSR}$ awards**




The proportion that would vest is shown at the bottom of the chart.

**Performance condition – PSP$^{EPS}$**
- Proportion of the award capable of exercise: determined by the rate of annual actual EPS growth over the three-year performance period, with nil vesting at annual actual EPS growth of 5% or less and 100% vesting at 11% growth as set out below:

**Performance condition – PSP$^{EPS}$**




- Rationale for performance measure: major investors consider EPS to be a key indicator of long-term financial performance and value creation.

## Performance Share Plan (PSP) *continued*

**Performance condition – PSP[TSR]**

– Proportion of the award capable of exercise determined by:

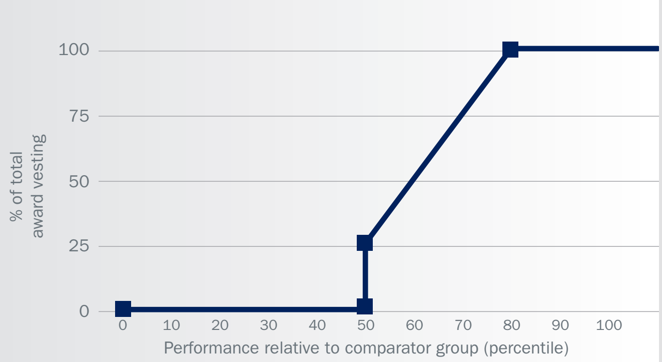
(i) the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 18 other international defence and aerospace companies (see table below):

PSP[TSR] – sectoral peer group

| | | |
|---|---|---|
| Boeing | General Dynamics | Raytheon |
| Cobham | GKN | Rockwell Collins |
| Dassault Aviation | Goodrich | Rolls-Royce |
| EADS | Honeywell International | Smiths Group |
| Embraer PN | Lockheed Martin | Thales |
| Finmeccanica | Northrop Grumman | United Technologies |

None of the shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group and 100% vest if it is in the top quintile (ie top 20%) as set out below:

**Performance condition – PSP[TSR]**




and

(ii) whether there has been a sustained improvement in the Company's underlying financial performance and whether it is appropriate to release some or all of the awards. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA[1]; order book; turnover; risk and underlying project performance.

– Rationale for performance measures: importance to major investors as an indication of both earnings and capital growth relative to other major companies in the same sector and to ensure that awards only vest if there has been a clear improvement in the Company's performance over the relevant period.

## Share Matching Plan (SMP)

**Key features for grants of awards in 2009:**

– stand-alone share investment plan with the investment linked to the award under the Annual Incentive Plan;

– participants are granted a conditional award of Matching Shares against the gross value of the annual incentive invested;

– Matching Shares attract dividends during the three-year deferral period, released on vesting of any Matching Shares;

– executive directors are required to invest one-third of their 2008 net annual incentive into the SMP; and

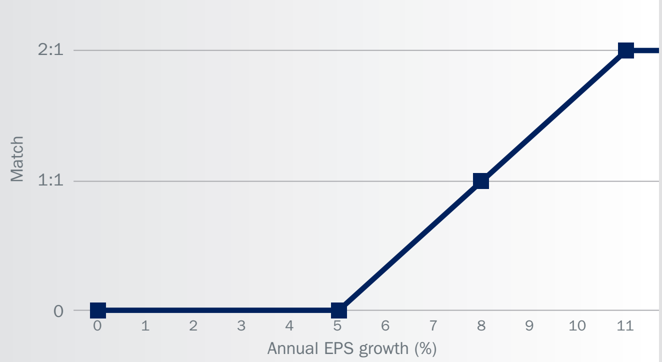
– maximum level of investment will be 50% of the net annual incentive.

**Match and performance condition**

– Nil match for actual EPS growth of less than 5% pa increasing uniformly to a 2:1 match at 11% pa growth.

– Rationale for performance measure: major investors consider EPS to be a key indicator of long-term financial performance and value creation.

**Performance condition – SMP 2009**




## Personal shareholding policy

The Committee has agreed a policy whereby all executive directors are required to establish and maintain a minimum personal shareholding equal to 200% of base salary. As a minimum, a holding equal to 100% of base salary must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes or long-term incentive schemes, by using 50% of the shares that vest or 50% of the options which are exercised on each occasion. Thereafter, executive directors are required to increase their personal shareholding gradually, on each occasion using 25% of the shares that vest or 25% of the options exercised each year, until a personal shareholding equal to 200% of annual base salary is achieved and maintained. These limits are reviewed periodically. A similar arrangement applies to senior executives eligible for share-based long-term incentives with limits aligned to the levels of awards made under these plans.

Details of the directors' personal shareholdings are shown in Table A on page 87.

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

### Share Incentive Plan (SIP)

During 2008 the UK executive directors were eligible to participate in the all-employee free shares element of the Share Incentive Plan. As a result of the Company's performance in 2008, all eligible employees (including the UK executive directors) will be entitled to receive shares worth £524. A similar arrangement operates for non-UK employees on a cash or shares basis depending on local tax and security laws.

The Company operates a share purchase arrangement (Partnership Shares) under the Share Incentive Plan. Under this arrangement, UK-based employees (including executive directors) may purchase ordinary shares in BAE Systems by either monthly investments of between £10 and £125 a month, or lump sum investments of between £10 and £1,500 in a tax year, both limited to 10% of salary if less. The Partnership Shares attract Matching Shares. As the plan is an all-employee plan, the Matching Shares are not subject to performance conditions in accordance with legislation. One free matching share is awarded for each Partnership Share up to a maximum of £63 per month.

Dividends paid in respect of the shares in the Share Incentive Plan for UK-based employees are reinvested as Dividend Shares.

### Dilution of share capital

The Committee has agreed that, in respect of new issue or treasury shares, shares representing no more than 1% (and no more than 0.5% for the executive schemes) of the Company's issued share capital will be used in any one financial year for the grant of incentives under all of the Company's employee share schemes. The table below sets out the available dilution capacity for the Company's employee share schemes based on the limits set out in the rules of those schemes.

| | 2008 |
|---|---|
| Total issued share capital as at 31 December 2008 | 3,582m |
| **All schemes:** | |
| 10% in any consecutive 10 years | 358.2m |
| Remaining headroom | 237.7m |
| **Executive schemes:** | |
| 5% in any consecutive 10 years | 179.1m |
| Remaining headroom | 107.2m |

The Company currently intends to use new issue shares to satisfy future share awards under the executive long-term incentive plans up to the 0.5% annual dilution limit, and to use treasury shares to satisfy awards of free shares and matching shares under the all-employee Share Incentive Plan. For outstanding options it is intended that new issue shares will be utilised for the Executive Share Option Plan, and treasury and new issue shares for the all-employee Save-As-You-Earn Share Option Scheme.

## Post-retirement benefits

### UK pension benefits

UK executive directors are members of the BAE Systems Executive Pension Scheme (the ExPS) and members of the underlying employee pension plans. As such, they are subject to the same contribution rates payable by employees of the underlying plans, and the benefits changes introduced in 2006 for post April 2006 service including the introduction of the Longevity Adjustment Factor, a reduction in the maximum level of pension increases and a change in the definition of Pensionable Pay.

The ExPS tops up the underlying employee plan to provide a target benefit for executive directors payable from normal retirement age of 1/30th of Final Pensionable Pay (FPP) for each year of ExPS pensionable service (subject to a maximum of two-thirds of FPP). FPP is defined as base salary averaged over the last 12 months prior to leaving service in respect of service accrued to 5 April 2006 and 36 months prior to leaving in respect of service from 6 April 2006. The ExPS also provides a lump sum death-in-service benefit equal to four times base salary at date of death, and a spouse's death-in-service pension equal to two-thirds of the prospective pension at normal retirement age. Children's allowances are also payable, usually up to the age of 18. Spouses' pensions and children's allowances are also payable upon death in retirement and death after leaving the Company's employment with a deferred pension. Pensions are increased annually by the rise in the Retail Prices Index subject to a maximum increase of 5% per year in respect of pre 6 April 2006 service and 2.5% per year in respect of service from 6 April 2006.

As a result of the 2006 age discrimination legislation, executive directors' default retirement age is 65 but they retain any previous rights they had to retire and draw their pensions without actuarial reduction for early payment at an earlier age.

Following the changes made to take account of the Pensions Simplification tax changes which came into effect from April 2006, UK executives reaching the Lifetime Allowance (LTA) are given a number of choices as previously reported. These are:

- remain in the pension scheme and pay any additional tax charge; or
- opt out of the pension scheme (and so earn no further pension benefits in respect of future service) and instead receive a taxable salary supplement. This supplement will be 30% of salary and 20% of salary for those senior executives with a two-thirds salary target after at least 20 years' and 30 years' service, respectively; or
- restrict scheme benefits to the value of the LTA with the remainder being provided directly from the Company as an unfunded promise. At retirement, the unfunded Company benefits can be either taken as pension or commuted in full for a taxable lump sum.

The Committee reviews these arrangements each year in the light of developing market practice and believes they remain appropriate as they provide executives with competitive pension benefits and choices for dealing with the LTA which may better suit their needs whilst being broadly cost neutral to the Company, are in line with market practice and do not compensate executives for changes in taxation.

**Ian King** is a member of the BAE Systems 2000 Pension Plan (the 2000 Plan), applicable to former employees of Marconi Electronic Systems (MES), and a member of the ExPS with a normal retirement age of 62. The 2000 Plan provides a pension of 1/50th of Final Pensionable Earnings (FPE) for each year of pensionable service, payable from a normal retirement age of 65, and members pay contributions of 8% of Pensionable Earnings. FPE under the 2000 Plan is the best three-year average of base salary and bonus in the ten Plan Years prior to leaving, less an offset for State pensions. The Company decided in 2006 to limit pensionable bonuses in the 2000 Plan in the 2006/07 Plan Year to 20% of base salary and to 10% of base salary for the 2007/08 Plan Year and thereafter. However, there is a guarantee that the FPE figure for benefits in respect of service prior to 6 April 2007 will not be less than the FPE figure at 5 April 2007 to ensure that employees do not lose the benefit of contributions paid on past bonuses. Ian King joined the ExPS in 1999 following the BAe/MES merger. Therefore Ian King's total pension is the sum of his 2000 Plan benefits plus the top-up from the ExPS.

**George Rose** is a member of the BAE Systems Pension Scheme paying contributions of 9.29% of base salary, and is a member of the ExPS with a normal retirement age of 60. George Rose was affected by the previously applicable Inland Revenue earnings cap on approved pensions and has an unapproved (ie non-tax qualified) pension arrangement to top up his benefits from the approved schemes. This was designed so that the total pension from all sources would be broadly in line with the pension he would have received from the Group pension schemes had he not been subject to the earnings cap. The Pension Simplification tax changes allowed the flexibility to remove the earnings cap for George Rose in respect of service from April 2006, although some of his benefits will remain to be provided by means of an unfunded promise from the Company. No further contributions will be paid into his funded unapproved top-up arrangement.

**US pension benefits**

**Walt Havenstein** is a member of the BAE Systems Employees' Retirement Plan which provides a pension from age 60 for each year of pensionable service of 1.25% on his Final Average Pay (FAP) up to Social Security Covered Compensation (circa $70,000) plus 1.5% on his FAP in excess of Social Security Covered Compensation. FAP is currently the highest three-year average of base salary plus bonus (which for pension purposes is limited from 2008 to a maximum of 150% of base salary) but the averaging period will increase by one year each year beginning in 2009 and reaching a ten-year average in 2015. Executive directors pay contributions at the same rates as other employees in the plan, being 1.5% of earnings. The pension does not carry any spouse's pension or pension increases. Walt Havenstein also receives a 50% match on his contributions to his 401(k) plan up to a maximum contribution of 8% of earnings.

Details of post-retirement benefits for each of the executive directors who served during 2008 are shown in Table D on page 93 and are calculated in accordance with the requirements of Schedule 7A of the Companies Act 1985.

**Other benefits**

Other benefits provided to the executive directors include a car allowance, the taxable benefit of any private use of a chauffeur-driven car and a cash allowance for medical examination.

Ian King was provided with Company support in 2008 to relocate his flat to central London as detailed in the notes to Table C on page 92.

**Executive directors' service contracts**

It is the Committee's policy that executive directors should normally have service contracts that provide for the Company to give the individual 12 months' notice of termination. This policy has been chosen because it provides a reasonable balance between the need to retain the services of key individuals and the need to limit the liabilities of the Company in the event of the termination of a contract. The executive directors have service contracts with Group companies and details of these are shown below.

| | Date of contract | Unexpired term | Notice period |
|---|---|---|---|
| Walt Havenstein | 1 December 2006 | 3 months | 3 months either party |
| Ian King | 27 June 2008 | 12 months | 12 months either party |
| George Rose | 16 November 1998 (amended: 3 December 1999 15 January 2004 and 17 October 2005) | 12 months | 12 months from the Company, 6 months from the individual |

In the event of the termination of an executive director's contract it is the Committee's policy to seek to limit any payment made in lieu of notice to a payment equal to the amount of one year's base salary. The service contracts for all of the executive directors contain specific provisions to the effect that the Company has the right, and in Walt Havenstein's case, generally has the obligation, to pay a sum equivalent to 12 months' salary (plus the continuation of 18 months' medical benefits in Walt Havenstein's case) in the event of the Company terminating their contracts for reasons other than gross misconduct. No executive director has provisions in his service contract that relate to a change of control of the Company (and neither does the Chairman nor the non-executive directors in their respective letters of appointment).

**Retirement arrangements for Mike Turner**

Mike Turner was employed under a service contract dated 22 February 1994 (amended 30 May 1995, 3 December 1999, 8 May 2002, 15 January 2004 and 14 October 2005) and, as announced on 16 October 2007, he stepped down and retired from the Company at the end of August 2008. The termination arrangements were set out in a termination agreement and disclosed in last year's report.

On leaving the Company at the end of August 2008, he received a termination payment of £236,884 in respect of his contractual and statutory rights relating to the unserved portion of his 12-month notice period to 16 October 2008, and an immediate pension of £524,063 pa and tax free lump sum of £1,637,488 as set out in Table D on page 93, calculated in accordance with the rules of the schemes.

He also received a payment due in respect of his 2008 annual bonus as set out in Table C on page 92 and his special incentive vested in full as set out on page 81 of this report. His other share plan interests were dealt with as disclosed in last year's report and summarised in the notes on page 91.

**Policy on external board appointments**

The long-standing policy of allowing executive directors to hold external non-BAE Systems-related non-executive directorships with the prior approval of the Committee will continue. The Committee considers that external directorships provide the Company's senior executives with valuable experience that is of benefit to BAE Systems. It is also considered appropriate for BAE Systems to contribute to the pool of non-executive expertise available for the benefit of the wider business community, thereby reciprocating the benefit that it in turn has received from other organisations which have permitted members of their senior management teams to serve on the BAE Systems Board. The Committee believes that it is reasonable for the individual executive director to retain any fees received from such appointments given the additional personal responsibility that this entails. Such fees retained by the executive directors in 2008 for the period in which they served on the BAE Systems Board were as follows: Ian King £32,691; George Rose £82,500; and Mike Turner £49,785 plus grants of Deferred Stock Units to the value of £72,766.

## Chairman's appointment, term and fees

Dick Olver was appointed Chairman on 1 July 2004. His appointment was for an initial fixed three-year term with effect from 17 May 2004 (the date that he was appointed to the Board as a non-executive director) and was extended by the Board in 2007, on the recommendation of the Nominations Committee (as chaired by Sir Peter Mason, the Senior Independent Director), for a second term of three years to 16 May 2010 unless terminated earlier in accordance with the Company's Articles of Association, or by either party giving the other not less than six months' prior written notice. His appointment is documented in a letter of appointment which is not a contract of employment and he is required to devote no fewer than two days a week to his duties as Chairman. His appointment as Chairman will automatically terminate if he ceases to be a director of the Company. His fee for the second three-year term, which has been set by the Committee at £600,000 per annum, will not be subject to review during the three-year term.

## Non-executive directors' appointment, term and fees

The non-executive directors do not have service contracts but do have letters of appointment detailing the basis of their appointment. The dates of their original appointment were as follows:

| Non-executive director | Date of appointment | Expiry of current term* |
|---|---|---|
| Phil Carroll | 07.09.2005 | 06.09.2009 |
| Michael Hartnall | 10.06.2003 | 09.06.2009 |
| Andy Inglis | 13.06.2007 | 12.06.2010 |
| Sir Peter Mason | 22.01.2003 | 21.01.2012 |
| Roberto Quarta | 07.09.2005 | 06.09.2011 |
| Sir Nigel Rudd | 10.09.2006 | 09.09.2009 |
| Carl Symon | 11.06.2008 | 10.06.2011 |
| Ravi Uppal | 02.04.2008 | 01.04.2011 |

* Subject to re-election at the AGM following their appointment and subsequently at intervals of no more than three years in accordance with the Company's Articles of Association.

The non-executive directors are normally appointed for two consecutive three-year terms subject to review after the end of the first three-year period and with any third term of three years being subject to rigorous review and taking into account the need progressively to refresh the Board. They do not have periods of notice and the Company has no obligation to pay compensation when their appointment terminates. They are subject to re-election at the Annual General Meeting (AGM) following their appointment and subsequently at intervals of no more than three years. Peter Weinberg retired from the Board on 7 May 2008 at the conclusion of the 2008 AGM having originally been appointed to the Board on 16 June 2005.

Non-executive directors are proposed by the Nominations Committee and are appointed by the Board on the basis of their experience to provide independent judgement on issues of strategy, performance, resources and standards of conduct. The letters of appointment for non-executive directors detail the amount of time it is anticipated that the individual will need to devote to his or her duties as a director, being 15 days per year plus additional commitment for chairing a committee or undertaking the role of Senior Independent Director. The level of their fees is set by the Non-Executive Directors' Fees Committee to reflect this time commitment and responsibility, and after reviewing practice in other comparable companies.

Having reviewed the time commitments required and the market competitive positioning, a number of changes have been made to the structure of fees payable to non-executive directors for 2009.

– The base fee has been increased by 4.8% from £63,000 to £66,000.

– The total time commitment and additional fee for chairing the Audit, Corporate Responsibility and Remuneration committees have been aligned at around 25 days and at £20,000, respectively.

| Committee | 2008 fee* | 2009 fee* |
|---|---|---|
| Audit Committee | £20,000 | £20,000 |
| Corporate Responsibility Committee | £15,000 | £20,000 |
| Remuneration Committee | £15,000 | £20,000 |

– The time commitment and additional fee for the responsibilities of being Senior Independent Director have been aligned to those for the committee chairmen. The Senior Independent Director is not a chairman of one of the above three committees.

– The previous transatlantic meeting allowance of £4,000 has been replaced by a travel allowance of £4,000 per meeting on each occasion that a non-executive director's attendance at a Board meeting necessitates air travel of more than five hours (one-way) to the meeting location. For 2009, a maximum of six travel allowances will be payable.

The table below summarises the fee structure for 2008 and 2009.

| Non-executive director | 2008 fee* | 2009 fee* |
|---|---|---|
| Chairman Audit Committee | £83,000 | £86,000 |
| Chairman Corporate Responsibility Committee | £78,000 | £86,000 |
| Chairman Remuneration Committee | £78,000 | £86,000 |
| Senior Independent Director | £78,000 | £86,000 |
| Other non-executive directors | £63,000 | £66,000 |

* Excludes the travel allowance (and in 2008 the transatlantic allowance) of £4,000 per meeting referred to above.

By order of the Board

**Dick Olver** Chairman
18 February 2009

## Tabular information on directors' shareholdings, share-based incentives, emoluments and pensions

**Table A**

### Directors' interests

| | As at 1 January 2008* | | | | |
|---|---|---|---|---|---|
| | Ordinary shares | Executive Share Option Plan[2] | Restricted Share Plan | Share Matching Plan | Performance Share Plan[2] |
| P J Carroll[1] | 12,000 | – | – | – | – |
| M J Hartnall | 20,000 | – | – | – | – |
| W P Havenstein | 72,328 | 327,640 | 10,249 | 18,947 | 303,607 |
| A G Inglis | – | – | – | – | – |
| I G King | 317,897 | 1,270,250 | 37,950 | 46,410 | 552,675 |
| Sir Peter Mason | 25,283 | – | – | – | – |
| R L Olver | 40,000 | – | – | – | – |
| R Quarta | – | – | – | – | – |
| G W Rose | 538,032 | 768,769 | 18,975 | – | 675,994 |
| Sir Nigel Rudd | 11,400 | – | – | – | – |
| C G Symon[3] | – | – | – | – | – |
| R K Uppal[4] | – | – | – | – | – |

| | As at 31 December 2008 | | | | |
|---|---|---|---|---|---|
| | Ordinary shares | Executive Share Option Plan[2] | Restricted Share Plan | Share Matching Plan | Performance Share Plan[2] |
| P J Carroll[1] | **12,000** | **–** | **–** | **–** | **–** |
| M J Hartnall | **20,000** | **–** | **–** | **–** | **–** |
| W P Havenstein | **144,467** | **327,640** | **10,249** | **45,065** | **452,661** |
| A G Inglis | **–** | **–** | **–** | **–** | **–** |
| I G King | **497,884** | **1,270,250** | **–** | **155,821** | **823,106** |
| Sir Peter Mason | **25,283** | **–** | **–** | **–** | **–** |
| R L Olver | **40,000** | **–** | **–** | **–** | **–** |
| R Quarta | **–** | **–** | **–** | **–** | **–** |
| G W Rose | **619,977** | **484,679** | **–** | **52,286** | **780,243** |
| Sir Nigel Rudd | **11,400** | **–** | **–** | **–** | **–** |
| C G Symon[3] | **–** | **–** | **–** | **–** | **–** |
| R K Uppal[4] | **–** | **–** | **–** | **–** | **–** |

* Or upon appointment.
1 The ordinary shares held by Phil Carroll are represented by 3,000 American Depositary Shares.
2 The Executive Share Option Plan and Performance Share Plan figures for Walt Havenstein include Stock Appreciation Rights.
3 Appointed as a director on 11 June 2008.
4 Appointed as a director on 2 April 2008.

The table above gives details of the interests in ordinary shares in BAE Systems plc held by directors and their connected persons for those individuals who were directors of the Company as at 31 December 2008. There have been no changes in the interests of the current directors listed in the table above between 31 December 2008 and 18 February 2009 with the exception of the interests in the ordinary shares of Ian King and George Rose who have each acquired an additional 97 ordinary shares since 31 December 2008 under the partnership and matching shares elements of the Share Incentive Plan so that their beneficial shareholdings at the date of this report stood at 497,981 and 620,074 respectively.

The Company's register of directors' interests (which is open to inspection) contains full details of directors' share interests.

**Information subject to audit**
The Auditors are required to report on the information contained in Tables B, C and D on pages 88 to 93.

**Table B**

## Share Options and Long-Term Incentive Plan (LTIP) Awards – Ian King

| Share Options | 1 January 2008 | Granted during the year | Exercised during the year | Lapsed during the year | 31 December 2008 | Exercise price £ | Date of grant | Date of exercise or lapse | Market price on exercise £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PSP TSR | 70,737 | – | 70,737 | – | – | nil | 30.09.03 | 08.10.08 | 3.76 | 30.09.08[1,2] | – |
| PSP TSR | 121,068 | – | 60,533 | – | 60,535 | nil | 30.03.04 | 31.03.08 | 4.83 | 30.03.08[1,3] | 30.03.11 |
| PSP TSR | 147,935 | – | 49,311 | – | 98,624 | nil | 24.03.05 | 25.03.08 | 4.77 | 24.03.08[1,4] | 24.03.12 |
| PSP TSR | 96,962 | – | – | – | 96,962 | nil | 12.04.06 | – | – | 12.04.09[5] | 12.04.13 |
| PSP TSR | 115,973 | – | – | – | 115,973 | nil | 30.03.07 | – | – | 30.03.10[5] | 30.03.14 |
| PSP TSR | – | 122,039 | – | – | 122,039 | nil | 26.03.08 | – | – | 26.03.11[5] | 26.03.15 |
| PSP EPS | – | 122,039 | – | – | 122,039 | nil | 07.05.08 | – | – | 26.03.11[5] | 26.03.15 |
| PSP TSR | – | 103,467 | – | – | 103,467 | nil | 08.09.08 | – | – | 08.09.11[5] | 08.09.15 |
| PSP EPS | – | 103,467 | – | – | 103,467 | nil | 08.09.08 | – | – | 08.09.11[5] | 08.09.15 |
| | **552,675** | **451,012** | **180,581** | **–** | **823,106** | | | | | | |
| ExSOP | 138,242 | – | – | – | 138,242 | 4.21 | 20.12.99 | – | – | 20.12.02[1] | 20.12.09 |
| ExSOP | 318,314 | – | – | – | 318,314 | 1.72 | 30.09.03 | – | – | 30.09.06[1] | 30.09.13 |
| ExSOP | 272,388 | – | – | – | 272,388 | 2.01 | 30.03.04 | – | – | 30.03.07[1] | 30.03.14 |
| ExSOP | 221,903 | – | – | – | 221,903 | 2.64 | 24.03.05 | – | – | 24.03.08[1] | 24.03.15 |
| ExSOP | 145,443 | – | – | – | 145,443 | 4.28 | 12.04.06 | – | – | 12.04.09[1] | 12.04.16 |
| ExSOP | 173,960 | – | – | – | 173,960 | 4.57 | 30.03.07 | – | – | 30.03.10[5] | 30.03.17 |
| | **1,270,250** | **–** | **–** | **–** | **1,270,250** | | | | | | |

| LTIPs | 1 January 2008 | Granted during the year | Vested during the year | Lapsed during the year | 31 December 2008 | Market price at date of award £ | Date of award | Date of vesting | Market price on vesting £ |
|---|---|---|---|---|---|---|---|---|---|
| SMP | 46,410 | – | – | – | 46,410 | 4.57 | 22.03.07 | – | – |
| SMP | – | 109,411 | – | – | 109,411 | 4.86 | 26.03.08 | – | – |
| | **46,410** | **109,411** | **–** | **–** | **155,821** | | | | |
| RSP | 37,950 | – | 37,950 | – | – | 2.64 | 24.03.05 | 25.03.08 | 4.77 |
| | **37,950** | **–** | **37,950** | **–** | **–** | | | | |

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 88 and 89.
1 Subject to a performance condition that has been met.
2 'Date exercisable' refers to the date on which the portion of the option exercised during the year became exercisable.
3 As (2) above. The option over shares remaining at the year end is exercisable on the third anniversary of grant.
4 As (2) above. The option over shares remaining at the year end is exercisable in two tranches on the second and third anniversary of grant.
5 Subject to a performance condition that is yet to be tested.

**Performance Share Plan (PSP)**
A full description of the PSP is set out on pages 82 and 83. PSP awards granted since 2008 attract dividends prior to vesting.

**PSP TSR** – nil vesting if the Company's Total Shareholder Return (TSR) at the end of the three-year performance period is outside the top 50% of TSRs achieved by a sectoral comparator group; 25% vesting if TSR is at median (50%); and 100% vesting if TSR is in the top 20%, with vesting on a straight-line basis between these two points.

**PSP EPS** – proportion of the award exercisable is determined by the rate of annual actual EPS growth over the three-year performance period, with nil vesting at annual actual EPS growth of 5% or less, 100% vesting at 11% growth, and vesting on a straight-line basis between these two points.

Awards that vest at the end of year three are exercisable in three tranches at the end of years three, four and five.

**Executive Share Option Plan (ExSOP)**

No options have been granted under this Plan since 2007 and it is intended only to be used in future in exceptional circumstances. Options granted under this Plan are normally exercisable between the third and tenth anniversary of grant. The maximum duration of an option is ten years.

(i) **2005-2007 grants** – 33.33% of each option grant is exercisable if the Company achieves on average real EPS growth pa of 3% but less than 4% over the three-year performance period; 66.67% for real EPS growth pa of 4% but less than 5%; and 100% for real EPS growth of 5% or more.

(ii) **2004 grant** – as in (i) but performance is retested at the end of year five against the full period from grant; and

(iii) **2001-2003 grants** – as in (i) but performance is retested at the end of years four and five against the full period from grant.

(iv) **1999 grant** (following the BAe/MES merger) under the predecessor Executive Share Option Scheme:

(a) grants to George Rose and Mike Turner were conditional on the satisfaction of a performance condition based on the achievement of merger integration cost savings over a three-year performance period.

(b) grant to Ian King could only be exercised if the pre-exceptional EPS for any three-year period over the ten-year option life exceeded the sum of inflation for that period and real growth of 9% was achieved.

**Table B** *continued*

## Share Options and Long-Term Incentive Plan (LTIP) Awards – George Rose

| Share Options | 1 January 2008 | Granted during the year | Exercised during the year | Lapsed during the year | 31 December 2008 | Exercise price £ | Date of grant | Date of exercise or lapse | Market price on exercise £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PSP[TSR] | 86,832 | – | – | – | 86,832 | nil | 30.09.03 | – | – | 30.09.08[1,2] | 30.03.10 |
| PSP[TSR] | 153,400 | – | 76,699 | – | 76,701 | nil | 30.03.04 | 31.03.08 | 4.83 | 30.03.08[1,3] | 30.03.11 |
| PSP[TSR] | 189,393 | – | 63,130 | – | 126,263 | nil | 24.03.05 | 25.03.08 | 4.77 | 24.03.08[1,4] | 24.03.12 |
| PSP[TSR] | 123,831 | – | – | – | 123,831 | nil | 12.04.06 | – | – | 12.04.09[5] | 12.04.13 |
| PSP[TSR] | 122,538 | – | – | – | 122,538 | nil | 30.03.07 | – | – | 30.03.10[5] | 30.03.14 |
| PSP[TSR] | – | 122,039 | – | – | 122,039 | nil | 26.03.08 | – | – | 26.03.11[5] | 26.03.15 |
| PSP[EPS] | – | 122,039 | – | – | 122,039 | nil | 07.05.08 | – | – | 26.03.11[5] | 26.03.15 |
| | **675,994** | **244,078** | **139,829** | **–** | **780,243** | | | | | | |
| ExSOP | 115,125 | – | – | – | 115,125 | 4.21 | 20.12.99 | – | – | 20.12.02[1] | 20.12.09 |
| ExSOP | 284,090 | – | 284,090 | – | – | 2.64 | 24.03.05 | 25.03.08 | 4.77 | 24.03.08[1] | 24.03.15 |
| ExSOP | 185,747 | – | – | – | 185,747 | 4.28 | 12.04.06 | – | – | 12.04.09[1] | 12.04.16 |
| ExSOP | 183,807 | – | – | – | 183,807 | 4.57 | 30.03.07 | – | – | 30.03.10[5] | 30.03.17 |
| | **768,769** | **–** | **284,090** | **–** | **484,679** | | | | | | |

| LTIPs | 1 January 2008 | Granted during the year | Vested during the year | Lapsed during the year | 31 December 2008 | Market price at date of award £ | Date of award | Date of vesting | Market price on vesting £ |
|---|---|---|---|---|---|---|---|---|---|
| SMP | – | 52,286 | – | – | 52,286 | 4.86 | 26.03.08 | – | – |
| | **–** | **52,286** | **–** | **–** | **52,286** | | | | |
| RSP | 18,975 | – | 18,975 | – | – | 2.64 | 24.03.05 | 25.03.08 | 4.77 |
| | **18,975** | **–** | **18,975** | **–** | **–** | | | | |

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 88 and 89.

1 Subject to a performance condition that has been met.
2 'Date exercisable' refers to the date on which the option outstanding at the year end became exercisable.
3 'Date exercisable' refers to the date on which the portion of the option exercised during the year became exercisable. The option over shares remaining at the year end is exercisable on the third anniversary of grant.
4 As (3) except that the option over shares remaining at the year end is exercisable in two tranches on the second and third anniversary of grant.
5 Subject to a performance condition that is yet to be tested.

**Share Matching Plan (SMP) – matching shares**
A full description of the SMP is set out on page 83. SMP awards attract dividends prior to vesting.

**2008 award** – nil match for actual EPS growth of 5% pa or less, increasing uniformly to a 1:1 match for 8% pa growth.

**2007 award** – nil vesting for real EPS growth pa of less than 3% over the three-year performance period, with one-third of the matched award vesting on average real EPS growth pa of 3% but less than 4%, two-thirds vesting with a growth rate of 4% but less than 5%, and full vesting at growth of 5% or over.

**Restricted Share Plan (RSP)**
Replaced by the SMP in 2007.

The matching award of shares under the RSP (under which awards have not been granted since 2006) was historically not subject to performance criteria as it was designed to retain key staff and encourage executives to re-invest in Company shares the cash bonuses that they had earned under the annual bonus plan which was itself subject to performance conditions.

**Share price information**
The mid-market price for the Company's ordinary shares at 31 December 2008 was 376.75p (2007 498p). The range during the year was 302.5p to 507p.

**Aggregate amount of gains made by directors**
The aggregate amount of gains made by directors from the exercise of share options in 2008, as calculated at the date of exercise, was £6,278,313 (2007 £14,882,281). The net aggregate value of assets received by directors in 2008 from long-term incentive plans, as calculated at the date of vesting, was £1,931,858 (2007 £1,066,284).

**Rationale for key performance measures for PSP, ExSOP and SMP**
**EPS** – importance to major investors as a key indicator of long-term financial performance and value creation.

**TSR (and secondary financial measure)** – importance to major investors as an indication of both earnings and capital growth relative to major companies in the same sector, and to ensure that awards only vest if there has been a clear improvement in the Company's performance over the relevant period.

# Remuneration report *continued*

**Table B** *continued*

## Share Options and Long-Term Incentive Plan (LTIP) Awards – Walt Havenstein

| Share Options | 1 January 2008 | Granted during the year | Exercised or released during the year | Lapsed during the year | 31 December 2008 | Exercise price £ | Date of grant | Date of exercise, release or lapse | Market price on exercise or release £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PSP[TSR] | 32,271 | – | 32,271 | – | – | – | 30.09.03 | 30.09.08 | 3.99 | 30.09.08[1,2] | – |
| PSP[TSR] | 52,909 | – | 26,454 | – | 26,455 | – | 30.03.04 | 31.03.08 | 4.85 | 30.03.08[1,3] | 30.09.11 |
| PSP[TSR] | 60,633 | – | 20,210 | – | 40,423 | – | 24.03.05 | 25.03.08 | 4.73 | 24.03.08[1,4] | 24.03.12 |
| PSP[TSR] | 9,949 | – | 3,220 | 289 | 6,440 | – | 22.12.05 | 22.12.08 | 3.43 | 22.12.08[1,4] | 22.12.12 |
| PSP[TSR] | 64,302 | – | – | – | 64,302 | – | 12.04.06 | – | – | 12.04.09[5] | 12.04.13 |
| PSP[TSR] | 83,543 | – | – | – | 83,543 | – | 30.03.07 | – | – | 30.03.10[5] | 30.03.14 |
| PSP[TSR] | – | 115,749 | – | – | 115,749 | – | 26.03.08 | – | – | 26.03.11[5] | 26.03.15 |
| PSP[EPS] | – | 115,749 | – | – | 115,749 | – | 07.05.08 | – | – | 26.03.11[5] | 26.03.15 |
| | **303,607** | **231,498** | **82,155** | **289** | **452,661** | | | | | | |
| ExSOP | 90,949 | – | – | – | 90,949 | 2.64 | 24.03.05 | – | – | 24.03.08[1] | 24.03.15 |
| ExSOP | 14,923 | – | – | – | 14,923 | 3.56 | 22.12.05 | – | – | 22.12.08[1] | 22.12.15 |
| ExSOP | 96,453 | – | – | – | 96,453 | 4.28 | 12.04.06 | – | – | 12.04.09[1] | 12.04.16 |
| ExSOP | 125,315 | – | – | – | 125,315 | 4.57 | 30.03.07 | – | – | 30.03.10[5] | 30.03.17 |
| | **327,640** | **–** | **–** | **–** | **327,640** | | | | | | |

| LTIPs | 1 January 2008 | Granted during the year | Vested during the year | Lapsed during the year | 31 December 2008 | Market price at date of award £ | Date of award | Date of vesting | Market price on vesting £ |
|---|---|---|---|---|---|---|---|---|---|
| SMP | 18,947 | – | – | – | 18,947 | 4.57 | 22.03.07 | – | – |
| SMP | – | 26,118 | – | – | 26,118 | 4.86 | 26.03.08 | – | – |
| | **18,947** | **26,118** | **–** | **–** | **45,065** | | | | |
| RSP | 10,249 | – | – | – | 10,249 | 4.18 | 12.04.06 | – | – |
| | **10,249** | **–** | **–** | **–** | **10,249** | | | | |

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 88 and 89.
1 Subject to a performance condition that has been met.
2 'Date exercisable' refers to the date on which the portion of the award delivered during the year was due to be delivered.
3 As (2) above. The remaining shares under award at the year end are due for delivery on the third anniversary of grant.
4 As (2) above. The remaining shares under award at the year end are due for delivery in two tranches on the second and third anniversary of grant.
5 Subject to a performance condition that is yet to be tested.

In addition, Walt Havenstein has a cash-settled Stock Appreciation Right (SAR) over 53,010 ordinary shares granted on 27 November 2000 at a SAR price of £3.73, exercisable from 27 November 2003 until 27 November 2010. This was exercisable only if growth in pre-exceptional EPS for any three-year period over the ten-year life exceeded the sum of inflation for that period and a growth requirement of 9%, which was met.

Note: Awards granted to Walt Havenstein (a US national) under the PSP are technically characterised as long-term incentives rather than options as, subject to the attainment of the performance condition, they are delivered automatically on the third, fourth and fifth anniversary of grant without the need to exercise an option. They are shown in the top portion of the table for ease of comparison. Gains on delivered PSP awards for Walt Havenstein are included in the directors' gains on LTIPs figure on page 89 whilst PSP gains for the other directors are included in the share option gains figure.

The 2003-2005 PSP awards and 2005 ExSOP options granted to Walt Havenstein are granted under the Stock Appreciation Rights Schedule to those plans. The exercise price referred to for the latter is the SAR price.

**Table B** *continued*

## Share Options and Long-Term Incentive Plan (LTIP) Awards – Mike Turner[1]

| Share Options | 1 January 2008 | Granted during the year | Exercised during the year | Lapsed during the year | 31 December 2008[2] | Exercise price £ | Date of grant | Date of exercise or lapse | Market price on exercise £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PSP[TSR] | 130,814 | – | 130,814 | – | – | nil | 30.09.03 | 01.09.08 | 4.78 | 01.09.08 | – |
| PSP[TSR] | 242,123 | – | 121,061 | – | – | nil | 30.03.04 | 31.03.08 | 4.83 | 30.03.08 | – |
| PSP[TSR] | – | – | 121,062 | – | – | nil | 30.03.04 | 01.09.08 | 4.78 | 01.09.08 | – |
| PSP[TSR] | 303,030 | – | 101,008 | – | – | nil | 24.03.05 | 25.03.08 | 4.77 | 24.03.08 | – |
| PSP[TSR] | – | – | 202,022 | – | – | nil | 24.03.05 | 01.09.08 | 4.78 | 01.09.08 | – |
| PSP[TSR] | 304,906 | – | – | – | 304,906 | nil | 12.04.06 | – | – | 12.04.09 | 30.09.09 |
| PSP[TSR] | 310,175 | – | – | – | 310,175 | nil | 30.03.07 | – | – | 30.03.10 | 30.09.10 |
| | **1,291,048** | **–** | **675,967** | **–** | **615,081** | | | | | | |
| ExSOP | 122,855 | – | – | – | 122,855 | 4.21 | 20.12.99 | – | – | 20.12.02 | 01.09.09 |
| ExSOP | 454,545 | – | 454,545 | – | – | 2.64 | 24.03.05 | 25.03.08 | 4.77 | 24.03.08 | – |
| ExSOP | 457,359 | – | – | – | 457,359 | 4.28 | 12.04.06 | – | – | 01.09.08 | 01.09.09 |
| ExSOP | 465,262 | – | – | – | 465,262 | 4.57 | 30.03.07 | – | – | 01.09.08 | 01.09.09 |
| | **1,500,021** | **–** | **454,545** | **–** | **1,045,476** | | | | | | |

| LTIPs | 1 January 2008 | Granted during the year | Vested during the year | Lapsed during the year | 31 December 2008[2] | Market price at date of award £ | Date of award | Date of vesting | Market price on vesting £ |
|---|---|---|---|---|---|---|---|---|---|
| SMP | 109,529 | – | 109,529 | – | – | 4.57 | 22.03.07 | 01.09.08[3] | 4.78 |
| SMP | – | 94,261 | – | – | 94,261 | 4.86 | 26.03.08 | – | – |
| | **109,529** | **94,261** | **109,529** | **–** | **94,261** | | | | |
| RSP | 37,950 | – | 37,950 | – | – | 2.64 | 24.03.05 | 25.03.08 | 4.77 |
| | **37,950** | **–** | **37,950** | **–** | **–** | | | | |
| PSA | 231,618 | – | 115,809 | – | 115,809 | 5.10 | 16.10.07 | 01.09.08[3] | 4.78 |
| | **231,618** | **–** | **115,809** | **–** | **115,809** | | | | |

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 88 and 89, except for the PSA for which the performance condition is set out below.

1 Retired as a director on 31 August 2008.

2 As at 31 August 2008, the date of Mike Turner's retirement, options outstanding totalled 1,068,979 under the PSP and 1,045,476 under ExSOP, and awards outstanding totalled 203,790 under the SMP, nil under the RSP and 231,618 under the PSA.

3 The SMP and PSA awards which vested on 1 September 2008 attracted reinvested dividends which equated on vesting to an additional 4,746 and 3,255 shares, respectively. The market price on vesting was £4.78. The value of the related gain is included in the figure for the aggregate gain from long-term incentive plans on page 89.

**Performance Share Award (PSA) – Performance condition**

Mike Turner was granted a contingent award over 231,618 shares on 16 October 2007 under which the shares would vest in two equal tranches in the year following his retirement on 31 August 2008, subject to the satisfaction of certain performance targets by 31 August 2008. These targets, which were fully met, related to continuing the successful implementation of the Company's business strategy, satisfaction of leadership objectives set by the Remuneration Committee, achieving an orderly handover of key external relationships and facilitating an orderly succession to the Chief Executive role. The Committee believed that this was the most appropriate incentive in relation to his period of service to retirement. The first tranche of shares under award was released on 1 September 2008; the second tranche will be released in 2009.

**Treatment of options and awards on retirement**

As disclosed in last year's report, the treatment of Mike Turner's outstanding options and awards at his retirement on 31 August 2008 was as follows:

- unexercised options under ExSOP were preserved and exercisable in full within 12 months of his retirement. Any performance condition that remained to be satisfied was waived;
- PSP awards already vested (awards granted in 2005 and earlier) were preserved and exercisable within six months of retirement;
- unvested PSP awards (awards granted in 2006 and 2007): the performance condition will be tested at the end of the normal three-year performance period, will vest to the extent that the performance condition has been met, and will be exercisable within six months. The number of shares that vest will not be pro-rated to reflect his actual service during the applicable three-year periods;
- unvested 2007 matching SMP award: the performance condition was tested at retirement; the award vested in full and was not time pro-rated; and
- unvested 2008 matching SMP award: the performance condition will be tested in February 2009 and the quantum of the award vesting will not be time pro-rated.

# Remuneration report *continued*

**Table C**

## Directors' remuneration

| | 2008 | | | | | | 2007 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Base salary £'000 | Fees £'000 | Bonus £'000 | Benefits £'000 | Other pay £'000 | Total £'000 | Base salary £'000 | Fees £'000 | Bonus £'000 | Benefits £'000 | Other pay £'000 | Total £'000 |
| **Chairman** | | | | | | | | | | | | |
| R L Olver | **–** | **600** | **–** | **59** | **–** | **659** | – | 562 | – | 19 | – | 581 |
| **Executive directors** | | | | | | | | | | | | |
| C V Geoghegan[1] | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | 490 | – | 411 | 33 | 147 | 1,081 |
| W P Havenstein[2] | **486** | **–** | **1,013** | **29** | **–** | **1,528** | 390 | – | 584 | 61 | – | 1,035 |
| I G King[2] | **678** | **–** | **1,275** | **169** | **–** | **2,122** | 545 | – | 532 | 22 | – | 1,099 |
| S L Mogford[1] | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | 176 | – | 243 | 13 | – | 432 |
| G W Rose | **593** | **–** | **695** | **72** | **–** | **1,360** | 560 | – | 532 | 32 | – | 1,124 |
| M J Turner[3] | **667** | **–** | **1,405** | **89** | **1,028** | **3,189** | 945 | – | 1,375 | 35 | 284 | 2,639 |
| **Non-executive directors** | | | | | | | | | | | | |
| Professor S Birley[1] | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | – | 26 | – | – | – | 26 |
| P J Carroll | **–** | **63** | **–** | **–** | **28** | **91** | – | 78 | – | – | – | 78 |
| Dr U Cartellieri[1] | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | **n/a** | – | 47 | – | – | – | 47 |
| M J Hartnall | **–** | **83** | **–** | **–** | **8** | **91** | – | 86 | – | – | – | 86 |
| A G Inglis[2] | **–** | **73** | **–** | **–** | **8** | **81** | – | 40 | – | – | – | 40 |
| Sir Peter Mason | **–** | **78** | **–** | **–** | **8** | **86** | – | 81 | – | – | – | 81 |
| R Quarta | **–** | **63** | **–** | **–** | **8** | **71** | – | 66 | – | – | – | 66 |
| Sir Nigel Rudd | **–** | **78** | **–** | **–** | **8** | **86** | – | 75 | – | – | – | 75 |
| C G Symon[4] | **–** | **35** | **–** | **–** | **12** | **47** | n/a | n/a | n/a | n/a | n/a | n/a |
| R K Uppal[4] | **–** | **47** | **–** | **–** | **12** | **59** | n/a | n/a | n/a | n/a | n/a | n/a |
| P A Weinberg[3] | **–** | **27** | **–** | **–** | **12** | **39** | – | 93 | – | – | – | 93 |
| | **2,424** | **1,147** | **4,388** | **418** | **1,132** | **9,509** | 3,106 | 1,154 | 3,677 | 215 | 431 | 8,583 |

1 Retired during or at the end of 2007.
2 Appointed in 2007.
3 Retired in 2008.
4 Appointed in 2008.

All emoluments and compensation paid to the directors during the year are shown above. Where the individual was appointed during the year the amount shown is for the period from appointment.

The other pay received by Mike Turner in 2008 comprises (i) a cash supplement of £200,000 payable from opting out of future accrual under the Company pension schemes between 1 January 2008 and his retirement, (ii) his termination payment of £236,884 referred to on page 85, and (iii) a cash payment of £590,625 representing half the conditional cash award under his special incentive referred to on page 81 (the balance of this cash award being payable shortly after the first anniversary of his retirement date).

The 2008 benefits figure for Ian King includes a taxable allowance of £25,000 and costs of £39,700 (grossed up) towards the cost of relocating his flat to central London.

The benefits received by the UK-based executive directors include, where applicable, the provision of a car and the taxable benefit of any private use of a chauffeur-driven car and attendance at corporate events. The benefits received by the Chairman, Dick Olver, include the taxable benefit relating to the private use of a chauffeur-driven car and attendance at corporate events. It should be noted that the calculation of the 2008 taxable benefit of any private use of a chauffeur-driven car has been revised to reflect HMRC guidance.

The benefits received by Walt Havenstein, the US-based executive director, include a cash allowance for a car, medical examination, dental benefits and insured life benefits.

The other pay received by the non-executive directors represents the travel allowance (previously transatlantic allowance) of £4,000 per meeting as set out on page 86.

Sir Richard Evans retired as a director and Chairman on 30 June 2004. He remained employed in a part-time customer relationship role and ceased to be an employee on 29 February 2008. In 2008, his remuneration was £265,480 (2007 £332,400) and comprised a salary, a cash allowance for a car, chauffeur-driven car and consultancy fees for his role as a member of the Home Market Advisory Board for Saudi Arabia.

There were no other payments to former directors during the year other than the Company pension payments to Richard Lapthorne and Sir Peter Gershon referred to in the notes to Table D on page 93.

**Table D**

## Post-retirement benefits

| | Age | NRA* | Accrued pension at 31 December 2008[1] £ per annum | Increase/ (decrease) in accrued benefits £ per annum | Change in accrued pension after allowing for inflation £ per annum | Transfer value at 1 January 2008[2] £ | Transfer value at 31 December 2008 £ | Director's contributions £ | Increase in transfer value less director's contributions £ |
|---|---|---|---|---|---|---|---|---|---|
| W P Havenstein[3] | 59 | 60 | 156,471 | 80,566 | 76,338 | 791,208 | 1,745,364 | 2,326 | 951,830 |
| I G King | 52 | 62 | 425,245 | 51,857 | 37,115 | 3,075,417 | 4,672,376 | 58,747 | 1,538,212 |
| G W Rose[4] | 56 | 60 | 330,769 | 35,195 | 23,525 | 4,326,358 | 5,573,907 | 54,876 | 1,192,673 |
| M J Turner[5] | 60 | 60 | 648,493 | (11,051) | (37,096) | 11,637,570 | 11,827,916 | – | 190,346 |

* Normal Retirement Age.

1 Accrued pensions may be reduced if they are taken before the normal retirement age of the scheme. In addition, a longevity adjustment factor applies to UK pension accrued after 5 April 2006.

2 Transfer values have been calculated in accordance with GN11 issued by the actuarial profession. For UK-based directors the assumptions are the same as those used in the calculation of cash equivalents from the schemes. For US-based directors the assumptions are the same as those used for accounting disclosures. The amount of the increase in transfer value arising from the change in assumptions is: Walt Havenstein (£nil); Ian King (£965,915); George Rose (£514,150); Mike Turner (£408,201).

3 Walt Havenstein's accrued pension comprises £21,856 from a contributory Qualified Plan and £134,615 from Non-Qualified Plans. In addition, Walt Havenstein participates in a Section 401(k) defined contribution arrangement set up for US employees in which the Company will match employee contributions up to a limit. In 2008 the Company paid contributions of $6,402 (£4,413) into this 401(k) arrangement. In addition, the Company paid $42,395 (£29,224) into a Deferred Compensation arrangement. Walt Havenstein is paid in US dollars. Of the change in the accrued benefit and the transfer value £42,296 and £471,786 respectively is due to currency movements.

4 George Rose has an unapproved retirement arrangement for pensionable service before 5 April 2006 that is partly funded and partly unfunded. No Company contributions have been made to these arrangements during the year.

5 As a result of the changes to taxation of pensions introduced in April 2006 Mike Turner elected to opt out of the pension scheme and since April 2006 had been receiving a taxable salary supplement of 30% of his base salary. Mike Turner retired from the Board on 31 August 2008 and started to draw his pension of £524,063 pa after having exchanged part of his pension for a tax-free cash lump sum of £1,637,488. The transfer value as at 31 December 2008 allows for this exchange of pension for tax-free cash.

Sir Peter Gershon and Richard Lapthorne, both former directors, have unfunded pension arrangements. In 2008 the Company paid Sir Peter Gershon a cash lump sum of £334,805 and pension of £18,188 and Richard Lapthorne a pension of £119,279 (2007 £93,554) in respect of these arrangements.

# Other statutory and regulatory information

**Applying the principles of the Combined Code on Corporate Governance**

The Board has structured its activities so as to incorporate the main and supporting principles in the UK's Combined Code, recognising these to be a sound statement of accepted good practice for a company such as BAE Systems. The core activities of the Board and its committees are documented and planned on an annual basis but this only forms the basic structure within which the Board operates. The directors are required to provide entrepreneurial leadership for the Company, relying on the business skills and judgement that each director possesses. The governance structure recognises this essential human element and the role of the Chairman in ensuring that decisions are made by the directors within a framework of prudent and effective controls.

The Board has adopted a document, the Board Charter, in which there is a statement of governance principles that guide the activities of the Board and also details of the roles of the Chairman, Chief Executive and the Senior Independent Director. The governance principles reflect the main and supporting principles contained in the Combined Code, and cover the following:

– Strategy – reviewing and agreeing strategy;

– Performance – monitoring the performance of the Group and also evaluating its own performance;

– Standards and Values – setting standards and values to guide the affairs of the Group;

– Oversight – ensuring an effective system of internal controls is in place, ensuring that the Board receives timely and accurate information on the performance of the Group and the proper delegation of authority; and

– People – ensuring the Group is managed by individuals with the necessary skills and experience, and that appointments to the Board are managed effectively.

The Board Charter states that the Chief Executive is responsible for the leadership and operational management of the Company within the strategy and business plan agreed by the Board. Included within the Charter is a schedule of matters that have been reserved for the Board's decision. These include approving the vision, values, principles of ethical conduct, overall governance structure of the Company, and its strategy and business plans. Within the Board's delegated authorities it has reserved for itself, amongst other things, certain decisions concerning contract bids and tenders, acquisitions and disposals of businesses, capital expenditure and Company-funded product development expenditure.

A copy of the Board Charter can be found on the Company's website, or alternatively, can be obtained from the Company Secretary.

**Compliance with the provisions of the Combined Code**

The Company was compliant with the provisions of the Combined Code on Corporate Governance throughout 2008.

The attendance by individual directors at meetings of the Board and its committees in 2008 was as follows:

| Director | Board | Audit Committee | Corporate Responsibility Committee | Nominations Committee | Remuneration Committee | Non-Executive Directors' Fees Committee |
|---|---|---|---|---|---|---|
| Mr P Carroll | 9 (9) | – | – | 5 (6) | – | – |
| Mr M J Hartnall | 8 (9) | 6 (6) | – | – | – | – |
| Mr W Havenstein | 8 (9) | – | – | – | – | 1 (1) |
| Mr A G Inglis | 8 (9) | – | 5 (5) | – | – | – |
| Mr I G King | 7 (9) | – | – | – | – | – |
| Sir Peter Mason | 9 (9) | 6 (6) | – | 6 (6) | 1 (1) | – |
| Mr R L Olver | 9 (9) | – | – | 6 (6) | – | 1 (1) |
| Mr R Quarta | 7 (9) | 5 (6) | – | – | 6 (7) | – |
| Mr G W Rose | 9 (9) | – | – | – | – | – |
| Sir Nigel Rudd | 7 (9) | – | 4 (5) | – | 7 (7) | – |
| Mr C G Symon[1] | 5 (5) | – | – | – | 3 (3) | – |
| Mr M J Turner[2] | 7 (7) | – | – | – | – | 1 (1) |
| Mr R K Uppal[3] | 7 (7) | – | 4 (4) | – | – | – |
| Mr P A Weinberg[4] | 3 (4) | – | 1 (1) | – | 1 (2) | – |

Figures in brackets denote the maximum number of meetings that could have been attended.

1 Appointed to the Board on 11 June 2008.
2 Retired from the Board on 31 August 2008.
3 Appointed to the Board on 2 April 2008.
4 Retired from the Board on 7 May 2008.

### The Board

The Board comprises a non-executive chairman, eight non-executive directors and three executive directors.

The Board considers all of the non-executive directors, with the exception of the Chairman, to be independent for the purposes of the Combined Code. Each of these directors has been identified on pages 64 and 65 of this report.

Following appointment to the Board, directors undertake an induction programme aimed at familiarising them with the Company. The programme for directors joining during 2008 included the following:

- Directors' duties, corporate governance and board procedures;
- Business planning and internal control processes;
- Strategy and planning;
- Metrics used to monitor business performance;
- Investor relations;
- Corporate responsibility (including ethical business conduct and health and safety); and
- Internal Audit.

In addition to the above, as part of the induction process, new directors will typically visit the Group's principal operations in order to meet employees and gain an understanding of the Group's products and services. On-going training is provided for the Board and individual directors as required.

During the year, the Chairman, Dick Olver, retired from the board of Thomson Reuters plc and was appointed a Business Ambassador for UK Trade & Investment and became a senior adviser to Clayton, Dubilier & Rice.

Mr Quarta is a partner in Clayton, Dubilier & Rice (CDR) and Mr Olver and Sir Nigel Rudd are advisers to that firm. The Board has considered Mr Quarta's and Sir Nigel Rudd's independence in light of the provisions in paragraph A.3.1 of the Combined Code concerning significant links with other directors through involvement with other companies or bodies. Following review, the Board considers that, for the purposes of the Code, their relationship through CDR does not constitute a significant link. In reaching this determination the following matters were taken into consideration:

- as advisers to CDR Mr Olver and Sir Nigel Rudd have no management responsibilities or oversight obligations in respect of CDR or any of its investments; and
- Mr Olver and Sir Nigel Rudd have no involvement with the companies that Mr Quarta is a director of, or has management responsibility for, within CDR.

Mr Olver and Sir Nigel Rudd have undertaken to advise the Board should there be any material change in their relationship with CDR whilst Mr Quarta has an involvement with that firm.

In 2008 the Board was scheduled to meet eight times and in addition one day was spent reviewing strategy. Additional Board meetings are called as required and in total the Board met nine times during the year.

The Board has appointed Sir Peter Mason as the Senior Independent Director. Amongst the duties undertaken by Sir Peter during the year was to meet with the non-executive directors without the Chairman present to discuss the Chairman's performance.

The Company's Articles of Association require that all new directors seek re-election to the Board at the following Annual General Meeting (AGM). In addition, all directors are required to stand down and seek re-election to the Board at least once every three years.

The Board has set out in the Notice of Annual General Meeting their reasons for supporting the re-election of those directors seeking re-election at the forthcoming AGM.

### Internal control

The Board has conducted a review of the effectiveness of the Group's system of internal controls, including financial, operational and compliance controls and risk management systems, in accordance with the Combined Code and the Turnbull guidance (as revised).

BAE Systems has developed a system of internal control that was in place throughout 2008 and to the date of this report, that encompasses, amongst other things, the policies, processes, tasks and behaviours that, taken together, seek to:

- facilitate the effective and efficient operation of the Company by enabling it to respond appropriately to significant operational, financial, compliance and other risks that it faces in carrying out its business;
- assist in ensuring that internal and external reporting is accurate and timely, and based on the maintenance of proper records supported by robust information-gathering processes; and
- assist in ensuring that the Company complies with applicable laws and regulations at all times, and also internal policies in respect of the standards of behaviour and conduct mandated by the Board.

Reporting within the Company is structured so that key issues are escalated through the management team ultimately to the Board if appropriate. The Operational Framework provides a common framework across the Company for operational and financial controls, and is reviewed on a regular basis by the Board. The business policies and processes detailed within the Operational Framework draw on global best practice and their application is mandated across the organisation. Lifecycle Management (LCM) is such a process, and promotes the application of best practice programme execution and facilitates continuous improvement across the Group. It considers the whole life of projects from inception to delivery into service and eventual disposal, and its application is critical to our capability in delivering projects to schedule and cost.

Further key processes are Integrated Business Planning (IBP), Quarterly Business Reviews (QBR) and Performance Centred Leadership (PCL). The IBP, approved annually by the Board, results in an agreed long-term strategy for each operating group, together with detailed near-term budgets. The QBRs evaluate progress

# Other statutory and regulatory information *continued*

against the IBP and business performance against objectives, measures and milestones. PCL drives business success by linking individual goals to those of the organisation, enabling employees to understand how their own success contributes to the success of the whole business.

Whilst the quality of the control processes is fundamental to the overall control environment, the consistent application of these processes is equally important. The consistent application of world-class control processes is a key management objective. The Company is committed to the protection of its assets, which include human, property and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

The Internal Audit team independently reviews the risk identification procedures and control processes implemented by management. It provides objective assurance as to the operation and validity of the systems of internal control through a programme of cyclical reviews making recommendations for business and control improvements as required.

The Board has delegated to the Audit Committee responsibility for reviewing in detail the effectiveness of the Company's system of internal controls. Having undertaken such reviews, the Committee reports to the Board on its findings so that the Board as a whole can take a view on this matter. In order to assist the Audit Committee and the Board in this review, the Company has developed the Operational Assurance Statement (OAS) process. This has been subject to regular review over a number of years, which has resulted in a number of refinements being made.

The OAS requires that each part of the business completes a formal review of its compliance against the Operational Framework, including operational and financial controls, and risk management processes. It is signed-off by the managing director of every line of business and relevant functional directors. The OAS is completed every six months and includes a formal assessment of business risk.

The overall responsibility for the system of internal control within BAE Systems rests with the directors of the Company. Responsibility for establishing and operating detailed control procedures lies with the line leaders of each operating business.

In line with any system of internal control, the policies and processes that are mandated in the Operational Framework are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material mis-statement or loss.

The responsibility for internal control procedures with joint ventures and other collaborations rests, on the whole, with the senior management of those operations. The Company monitors its investments and exerts influence through Board representation.

### Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Operating group reviews on pages 36 to 44. The financial position of the Group, including information on order book, cash flow, treasury policy and liquidity, can be found in the Financial review on pages 28 to 34. Principal risks are detailed on pages 58 to 61. In addition, the financial statements include, amongst other things, notes on finance costs (page 120), loans and overdrafts (page 134) and financial risk management (page 155).

After making due enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the accounts.

### Relations with shareholders

The Company has a well-developed investor relations programme managed by the Chief Executive, Group Finance Director and Investor Relations Director. In addition, the Chairman is in regular contact with major shareholders and looks to keep them informed of progress on corporate governance matters. In order to assist in developing an understanding of the views of major shareholders, each year the Company commissions a survey of investors undertaken by external consultants. The results of the survey are presented to the Board.

The Company maintains a comprehensive Investor Relations website that provides, amongst other things, information on investing in BAE Systems and copies of the presentation materials used for key shareholders presentations. This can be accessed via the Company's website, www.baesystems.com

The AGM provides all shareholders with the opportunity to develop their understanding of the Company and ask questions on the matters put to the meeting including this Annual Report. All shareholders are entitled to vote on the resolutions put to the AGM and, to ensure that all votes are counted, the Company's Articles of Association requires that a poll is taken on all the resolutions in the Notice of Meeting. The results of the votes on the resolutions will be published on the Company's website.

### Principal activities

The BAE Systems Group delivers, through its wholly-owned subsidiaries and equity accounted investments, a full range of systems and services for air, land and naval forces, as well as advanced electronics, information technology solutions and customer support services.

### Directors

The current directors who served during the 2008 financial year are listed on pages 64 to 65. Of those directors, Ravi Uppal was appointed to the Board on 2 April 2008 and Carl Symon on 11 June 2008. Peter Weinberg served as a director during the period up to his retirement on 7 May 2008 and Mike Turner served during the period up to his retirement on 31 August 2008.

### Dividend

An interim dividend of 5.8p per share was paid on 1 December 2008. The directors propose a final dividend of 8.7p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2009 to shareholders on the share register on 24 April 2009.

**Annual General Meeting (AGM)**
The Company's AGM will be held on 6 May 2009. The Notice of Annual General Meeting is enclosed with this Annual Report and details the resolutions to be proposed at the meeting.

**Office of Fair Trading undertakings**
As a consequence of the merger between British Aerospace and the former Marconi Electronics Systems businesses in 1999, the Company gave certain undertakings to the Secretary of State for Trade and Industry (now the Secretary of State for Business, Enterprise and Regulatory Reform). In February 2007, the Company was released from the majority of these undertakings and the remainder have been superseded and varied by a new set of undertakings. Compliance with the undertakings is monitored by a compliance officer. Further information regarding the undertakings and the contact details of the compliance officer may be obtained through the Company Secretary at the Company's registered office or through the Company's website.

**Supplier payment policy**
It is Group policy that suppliers should be paid in accordance with the payment terms and conditions stated in the applicable purchase order. In the UK, the Group is a signatory to the government's Prompt Payment Code, under which it has undertaken to pay suppliers on time, give clear guidance on payment procedures and encourage the adoption of the code throughout its supply chain.

The average number of days' credit provided in 2008 by suppliers was 34 days (2007 39 days).

**Charitable donations**
During 2008, the amount donated for charitable purposes in the UK was £3.4m (2007 £1.4m). Further details of the Company's charitable activities are set out on page 54.

**Political donations**
No political donations were made in 2008.

**Structure of share capital**
As at 31 December 2008, the Company's authorised share capital of £188,750,001 comprised 4,800,000,000 ordinary shares of 2.5p each, 275,000,000 7.75p (net) cumulative redeemable preference shares of 25p each and one Special Share of £1.

As at 31 December 2008, BAE Systems' issued share capital of £89,545,439 comprised 3,581,817,533 ordinary shares of 2.5p each and one Special Share of £1.

**Treasury shares**
No treasury shares were acquired by the Company during 2008. As at 1 January 2008, the number of shares held in treasury totalled 61,945,000 (having a total nominal value of £1,548,625 and representing 1.73% of the Company's called up share capital at 1 January 2008). During 2008, the Company used 6,906,047 treasury shares (having a total nominal value of £172,651 and representing 0.19% of the Company's called up share capital at 31 December 2008) to satisfy awards under the Free and Matching elements of the Share Incentive Plan and options under the Save-As-You-Earn Share Option Scheme. The 3,562,049 treasury shares utilised in respect of the Share Incentive Plan were disposed of by the Company for nil consideration; the 3,343,998 treasury shares utilised under the Save-As-You-Earn Option Scheme were disposed of by the Company for a total consideration of £3,109,918. As at 31 December 2008, the number of shares held in treasury totalled 55,038,953 (having a total nominal value of £1,375,974 and representing 1.54% of the Company's called up share capital at 31 December 2008).

The rights to such shares are restricted in accordance with the Companies Acts and, in particular, the voting rights attaching to these shares are automatically suspended.

**Rights and obligations of ordinary shares**
On a show of hands at a general meeting every holder of ordinary shares present in person or by proxy and entitled to vote shall have one vote and, on a poll, every member present in person or by proxy and entitled to vote shall have one vote for every ordinary share held. Subject to the relevant statutory provisions and the Company's Articles of Association, holders of ordinary shares are entitled to a dividend where declared or paid out of profits available for such purposes. Subject to the relevant statutory provisions and the Company's Articles of Association, on a return of capital on a winding-up, holders of ordinary shares are entitled, after repayment of the £1 Special Share, to participate in such a return.

**Rights and obligations of the Special Share**
The Special Share is held on behalf of the Secretary of State for Business, Enterprise and Regulatory Reform (the 'Special Shareholder'). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the chief executive and any executive chairman are British.

The holder of the Special Share is entitled to attend a general meeting, but the Special Share carries no right to vote or any other rights at any such meeting, other than to speak in relation to any business in respect of the Special Share. Subject to the relevant statutory provisions and the Company's Articles of Association, on a return of capital on a winding-up, the Special Share shall be entitled to repayment of the £1 capital paid up on the Special Share in priority to any repayment of capital to any other members.

The holder of the Special Share has the right to require the Company to redeem the Special Share at par or convert the Special Share into one ordinary share at any time.

# Other statutory and regulatory information *continued*

### Restrictions on transfer of securities

The restrictions on the transfer of shares in the Company are as follows:

- the Special Share may only be issued to, held by and transferred to the Special Shareholder or his successor or nominee;
- the directors shall not register any allotment or transfer of any shares to a foreign person, or foreign persons acting in concert, who at the time have more than a 15% voting interest in the Company, or who would, following such allotment or transfer, have such an interest;
- the directors shall not register any person as a holder of any shares unless they have received: (i) a declaration stating that upon registration, the share(s) will not be held by foreign persons or that upon registration the share(s) will be held by a foreign person or persons; (ii) such evidence (if any) as the directors may require of the authority of the signatory of the declaration; and (iii) such evidence or information (if any) as to the matters referred to in the declaration as the directors consider appropriate;
- the directors may, in their absolute discretion, refuse to register any transfer of shares which are not fully paid up (but not so as to prevent dealings in listed shares from taking place);
- the directors may also refuse to register any instrument of transfer of shares unless the instrument of transfer is in respect of only one class of share and it is lodged at the place where the register of members is kept, accompanied by a relevant certificate or such other evidence as the directors may reasonably require to show the right of the transferor to make the transfer;
- the directors may refuse to register an allotment or transfer of shares in favour of more than four persons jointly;
- where a shareholder has failed to provide the Company with certain information relating to their interest in shares, the directors can, in certain circumstances, refuse to register a transfer of such shares;
- certain restrictions may from time to time be imposed by laws and regulations (for example, insider trading laws);
- restrictions may be imposed pursuant to the Listing Rules of the Financial Services Authority whereby certain of the Group's employees require the Company's approval to deal in shares; and
- awards of shares made under the Company's share incentive plan are subject to restrictions on the transfer of shares prior to vesting.

The Company is not aware of any arrangements between its shareholders that may result in restrictions on the transfer of shares and/or voting rights.

### Significant direct and indirect holders of securities

As at 18 February 2009, the Company had been advised of the following significant direct and indirect interests in the issued ordinary share capital of the Company:

| Name of shareholder | Percentage notified |
|---|---|
| AXA S.A. and its group of companies | 9.02% |
| Barclays PLC | 3.98% |
| Franklin Resources Inc, and affiliates | 4.92% |
| Legal & General Group Plc | 4.07% |
| BlackRock, Inc | 4.96% |

### Exercise of rights of shares in employee share schemes

The Trustees of the employee trusts do not seek to exercise voting rights on shares held in the employee trusts other than on the direction of the underlying beneficiaries. No voting rights are exercised in relation to shares unallocated to individual beneficiaries.

### Restrictions on voting deadlines

The notice of any general meeting shall specify the deadline for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be proposed at the general meeting. The number of proxy votes for, against or withheld in respect of each resolution are publicised on the Company's website after the meeting.

### Appointment and replacement of directors

Subject to certain nationality requirements mentioned below, the Company may by ordinary resolution appoint any person to be a director.

The majority of directors holding office must be British. Otherwise the directors who are not British shall vacate office in such order that those who have been in office for the shortest period since their appointment shall vacate their office first, unless all of the directors otherwise agree among themselves. Any director who holds the office of either chairman (in an executive capacity) or chief executive shall also be British.

The Company must have six directors holding office at all times. If the number is reduced to below six, then such number of persons shall be appointed as directors as soon as is reasonably practicable to reinstate the number of directors to six. The Company may by ordinary resolution from time to time vary the minimum number of directors.

At each AGM of the Company, any director who was elected or last re-elected at or before the AGM held in the third calendar year before the then current calendar year must retire by rotation and such further directors must retire by rotation so that in total one-third of the directors retire by rotation each year. A retiring director is eligible for re-election.

### Amendment of the Company's Articles of Association

The Company's Articles of Association may only be amended by a special resolution at a general meeting of shareholders. Where class rights are varied, such amendments must be approved by the members of each class of shares separately.

In addition, certain provisions of the Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the chief executive and any executive chairman are British.

At the 2009 AGM a special resolution will be put to shareholders proposing amendments to the existing Articles of Association primarily in order to accommodate the provisions of the new Companies Act 2006.

**Powers of the directors**

The directors are responsible for the management of the business of the Company and may exercise all powers of the Company subject to applicable legislation and regulation and the Memorandum and Articles of Association.

At the 2008 AGM, the directors were given the power to buy back a maximum number of 351,337,974 ordinary shares at a minimum price of 2.5p each. The maximum price was an amount equal to 105% of the average of the middle market quotations of the Company's ordinary shares as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the day on which such ordinary shares are contracted to be purchased. This power will expire at the earlier of the conclusion of the 2009 AGM or 30 June 2009. A special resolution will be proposed at the 2009 AGM to renew the Company's authority to acquire its own shares.

At the 2008 AGM, the directors were given the power to issue new shares up to an amount of £29,275,236. This power will expire on the earlier of the conclusion of the 2009 AGM or 30 June 2009. Accordingly, a resolution will be proposed at the 2009 AGM to renew the Company's authority to issue further new shares.

**Conflicts of interest**

During 2008 provisions in the Companies Act 2006 concerning a director's duties in dealing with actual or potential conflicts of interest became effective. In accordance with these provisions, shareholders approved changes to the Company's Articles of Association to allow directors to authorise such conflicts.

To avoid potential conflicts of interest the Board requires the Nominations Committee to check that any individuals it nominates for appointment to the Board are free of potential conflicts, and the committee's terms of reference were amended in 2008 to reflect this. In addition, the Board's procedures and the induction programme for new directors emphasise a director's personal responsibility for complying with the duties relating to conflicts of interest. The procedure adopted by the Board for the authorisation of conflicts reminds directors of the need to consider their duties as directors and not grant an authorisation unless they believe, in good faith, that this would be likely to promote the success of the Company. As required by law, the potentially conflicted director cannot vote on an authorisation resolution or be counted in the quorum. Any authorisation granted may be terminated at any time and the director is informed of the obligation to inform the Company without delay should there be any material change in the nature of the conflict or potential conflict so authorised. The Nominations Committee has been asked to review on an annual basis any authorisations granted and to make recommendations to the Board as appropriate.

**Directors' indemnities**

The Company has entered into deeds of indemnity with all its current directors and those persons who were directors for any part of 2008 which are qualifying indemnity provisions for the purpose of the Companies Act 2006. A similar indemnity has been provided to Sir Richard Evans, a former director who retired from the Board on 30 June 2004 but up to 29 February 2008 was employed by the Company in a part-time customer relationship role.

The directors of BAE Systems 2000 Pension Plan Trustees Limited and BAE Systems Executive Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems 2000 Pension Plan and the BAE Systems Executive Pension Scheme, respectively, which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

All such indemnity provisions are in force as at the date of this Directors' report.

**Change of control – significant agreements**

The following significant agreements contain provisions entitling the counterparties to exercise termination, alteration or other similar rights in the event of a change of control of the Company:

– The Group has entered into a £1.5bn Revolving Credit Facility dated 1 February 2005 (as amended) and a £500m Letter of Credit Facility dated 27 March 2006, which provide that, in the event of a change of control of the Company, the lenders are entitled to renegotiate terms, or if no agreement is reached on negotiated terms within a certain period, to call for the repayment or cancellation of the facilities. The Revolving Credit Facility was undrawn as at 31 December 2008.

– The Company has entered into a Restated and Amended Shareholders Agreement with European Aeronautic Defence and Space Company EADS N.V. (EADS) and Finmeccanica S.p.A (Finmeccanica) relating to MBDA S.A.S. dated 18 December 2001 (as amended). In the event that control of the Company passes to certain specified third party acquirors, the agreement allows EADS and Finmeccanica to exercise an option to terminate certain executive management level nomination and voting rights and certain shareholder information rights of the Company in relation to the MBDA joint venture. Following the exercise of this option, the Company would have the right to require the other shareholders to purchase its interest in MBDA at fair market value. The Company and EADS have agreed that if Finmeccanica acquires a controlling interest in the Company, EADS will increase its shareholding in MBDA to 50% by purchasing the appropriate number of shares in MBDA at fair market value.

# Other statutory and regulatory information *continued*

- The Company, BAE Systems North America Inc. (now BAE Systems, Inc.) and BAE Systems Holdings Inc. entered into a Special Security Agreement dated 29 November 2000 with the US Department of Defense regarding the management of BAE Systems, Inc. in order to comply with the US government's national security requirements. In the event of a change of control of the Company, the Agreement may be terminated or altered by the US Department of Defense.
- The Company has entered into a Joint Venture Agreement with VT Group plc and BVT Surface Fleet Limited dated 1 July 2008. In the event that a third party (together, if applicable, with persons acting in concert with any such third party) acquires a controlling interest of greater than 30% in the Company, VT Group plc may exercise a put option requiring the Company to purchase its interest in BVT Surface Fleet Limited at the higher of £380m and the fair market value on exit of such interest, subject to downward adjustment for certain matters.

In addition, the Company's share plans contain provisions as a result of which options and awards may vest and become exercisable on a change of control of the Company in accordance with the rules of the plans.

**Persons with whom the Company has essential contractual and other arrangements**

The Company's largest customers for its products and services are the governments of the United Kingdom, the United States, the Kingdom of Saudi Arabia and Australia. In the US, BAE Systems is subject to the Special Security Agreement that safeguards US national security interests, as a result of which BAE Systems is allowed to supply products and services of a highly sensitive nature to the US government. Likewise, in Australia, BAE Systems is subject to an Overarching Deed with the Commonwealth of Australia that protects the Commonwealth of Australia's national security and other interests and allows the Company to own certain Australian defence-related industrial assets. Agreements between the governments of the United Kingdom and the Kingdom of Saudi Arabia relating to defence co-operation programmes continue to remain essential to the development of the Company's business in Saudi Arabia.

**Auditors**

KPMG Audit Plc, the auditors for the Company, have indicated their willingness to continue in office and a resolution proposing their re-appointment will be put to the AGM.

**Statement of directors' responsibilities in respect of the Annual Report and financial statements**

The directors are responsible for preparing the Annual Report and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and applicable law, and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

The Group financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position and the performance of the Group; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

The parent company financial statements are required by law to give a true and fair view of the state of affairs of the parent company.

In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a directors' report, directors' remuneration report and corporate governance statement that comply with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

**Statement of disclosure of information to auditors**
The directors who held office at the date of approval of this Directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he ought to have taken to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

**Responsibility statement of the directors in respect of the annual financial report**
Each of the directors listed below confirms that to the best of his knowledge:

– the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and

– the Directors' report includes a fair review of the development and performance of the business, and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

| | |
|---|---|
| Dick Olver | Chairman |
| Ian King | Chief Executive |
| Walt Havenstein | Chief Operating Officer – BAE Systems, Inc. |
| George Rose | Group Finance Director |
| Phil Carroll | Non-executive director |
| Michael Hartnall | Non-executive director |
| Andy Inglis | Non-executive director |
| Sir Peter Mason | Non-executive director |
| Roberto Quarta | Non-executive director |
| Sir Nigel Rudd | Non-executive director |
| Carl Symon | Non-executive director |
| Ravi Uppal | Non-executive director |

By order of the Board

**David Parkes** Company Secretary
18 February 2009

# Financial statements and shareholder information

## Financial statements and shareholder information contents 6



Detica NerveCentre uses interactive whiteboards to facilitate presentations, demonstrations and discussions. Fully integrated into the Detica NerveCentre technical infrastructure, these whiteboards enable Detica staff and clients to work collaboratively and efficiently, capturing ideas and solutions generated in digital form.

# Index to the accounts

# Independent auditors' report to the members of BAE Systems plc

We have audited the Group and parent company financial statements (the financial statements) of BAE Systems plc for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's 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 and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

**Respective responsibilities of directors and auditors**
The directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU, and for preparing the parent company financial statements and the Directors' Remuneration Report in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities on page 100.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

**Basis of audit opinion**
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

**Opinion**
In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- the parent company financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the parent company's affairs as at 31 December 2008;
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

**KPMG Audit Plc**
Chartered Accountants
Registered Auditor
London

18 February 2009

# Consolidated income statement

for the year ended 31 December

| | Notes | 2008 £m | Total 2008 £m | 2007 £m | Total 2007 £m |
|---|---|---|---|---|---|
| **Continuing operations** | | | | | |
| **Combined sales of Group and equity accounted investments** | 3 | | **18,543** | | 15,710 |
| Less: share of sales of equity accounted investments | 3 | | **(1,872)** | | (1,401) |
| **Revenue** | 3 | | **16,671** | | 14,309 |
| **Operating costs** | 4 | | **(15,386)** | | (13,480) |
| **Other income** | 5 | | **415** | | 209 |
| *Group operating profit excluding amortisation and impairment of intangible assets* | | **2,003** | | 1,335 | |
| *Amortisation* | 11 | **(247)** | | (149) | |
| *Impairment* | 11 | **(56)** | | (148) | |
| **Group operating profit** | | | **1,700** | | 1,038 |
| *Share of results of equity accounted investments excluding finance costs and taxation expense* | | **132** | | 142 | |
| *Financial income of equity accounted investments* | | **44** | | 35 | |
| *Taxation expense of equity accounted investments* | | **(37)** | | (38) | |
| **Share of results of equity accounted investments** | 14 | **139** | | 139 | |
| *Impairment in respect of equity accounted investments* | 14 | **(121)** | | – | |
| **Contribution from equity accounted investments** | | | **18** | | 139 |
| *EBITA[1] excluding profit on disposal of businesses and uplift on acquired inventories* | | **1,897** | | 1,449 | |
| *Profit on disposal of businesses[2]* | 9 | **238** | | 40 | |
| *Uplift on acquired inventories (included in operating costs)* | | **–** | | (12) | |
| *EBITA[1]* | | **2,135** | | 1,477 | |
| *Amortisation* | | **(247)** | | (149) | |
| *Impairments* | | **(177)** | | (148) | |
| *Financial income of equity accounted investments* | | **44** | | 35 | |
| *Taxation expense of equity accounted investments* | | **(37)** | | (38) | |
| **Operating profit** | 3 | | **1,718** | | 1,177 |
| **Finance costs** | 6 | | | | |
| Financial income | | **3,380** | | 1,257 | |
| Financial expense | | **(2,727)** | | (1,199) | |
| | | | **653** | | 58 |
| **Profit before taxation** | | | **2,371** | | 1,235 |
| **Taxation expense** | 8 | | | | |
| UK taxation | | **(351)** | | (201) | |
| Overseas taxation | | **(252)** | | (134) | |
| | | | **(603)** | | (335) |
| **Profit for the year from continuing operations** | | | **1,768** | | 900 |
| **Profit for the year from discontinued operations** | 9 | | **–** | | 22 |
| **Profit for the year** | | | **1,768** | | 922 |
| **Attributable to:** | | | | | |
| BAE Systems shareholders | | | **1,745** | | 901 |
| Minority interests | | | **23** | | 21 |
| | | | **1,768** | | 922 |
| **Earnings per share** | 10 | | | | |
| Continuing operations: | | | | | |
| Basic earnings per share | | | **49.6p** | | 26.0p |
| Diluted earnings per share | | | **49.5p** | | 25.8p |
| Discontinued operations: | | | | | |
| Basic earnings per share | | | **–** | | 0.6p |
| Diluted earnings per share | | | **–** | | 0.6p |
| Total: | | | | | |
| Basic earnings per share | | | **49.6p** | | 26.6p |
| Diluted earnings per share | | | **49.5p** | | 26.4p |

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
2 Comprises a loss of £nil in operating costs (2007 £8m) and a profit of £238m in other income (2007 £48m).

# Consolidated balance sheet

as at 31 December

| | Notes | **2008 £m** | 2007 £m |
|---|---|---|---|
| **Non-current assets** | | | |
| Intangible assets | 11 | **12,306** | 9,559 |
| Property, plant and equipment | 12 | **2,446** | 1,774 |
| Investment property | 13 | **112** | 113 |
| Equity accounted investments | 14 | **1,034** | 781 |
| Other investments | 15 | **6** | 6 |
| Other receivables | 16 | **162** | 322 |
| Other financial assets | 17 | **514** | 48 |
| Deferred tax assets | 8 | **1,026** | 567 |
| | | **17,606** | 13,170 |
| **Current assets** | | | |
| Inventories | 18 | **926** | 701 |
| Trade and other receivables including amounts due from customers for contract work | 16 | **3,831** | 2,933 |
| Current tax | | **14** | 35 |
| Other investments | 15 | **–** | 164 |
| Other financial assets | 17 | **674** | 101 |
| Cash and cash equivalents | | **2,624** | 3,062 |
| | | **8,069** | 6,996 |
| Non-current assets and disposal groups held for sale | 19 | **–** | 94 |
| | | **8,069** | 7,090 |
| **Total assets** | 3 | **25,675** | 20,260 |
| **Non-current liabilities** | | | |
| Loans | 20 | **(2,608)** | (2,197) |
| Trade and other payables | 21 | **(701)** | (413) |
| Retirement benefit obligations | 22 | **(3,365)** | (1,629) |
| Other financial liabilities | 17 | **(383)** | (26) |
| Deferred tax liabilities | 8 | **(80)** | (40) |
| Provisions | 23 | **(459)** | (399) |
| | | **(7,596)** | (4,704) |
| **Current liabilities** | | | |
| Loans and overdrafts | 20 | **(173)** | (299) |
| Trade and other payables | 21 | **(9,165)** | (8,245) |
| Other financial liabilities | 17 | **(362)** | (71) |
| Current tax | | **(704)** | (499) |
| Provisions | 23 | **(386)** | (410) |
| | | **(10,790)** | (9,524) |
| Liabilities directly associated with disposal groups held for sale | 19 | **–** | (30) |
| | | **(10,790)** | (9,554) |
| **Total liabilities** | 3 | **(18,386)** | (14,258) |
| **Net assets** | | **7,289** | 6,002 |
| | | | |
| **Capital and reserves** | | | |
| Issued share capital | 25, 27 | **90** | 90 |
| Share premium | 27 | **1,238** | 1,222 |
| Other reserves | 27 | **5,974** | 4,631 |
| Retained earnings | 27 | **(68)** | 23 |
| **Total equity attributable to equity holders of the parent** | | **7,234** | 5,966 |
| **Minority interests** | 27 | **55** | 36 |
| **Total equity** | | **7,289** | 6,002 |

Approved by the Board on 18 February 2009 and signed on its behalf by:

| | |
|---|---|
| **I G King** | **G W Rose** |
| Chief Executive | Group Finance Director |

# Consolidated cash flow statement

for the year ended 31 December

| | Notes | 2008 £m | 2007 £m |
|---|---|---|---|
| Profit for the year from continuing operations | | **1,768** | 900 |
| Profit for the year from discontinued operations | | **–** | 22 |
| **Profit for the year** | | **1,768** | 922 |
| Taxation expense | | **603** | 335 |
| Share of results of equity accounted investments | 14 | **(139)** | (139) |
| Net finance costs | | **(653)** | (58) |
| Depreciation, amortisation and impairment | | **755** | 610 |
| (Gain)/loss on disposal of property, plant and equipment | 4, 5 | **(33)** | 3 |
| Gain on disposal of investment property | 5 | **(5)** | (47) |
| Gain on disposal of non-current other investments | | **–** | (8) |
| Gain on disposal of businesses – continuing operations | 4, 5 | **(238)** | (40) |
| Gain on disposal of businesses – discontinued operations | 9 | **–** | (22) |
| Cost of equity-settled employee share schemes | | **51** | 34 |
| Movements in provisions | | **(115)** | 52 |
| Decrease in liabilities for retirement benefit obligations | | **(272)** | (233) |
| Decrease/(increase) in working capital: | | | |
| Inventories | | **46** | (188) |
| Trade and other receivables | | **(5)** | (271) |
| Trade and other payables | | **246** | 1,212 |
| Cash inflow from operating activities | | **2,009** | 2,162 |
| Interest paid | | **(249)** | (224) |
| Interest element of finance lease rental payments | | **(5)** | (6) |
| Taxation paid | | **(261)** | (112) |
| **Net cash inflow from operating activities** | | **1,494** | 1,820 |
| Dividends received from equity accounted investments | 14 | **89** | 78 |
| Interest received | | **156** | 175 |
| Purchases of property, plant and equipment | | **(520)** | (307) |
| Purchases of intangible assets | | **(32)** | (31) |
| Equity accounted investment funding | | **–** | (4) |
| Proceeds from sale of property, plant and equipment | | **44** | 13 |
| Proceeds from sale of investment property | | **5** | 53 |
| Proceeds from sale of non-current other investments | | **–** | 15 |
| Purchase of non-current other investments | 15 | **–** | (1) |
| Purchase of subsidiary undertakings | 29, 31 | **(1,078)** | (1,731) |
| Cash and cash equivalents acquired with subsidiary undertakings | 29 | **2** | 6 |
| Purchase of equity accounted investments | 29 | **(12)** | (1) |
| Proceeds from sale of subsidiary undertakings | 9 | **131** | 96 |
| Cash and cash equivalents disposed of with subsidiary undertakings | 29 | **(60)** | (1) |
| Proceeds from sale of equity accounted investments | 9 | **16** | 57 |
| Proceeds from sale of other deposits | | **164** | 343 |
| **Net cash outflow from investing activities** | | **(1,095)** | (1,240) |
| Capital element of finance lease rental payments | | **(18)** | (25) |
| Proceeds from issue of share capital | 27 | **16** | 805 |
| Purchase of treasury shares | 27 | **–** | (152) |
| Purchase of own shares | 27 | **(43)** | (50) |
| Equity dividends paid | 30 | **(478)** | (396) |
| Dividends paid to minority interests | | **(11)** | (1) |
| Dividends paid on preference shares | | **–** | (10) |
| Cash outflow from matured derivative financial instruments | | **(440)** | (14) |
| Cash inflow from reduction in cash collateral | | **106** | 9 |
| Cash outflow from repayment of loans | | **(306)** | (777) |
| **Net cash outflow from financing activities** | | **(1,174)** | (611) |
| **Net decrease in cash and cash equivalents** | | **(775)** | (31) |
| Cash and cash equivalents at 1 January | | **3,046** | 3,074 |
| Effect of foreign exchange rate changes on cash and cash equivalents | | **334** | 3 |
| **Cash and cash equivalents at 31 December** | | **2,605** | 3,046 |
| Comprising: | | | |
| Cash and cash equivalents | | **2,624** | 3,062 |
| Overdrafts | | **(19)** | (16) |
| **Cash and cash equivalents at 31 December** | | **2,605** | 3,046 |

# Consolidated statement of recognised income and expense

for the year ended 31 December

| | Notes | 2008 £m | 2007 £m |
|---|---|---|---|
| Currency translation on foreign currency net investments: | | | |
| Subsidiaries | | **807** | (1) |
| Equity accounted investments | 14 | **197** | 43 |
| Amounts credited to hedging reserve | | **469** | 41 |
| Net actuarial (losses)/gains on defined benefit pension schemes: | | | |
| Subsidiaries | | **(1,937)** | 544 |
| Equity accounted investments | | **(60)** | 24 |
| Fair value movements on available-for-sale investments | | **–** | 5 |
| Current tax on items taken directly to equity | 8 | **58** | 96 |
| Deferred tax on items taken directly to equity: | | | |
| Subsidiaries | 8 | **425** | (259) |
| Tax rate adjustment[1] | 8 | **–** | (19) |
| Equity accounted investments | | **17** | (6) |
| Recycling of fair value movements on disposal of available-for-sale investments | | **–** | (6) |
| Recycling of cumulative currency translation on disposal: | | | |
| Continuing operations | | **1** | – |
| **Net (expense)/income recognised directly in equity** | | **(23)** | 462 |
| **Profit for the year** | | **1,768** | 922 |
| **Total recognised income and expense** | | **1,745** | 1,384 |
| | | | |
| **Attributable to:** | | | |
| Equity shareholders | | **1,722** | 1,363 |
| Minority interests | | **23** | 21 |
| | | **1,745** | 1,384 |

1 The UK current tax rate was reduced from 30% to 28% with effect from 1 April 2008. In 2007, in line with this change, the rate applying to UK deferred tax assets and liabilities was also reduced from 30% to 28%, creating a rate adjustment, which was partly reflected in the Consolidated income statement and partly in the Consolidated statement of recognised income and expense.

## 1. Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

**Basis of preparation**

The consolidated financial statements of BAE Systems plc have been prepared in accordance with EU endorsed International Financial Reporting Standards (IFRS), International Financial Reporting Interpretations Committee interpretations (IFRICs) and the Companies Act 1985 applicable to companies reporting under IFRS.

The consolidated financial statements are presented in pounds sterling and, unless stated otherwise, rounded to the nearest million. They have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and other relevant financial assets and financial liabilities (including derivative instruments).

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates and judgements.

The directors consider the potential key areas of judgements required to be made in applying the Group's accounting policies. These relate to:

– the determination of the revenue recognition approach to apply to individual contracts;
– the classification of financial assets or liabilities;
– the classification of retirement benefit plans between defined benefit and defined contribution arrangements; and
– the classification of investments as subsidiaries, equity accounted investments or otherwise.

The directors do not consider that the practical application of the judgements is significantly uncertain or subjective in nature.

An analysis and explanation of the critical accounting estimates and judgements used in producing this set of financial statements is made in the Directors' report on pages 33 and 34.

**Basis of consolidation**

The financial statements of the Group consolidate the results of the Company and its subsidiary entities, and include its share of its joint ventures' and associates' results accounted for under the equity method, all of which are prepared to 31 December.

A subsidiary is an entity controlled by the Group. Control is the power to govern the operating and financial policies of the entity so as to obtain benefits from its activities. Subsidiaries include the special purpose entities that the Group transacted through for the provision of guarantees in respect of residual values and head lease and finance payments on certain regional aircraft sold.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. The results of such subsidiaries are included in the consolidated income statement from the date of acquisition, up to the date of disposal.

An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. An entity is regarded as an associate if the Group has significant influence, but not control, over its operating and financial policies. Joint ventures and associates are accounted for under the equity method where the Group's income statement includes its share of their profits and losses and the Group's balance sheet includes its share of their net assets.

Where the Group contributes a business, or other non-monetary assets for an interest in a subsidiary, joint venture or associate, such transactions are recorded so that the reduction in ownership of the business being contributed is accounted for as a disposal while the increased interest in the enlarged Group or new interest in the business contributed by other parties to the transaction is accounted for as an acquisition. Fair values are applied to those operations which are subject to the exchange and which have not previously been held within the Group. Any loss or gain resulting from the transaction is recorded in the income statement.

**Goodwill**

Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing.

Goodwill arising on acquisitions before the date of transition to IFRS (1 January 2004) has been retained at the previous UK GAAP amounts, as any amounts related to intangible assets that would have been recorded in the acquired entity if it had applied IAS 38 *Intangible Assets* at the date it was acquired by the Group were considered immaterial, after being tested for impairment at that date. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

**Impairment**

The carrying amounts of the Group's intangible assets, property, plant and equipment, and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36 *Impairment of Assets*. If any such indication exists, the asset's recoverable amount is estimated. For intangible assets that are not yet available for use, and goodwill, the recoverable amount is estimated at each balance sheet date. All other assets are considered for impairment under the relevant standard.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

The recoverable amount of assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at appropriate pre-tax discount rates. Receivables with a short-term duration are not discounted.

The recoverable amount of other assets is the greater of their fair value less cost to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate.

For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

## 1. Accounting policies *continued*

An impairment loss in respect of assets, other than goodwill, carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised. An impairment loss in respect of an equity investment classified as available-for-sale is not reversed through profit or loss. An impairment loss in respect of goodwill is not reversed. An impairment loss in respect of other assets is reversed if there has been a change in the estimate used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

**Revenue and profit recognition**

Sales include the Group's net share of sales of joint ventures and associates. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of joint ventures and associates.

Long-term contracts

The majority of the Group's long-term contract arrangements are accounted for under IAS 11 *Construction Contracts*. Sales are recognised when the Group has obtained the right to consideration in exchange for its performance. This is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods sold and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

Revenue from the sale of goods not under a long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date.

Sales and profits on intercompany trading are generally determined on an arm's length basis.

Lease income

Rental income from aircraft operating leases is recognised in revenue on a straight-line basis over the term of the relevant lease. Lease incentives granted are charged to the income statement over the term of the lease.

**Foreign currencies**

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the consolidated income statement unless they qualify for net investment hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

For consolidation purposes, the assets and liabilities of overseas subsidiary entities, joint ventures and associates are translated at the exchange rate ruling at the balance sheet date. Income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences, including exchange differences arising from the translation of borrowings and other financial instruments designated as hedges of such investments, are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

**Research and development**

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Group-funded expenditure on research activities is written off as incurred and charged to the income statement.

Group-funded expenditure on development activities applied to a plan or design for the production of new or substantially improved products and processes is capitalised as an internally generated intangible asset if certain conditions are met. The expenditure capitalised includes the cost of materials, direct labour and related overheads. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses. Capitalised development expenditure is amortised over the expected life of the product.

Where the research and development activity is performed for customers, the revenue arising is recognised in accordance with the Group's revenue recognition policy above.

**Other intangible assets**

Acquired computer software licences for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software.

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Capitalised software development expenditure is stated at cost less accumulated amortisation and impairment losses. Group-funded expenditure associated with enhancing or maintaining computer software programmes for sale is recognised as an expense as incurred.

Trademarks and licences have definite useful lives and are carried at cost less accumulated amortisation and impairment losses.

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing.

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of the intangible assets.

The estimated useful lives are as follows:

| | |
|---|---|
| Acquired computer software licences | 2 to 5 years |
| Capitalised software development | 2 to 5 years |
| Trademarks and licences | up to 20 years |
| Other intangibles | up to 10 years |

## 1. Accounting policies *continued*

**Property, plant and equipment**
Items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads.

Depreciation is provided, normally on a straight-line basis, to write off the cost of property, plant and equipment over their estimated useful lives to any estimated residual value, using the following rates:

| | |
|---|---|
| Buildings | up to 50 years, or the lease term if shorter |
| Research equipment | 8 years |
| Computing equipment, motor vehicles and short-life works equipment | 3 to 5 years |
| Aircraft | up to 15 years, or the lease term if shorter |
| Other equipment | 10 to 15 years, or the project life if shorter |

In the Group's US businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

No depreciation is provided on freehold land and assets in the course of construction.

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date. Where applicable, useful lives reflect the component accounting principle.

Assets obtained under finance leases are included in property, plant and equipment and stated at an amount equal to the lower of the fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

**Investment property**
Land and buildings that are leased to non-Group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and accumulated impairment losses.

Depreciation is provided, on a straight-line basis, to write off the cost of investment property over its estimated useful life of up to 50 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

**Other investments**
The Group determines the classification of its other investments at initial recognition taking account of, where relevant, the purpose for which the investments were acquired. The Group classifies its other investments as follows:

(a) loans and receivables: term deposits, principally comprising funds held with banks and other financial institutions, are carried at amortised cost using the effective interest method;
(b) at fair value through profit or loss: financial instruments held for trading or designated by management on initial recognition. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date;
(c) held to maturity: non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity. During the year, the Group did not hold any investments in this category;
(d) available-for-sale: investments other than interests in joint ventures and associates and term deposits and not classified as (b) or (c) above. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date.

Purchases and sales of investments are recognised at the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss.

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership.

Realised and unrealised gains and losses arising from changes in the fair value of the investments classified as at fair value through profit or loss are included in finance costs in the income statement in the period in which they arise. Unrealised gains or losses arising from changes in the fair value of investments classified as available-for-sale are recognised in equity. When investments classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities within finance costs.

The fair values of quoted investments are based on bid prices at the balance sheet date.

**Trade and other receivables**
Trade and other receivables are stated at their amortised cost less impairment losses. A provision for impairment is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired.

Amounts due from customers for contract work include long-term contract balances less attributable progress payments.

Long-term contract balances are stated at cost, plus attributable profit, less provision for any anticipated losses. Appropriate provisions for any losses are made in the year in which they are first foreseen.

Progress payments are amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery and are credited, as progress payments, against any expenditure incurred for the particular contract. Any unexpended balance in respect of progress payments is held in trade and other payables as customer stage payments or, if the amounts are subject to advance payment guarantees unrelated to company performance, as cash received on customers' account.

Cash received on customers' account is excluded from net cash/(debt) as defined by the Group.

**Inventories**
Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

## 1. Accounting policies *continued*

**Cash and cash equivalents**
Cash and cash equivalents includes cash in hand, call deposits and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

**Non-current assets and disposal groups held for sale**
Non-current assets and disposal groups are classified as assets held for sale and stated at the lower of carrying amount and fair value less costs to sell if their carrying amount is to be recovered principally through a sale transaction rather than through continuing use.

This condition is regarded as met only when the sale is highly probable and expected to be completed within a year from the classification. In addition, the asset (or disposal group) is to be available for immediate sale in its present condition and is actively being marketed at a price that is reasonable in relation to its current fair value.

**Loans and overdrafts**
Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost or fair value in respect of the hedged risk where hedge accounting has been adopted, with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

**Borrowing costs**
Borrowing costs in connection with the acquisition or construction of items of property, plant and equipment, investment property and inventories are not capitalised.

**Trade and other payables**
Trade and other payables are stated at their cost.

**Leases**
Assets obtained under finance leases are included in property, plant and equipment at cost and are depreciated over their useful lives, or the lease term, whichever is the shorter. Future instalments under such leases, net of financing costs, are included within loans. Rental payments are apportioned between the finance element, which is included in finance costs, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant charge on the outstanding obligation.

Payments, including any incentives, made under operating leases are recognised in the income statement on a straight-line basis over the lease term.

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and accumulated impairment losses. Rental income is recognised in revenue on a straight-line basis.

Assets leased out under finance leases cease to be recognised in the balance sheet after the inception of the lease. Instead, a finance lease receivable, representing the discounted future lease payments to be received from the lessee plus any discounted unguaranteed residual value, is recorded as a long-term financial asset. Interest income is recognised in the income statement as it accrues, taking into account the effective yield on the asset.

**Derivative financial instruments**
The global nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures as well as to manage anticipated economic cash flow exposures over the medium term. The Group also uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon. The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

Derivative financial instruments are recognised initially at fair value. Subsequent to initial recognition, such instruments are stated at fair value at the balance sheet date. Where a derivative financial instrument is designated as a hedge of cash flows relating to a highly probable forecast transaction (income or expense), the effective portion of any change in the fair value of the instrument is recognised directly in reserves. Amounts recognised in reserves are recycled from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement immediately. Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability, and gains and losses on the derivative instrument, are recognised in the income statement for the period. Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement for the period.

**Tax**
Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided in full, using the balance sheet liability method, on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

## 1. Accounting policies *continued*

### Provisions
A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

A provision for warranties is recognised when the underlying products and services are sold. The provision is based on historical warranty data and a weighting of all possible outcomes against their associated probabilities.

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. Future operating costs are not provided for.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of work-in-progress for that portion of the work which has already been completed, and as liability provisions for the remainder. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

### Employee benefits – Pension obligations
Group companies operate various pension plans. The Group has both defined benefit and defined contribution plans.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

For defined benefit retirement plans, the cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of recognised income and expense. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period until the benefits become vested.

The retirement benefit obligations recognised in the balance sheet represent the present value of the defined benefit obligations as adjusted for unrecognised past service cost and as reduced by the fair value of scheme assets.

### Long-term service benefits – Equity and equity-related compensation benefits
The Group issues equity-settled and cash-settled share options to employees. In accordance with the requirements of IFRS 2 *Share-based Payments*, the Group has applied IFRS 2 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005 and all cash-settled options outstanding at the balance sheet date.

As explained in note 26, equity-settled share options are measured at fair value at the date of grant using an option pricing model. The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of the number of shares that will actually vest.

Cash-settled share options are measured at fair value at the balance sheet date using an option pricing model. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of the options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

### Preference share capital
In 2007, the Group's 7.75p (net) cumulative redeemable preference shares of 25p each were converted into the Group's ordinary shares of 2.5p on the basis of 0.47904 ordinary shares for every preference share.

In accordance with IAS 32 *Financial Instruments: Presentation*, the preference shares were considered a compound financial instrument and, accordingly, split into an underlying debt instrument, classified within loans and overdrafts, and an equity conversion option, classified within equity.

The underlying debt instrument was presented on an amortised cost basis until extinguished on conversion.

The equity conversion option was presented at its historic fair value, based on the date of original issue of the preference shares. On conversion of the preference shares into ordinary shares, the equity component was reclassified to share capital and share premium.

### Dividends
Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared.

## 2. Changes in accounting policies

**Standards, amendments and interpretations effective in 2008**
With effect from 1 January 2008 the Group has early adopted IFRS 8, *Operating Segments* (effective for accounting periods beginning on or after 1 January 2009). This requires that entities adopt the 'management approach' to the financial reporting of their operating segments, under which segment information is presented on the same basis as that used for internal reporting purposes. The standard is concerned with disclosure only and has no impact on the consolidated income statement or balance sheet.

The following interpretation to published standards is effective for accounting periods beginning on or after 1 January 2008:

– IFRIC 11, *IFRS 2, Group and Treasury Share Transactions*, provides guidance on whether share-based transactions involving treasury shares or group entities should be accounted for as equity-settled or cash-settled share-based payment transactions.

This does not have any impact on the Group's accounts.

**Amendments to existing standards and interpretations that are not yet effective and have not been early adopted by the Group**
The following EU endorsed amendments and interpretations to published standards are effective for accounting periods beginning on or after 1 July 2008, and have not been early adopted by the Group:

– Amendments to IAS 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosures*, permit the reclassification of some financial instruments under limited circumstances and require additional disclosures in the event that a reclassification is made. These amendments are not expected to have any impact on the Group's accounts; and

– IFRIC 13, *Customer Loyalty Programmes* is not relevant to the Group.

The following EU endorsed standards, and amendments and interpretations to published standards are effective for accounting periods beginning on or after 1 January 2009, but have not been early adopted by the Group:

– Amendment to IAS 23, *Borrowing Costs* requires capitalisation of borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) as part of the cost of that asset. There is no longer an option to immediately expense those borrowing costs. Whilst this will represent a change in the Group's accounting policy, application of the revised standard is prospective. It is not expected to have a significant impact on the Group's accounts on the basis of the current profile of the Group's borrowing and the way its qualifying assets are generally funded;

– Amendment to IAS 1, *Presentation of Financial Statements: A Revised Presentation*, provides an entity with a choice of presenting one performance statement ('statement of comprehensive income') or two statements ('income statement' and 'statement of comprehensive income'). There is also a requirement to present a new financial statement ('consolidated statement of changes in equity'), which will present information that has previously been disclosed in the notes. In addition, where entities restate or reclassify comparative information, they will be required to present a restated opening balance sheet for the earliest comparative period. The standard is concerned with disclosure only, and it is likely that both the income statement and statement of comprehensive income will continue to be presented as separate performance statements;

– Amendment to IFRS 2, *Share-based Payment: Vesting Conditions and Cancellations*, provides clarification of the vesting conditions which should be included in the grant date fair value for transactions with employees and others providing similar services. It is not expected to have an impact on the Group's accounts;

– Amendments to IAS 32, *Financial Instruments* and IAS 1, *Presentation of Financial Statements: Puttable Financial Instruments and Obligations Arising on Liquidation,* require entities to classify puttable financial instruments as equity, where the entity is obliged to deliver a share of net assets of the entity upon liquidation. It is not expected to have an impact on the Group's accounts;

– Amendments to IFRS 1, *First-time adoption of IFRS* and IAS 27*, Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly-Controlled Entity or Associate*, allow first time adopters to use a deemed cost of either fair value or the carrying amount under previous accounting practice to measure the initial cost of investments in the separate financial statements. There are no plans to transition the Group's subsidiaries to IFRS and, therefore, the amendments will have no impact on the Group;

– Improvements to IFRSs 2008 is the first standard issued under the International Accounting Standards Board's annual improvements process. It amends 20 existing standards, basis of conclusions and guidance. The improvements include changes in presentation, recognition and measurement requirements. They are not expected to have any material impact on the Group's accounts; and

– IFRIC 14, *IAS 19, The Limit on Defined Benefit Asset, Minimum Funding Requirements and their Interaction*, aims to clarify how to determine in normal circumstances the limit on the asset that an employer's balance sheet may contain in respect of its defined benefit pension plans and when additional liabilities might be required to be recognised. This will not have any impact on the Group's accounts.

## 3. Segmental analysis

The Group has five reportable segments which are organised around a combination of the different products and services they provide and the geographical area in which they operate:

- Electronics, Intelligence & Support, based primarily in the US, designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications. It comprises four lines of business: Electronic Solutions, Information Solutions, Platform Solutions and Support Solutions, and includes the acquired MTC business (note 31);
- Land & Armaments, based primarily in the US, is a leader in the design, development, production, through-life support and upgrade of armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems and munitions;
- Programmes & Support comprises the Group's UK-based air and naval activities, the Integrated System Technologies (Insyte) business and the acquired Detica business (note 31);
- International comprises the Group's businesses in Saudi Arabia and Australia, including the acquired Tenix Defence business (note 31), and its interests in the pan-European MBDA joint venture, Saab of Sweden and Air Astana; and
- HQ & Other Businesses comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

Management monitors the results of these operating groups to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on underlying EBITA[1]. This is reconciled below to the operating group result and the operating profit in the consolidated financial statements. Finance costs and taxation expense are managed on a Group basis.

### Analysis by operating group

| | Combined sales of Group and equity accounted investments | | Less: sales by equity accounted investments | | Add: sales to equity accounted investments | | Revenue | |
|---|---|---|---|---|---|---|---|---|
| | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| Electronics, Intelligence & Support | **4,459** | 3,916 | **–** | (7) | **–** | – | **4,459** | 3,909 |
| Land & Armaments | **6,407** | 3,538 | **(1)** | (1) | **1** | – | **6,407** | 3,537 |
| Programmes & Support | **4,638** | 5,327 | **(1,531)** | (1,367) | **983** | 1,111 | **4,090** | 5,071 |
| International | **3,333** | 3,359 | **(1,446)** | (1,307) | **–** | – | **1,887** | 2,052 |
| HQ & Other Businesses | **235** | 243 | **–** | – | **–** | – | **235** | 243 |
| | **19,072** | 16,383 | **(2,978)** | (2,682) | **984** | 1,111 | **17,078** | 14,812 |
| Intra-operating group sales/revenue | **(529)** | (673) | **25** | – | **97** | 170 | **(407)** | (503) |
| | **18,543** | 15,710 | **(2,953)** | (2,682) | **1,081** | 1,281 | **16,671** | 14,309 |

| | Intra-operating group revenue | | Revenue from external customers | |
|---|---|---|---|---|
| | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| Electronics, Intelligence & Support | **94** | 97 | **4,365** | 3,812 |
| Land & Armaments | **30** | 11 | **6,377** | 3,526 |
| Programmes & Support | **248** | 361 | **3,842** | 4,710 |
| International | **11** | 10 | **1,876** | 2,042 |
| HQ & Other Businesses | **24** | 24 | **211** | 219 |
| | **407** | 503 | **16,671** | 14,309 |

| | Capital expenditure[2] | | Depreciation and amortisation[2] | |
|---|---|---|---|---|
| | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| Electronics, Intelligence & Support | **105** | 92 | **104** | 84 |
| Land & Armaments | **98** | 82 | **227** | 144 |
| Programmes & Support | **85** | 77 | **92** | 110 |
| International | **212** | 60 | **46** | 18 |
| HQ & Other Businesses | **52** | 30 | **69** | 51 |
| | **552** | 341 | **538** | 407 |

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
2 Includes intangible assets, property, plant and equipment, and investment property.

## 3. Segmental analysis *continued*

| | Underlying EBITA[1] (restated) | | Profit/(loss) on disposal of businesses | | Uplift on acquired inventories | | Amortisation of intangible assets | | Impairment of intangible assets | | Operating group result[2] | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| Electronics, Intelligence & Support | **506** | 437 | **61** | (8) | **–** | – | **(24)** | (15) | **–** | – | **543** | 414 |
| Land & Armaments | **566** | 324 | **–** | – | **–** | (12) | **(168)** | (110) | **(40)** | – | **358** | 202 |
| Programmes & Support | **491** | 456 | **177** | – | **–** | – | **(24)** | (19) | **(5)** | (145) | **639** | 292 |
| International | **435** | 435 | **–** | – | **–** | – | **(30)** | (4) | **(120)** | – | **285** | 431 |
| HQ & Other Businesses | **(101)** | (203) | **–** | 48 | **–** | – | **(1)** | (1) | **(12)** | (3) | **(114)** | (159) |
| | **1,897** | 1,449 | **238** | 40 | **–** | (12) | **(247)** | (149) | **(177)** | (148) | **1,711** | 1,180 |
| Financial income of equity accounted investments | | | | | | | | | | | **44** | 35 |
| Taxation expense of equity accounted investments | | | | | | | | | | | **(37)** | (38) |
| **Operating profit** | | | | | | | | | | | **1,718** | 1,177 |
| Finance costs | | | | | | | | | | | **653** | 58 |
| **Profit before taxation** | | | | | | | | | | | **2,371** | 1,235 |
| Taxation expense | | | | | | | | | | | **(603)** | (335) |
| **Profit for the year from continuing operations** | | | | | | | | | | | **1,768** | 900 |

| | Assets excluding intangible assets and equity accounted investments | | Intangible assets | | Equity accounted investments | | Total assets | | Total liabilities | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| Electronics, Intelligence & Support | **1,954** | 1,406 | **5,272** | 4,491 | **4** | 3 | **7,230** | 5,900 | **(1,470)** | (1,164) |
| Land & Armaments | **2,019** | 1,510 | **5,712** | 4,435 | **–** | – | **7,731** | 5,945 | **(1,505)** | (1,191) |
| Programmes & Support | **866** | 1,035 | **875** | 575 | **217** | 45 | **1,958** | 1,655 | **(3,506)** | (3,696) |
| International | **1,899** | 1,106 | **429** | 27 | **813** | 733 | **3,141** | 1,866 | **(1,933)** | (1,778) |
| HQ & Other Businesses | **1,690** | 882 | **18** | 31 | **–** | – | **1,708** | 913 | **(3,035)** | (1,705) |
| | **8,428** | 5,939 | **12,306** | 9,559 | **1,034** | 781 | **21,768** | 16,279 | **(11,449)** | (9,534) |
| Disposal groups held for sale (note 19) | | | | | | | **–** | 94 | **–** | (30) |
| Tax | | | | | | | **1,040** | 602 | **(784)** | (539) |
| Retirement benefit obligations | | | | | | | **40** | 59 | **(3,365)** | (1,629) |
| Cash/(debt) as defined by the Group (note 29) | | | | | | | **2,827** | 3,226 | **(2,788)** | (2,526) |
| **Consolidated total assets/(liabilities)** | | | | | | | **25,675** | 20,260 | **(18,386)** | (14,258) |

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. See page 29.
2 The analysis by operating group of the share of results of equity accounted investments is provided in note 14.

### Analysis of non-current assets by geographical location

| | Carrying value of non-current assets | |
|---|---|---|
| Asset location | **2008 £m** | 2007 £m |
| United Kingdom | **1,774** | 1,529 |
| Rest of Europe | **1,272** | 1,147 |
| Saudi Arabia | **704** | 400 |
| United States | **11,703** | 9,351 |
| Asia and Pacific | **554** | 60 |
| Africa, Central and South America | **22** | 11 |
| **Non-current operating group assets** | **16,029** | 12,498 |
| Financial instruments | **985** | 149 |
| Inventories | **926** | 701 |
| Trade and other receivables | **3,828** | 2,931 |
| **Total operating group assets** | **21,768** | 16,279 |

## 3. Segmental analysis *continued*

### Analysis of sales and revenue by geographical location

| | Sales | | Revenue | |
|---|---|---|---|---|
| Customer location | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| United Kingdom | **3,398** | 3,433 | **2,908** | 3,179 |
| Rest of Europe | **2,647** | 2,611 | **1,633** | 1,750 |
| Saudi Arabia | **1,626** | 1,903 | **1,538** | 1,836 |
| Rest of Middle East | **130** | 158 | **87** | 91 |
| United States | **9,417** | 6,264 | **9,401** | 6,216 |
| Canada | **129** | 119 | **125** | 117 |
| Asia and Pacific | **808** | 978 | **692** | 930 |
| Africa, Central and South America | **388** | 244 | **287** | 190 |
| | **18,543** | 15,710 | **16,671** | 14,309 |

### Analysis of revenue by category

| | **2008 £m** | 2007 £m |
|---|---|---|
| Sale of goods | **6,042** | 4,559 |
| Construction contracts | **8,176** | 7,611 |
| Services | **2,376** | 2,070 |
| Lease income | **68** | 63 |
| Royalty income | **9** | 6 |
| | **16,671** | 14,309 |

### Analysis of revenue by major customer

Revenue from the Group's three principal customers is as follows:

| | **2008 £m** | 2007 £m |
|---|---|---|
| UK Ministry of Defence | **3,669** | 3,871 |
| US Department of Defense | **7,094** | 4,389 |
| Kingdom of Saudi Arabia Ministry of Defence and Aviation | **1,531** | 1,808 |

Revenue from the UK Ministry of Defence amounted to £3,669m (2007 £3,871m) arising from sales by all five operating groups. Revenue from the US Department of Defense was £7,094m (2007 £4,389m) from sales by the Programmes & Support, Electronics, Intelligence & Support, Land & Armaments and International operating groups. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was £1,531m (2007 £1,808m) from sales by the Electronics, Intelligence & Support and International operating groups.

## 4. Operating costs

| | 2008 £m | 2007 £m |
|---|---|---|
| Raw materials and other bought in items | **7,809** | 5,557 |
| Change in inventories of finished goods and work-in-progress | **(1,395)** | 13 |
| Cost of inventories expensed | **6,414** | 5,570 |
| Staff costs (note 7) | **4,618** | 3,924 |
| Depreciation, amortisation and impairment | **634** | 610 |
| Loss on disposal of property, plant and equipment | **1** | 4 |
| Loss on disposal of businesses (note 9) | **–** | 8 |
| Other operating charges | **3,719** | 3,364 |
| | **15,386** | 13,480 |
| Included within the analysis of operating costs are the following expenses: | | |
| Lease and sublease payments: | | |
| Minimum lease payments | **151** | 112 |
| | **151** | 112 |
| Research and development expense including amounts funded under contract | **1,044** | 1,460 |

**Significant one-off costs included in operating costs**

| | 2008 £m | 2007 £m |
|---|---|---|
| Rationalisation programmes | **87** | 25 |
| | | |
| Electronics, Intelligence & Support | **7** | 5 |
| Land & Armaments | **19** | 2 |
| Programmes & Support | **52** | 4 |
| International | **4** | 9 |
| HQ & Other Businesses | **5** | 5 |
| | **87** | 25 |

**Fees payable to the Company's auditor and its associates included in operating costs**

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | **UK £'000** | **Overseas £'000** | **Total £'000** | UK £'000 | Overseas £'000 | Total £'000 |
| **Fees payable to the Company's auditor for the audit of the Company's annual accounts*** | **1,333** | **–** | **1,333** | 1,111 | – | 1,111 |
| **Fees payable to the Company's auditor and its associates for other services** | | | | | | |
| The audit of the Company's subsidiaries pursuant to legislation* | **2,178** | **3,576** | **5,754** | 2,203 | 3,407 | 5,610 |
| Other services pursuant to legislation: | | | | | | |
| Interim review | **543** | **–** | **543** | 520 | – | 520 |
| Other including shareholder circular related work | **81** | **–** | **81** | 104 | – | 104 |
| **Further assurance services** | | | | | | |
| Advice on accounting matters | **19** | **3** | **22** | 28 | – | 28 |
| Internal controls | **39** | **–** | **39** | 16 | – | 16 |
| Due diligence | **795** | **–** | **795** | 880 | 1,036 | 1,916 |
| **Tax services** | | | | | | |
| Compliance | **392** | **1,112** | **1,504** | 308 | 793 | 1,101 |
| Advisory | **490** | **547** | **1,037** | 909 | 488 | 1,397 |
| **Other services** | **–** | **–** | **–** | 313 | – | 313 |
| Total fees payable to the Company's auditor and its associates | **5,870** | **5,238** | **11,108** | 6,392 | 5,724 | 12,116 |
| | | | | | | |
| * Total fees payable to the Company's auditor and its associates for audit services | | | **7,087** | | | 6,721 |

Tax services include tax compliance support and services in relation to the Group's expatriate employees based around the world. The majority of services provided outside the UK were provided in the US.

## 5. Other income

| | 2008 £m | 2007 £m |
|---|---|---|
| Rental income from operating leases | **47** | 46 |
| Profit on disposal of investment property | **5** | 47 |
| Profit on disposal of property, plant and equipment | **34** | 1 |
| Profit on disposal of businesses (note 9) | **238** | 48 |
| Management recharges to equity accounted investments | **17** | 15 |
| Other | **74** | 52 |
| | **415** | 209 |

## 6. Finance costs

| | 2008 £m | 2007 £m |
|---|---|---|
| Interest income | **147** | 169 |
| Net present value adjustments | **3** | 21 |
| Expected return on pension scheme assets (note 22) | **846** | 845 |
| Net gain on remeasurement of financial instruments[1] | **681** | 135 |
| Gain on sale of available-for-sale investments | **–** | 6 |
| Foreign exchange gains[2] | **1,703** | 81 |
| Financial income | **3,380** | 1,257 |
| Interest expense: | | |
| On bank loans and overdrafts | **(2)** | (4) |
| On finance leases | **(5)** | (6) |
| On bonds and other financial instruments | **(253)** | (218) |
| On preference debt | **–** | (13) |
| | **(260)** | (241) |
| Facility fees | **(4)** | (4) |
| Net present value adjustments | **(30)** | (22) |
| Interest charge on pension scheme liabilities (note 22) | **(795)** | (753) |
| Net loss on remeasurement of financial instruments at fair value through profit or loss[3] | **(917)** | (77) |
| Foreign exchange losses[4] | **(721)** | (102) |
| Financial expense | **(2,727)** | (1,199) |
| **Net finance costs** | **653** | 58 |

### Additional analysis of finance costs

| | 2008 £m | 2007 £m |
|---|---|---|
| Net finance costs – Group | **653** | 58 |
| Net finance costs – share of equity accounted investments | **44** | 35 |
| | **697** | 93 |
| Analysed as: | | |
| Net interest: | | |
| Interest income | **147** | 169 |
| Interest expense | **(260)** | (241) |
| Facility fees | **(4)** | (4) |
| Net present value adjustments | **(27)** | (1) |
| Gain on sale of available-for-sale investments | **–** | 6 |
| Share of equity accounted investments | **42** | 33 |
| | **(102)** | (38) |
| Other finance costs: | | |
| Group: | | |
| Net financing credit on pensions | **51** | 92 |
| Market value and foreign exchange movements on financial instruments and investments | **746** | 37 |
| Share of equity accounted investments | **2** | 2 |
| | **697** | 93 |

1 The increase in the net gain on remeasurement of financial instruments has mainly been driven by exchange movements on the US dollar relating to debt-related derivative financial instruments, and on the Euro, relating to hedging loans from equity accounted investments.
2 The increase in foreign exchange gains mainly reflects the exchange gain on an intercompany loan from the UK to the US businesses.
3 The net loss on remeasurement of financial instruments at fair value through profit or loss is principally due to the movement in the US dollar exchange rate on hedges relating to a portion of the intercompany loan from the UK to the US businesses.
4 The increase in foreign exchange losses is mainly due to movements in the Euro exchange rate relating to loans from equity accounted investments, and the revaluation of a loan from the US business to the UK.

## 7. Employees and directors

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

| | Weekly average | | At year end | |
|---|---|---|---|---|
| | **2008 Number '000** | 2007 Number '000 | **2008 Number '000** | 2007 Number '000 |
| Electronics, Intelligence & Support | **32** | 31 | **34** | 31 |
| Land & Armaments | **21** | 16 | **21** | 21 |
| Programmes & Support | **26** | 27 | **26** | 27 |
| International | **9** | 7 | **11** | 7 |
| HQ & Other Businesses | **2** | 2 | **2** | 2 |
| | **90** | 83 | **94** | 88 |

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

| | **2008 £m** | 2007 £m |
|---|---|---|
| Wages and salaries | **4,053** | 3,353 |
| Social security costs | **324** | 269 |
| Share options granted to directors and employees – equity-settled | **18** | 18 |
| Share options granted to directors and employees – cash-settled | **(23)** | 40 |
| Pension costs – defined contribution plans (note 22) | **84** | 62 |
| Pension costs – defined benefit plans (note 22)[1] | **160** | 178 |
| US healthcare plans (note 22) | **2** | 4 |
| | **4,618** | 3,924 |

1 Excludes £21m of past service credit included within other income (note 5).

The Group considers key management personnel as defined under IAS 24 *Related Party Disclosures* to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 75 to 93. Total emoluments for directors and other key management personnel were:

| | **2008 £'000** | 2007 £'000 |
|---|---|---|
| Short-term employee benefits | **14,954** | 13,221 |
| Post-employment benefits | **1,339** | 942 |
| Termination benefits | **237** | – |
| Share-based payment | **5,142** | 5,300 |
| | **21,672** | 19,463 |

## 8. Tax

### Taxation expense

| | 2008 £m | 2007 £m |
|---|---|---|
| **Current taxation expense** | | |
| UK corporation tax | | |
| Current tax | **(357)** | (140) |
| Double tax relief | **7** | 29 |
| Adjustment in respect of prior years | **19** | (21) |
| | **(331)** | (132) |
| Overseas tax charges | | |
| Current year | **(241)** | (160) |
| Adjustment in respect of prior years | **23** | – |
| | **(218)** | (160) |
| | **(549)** | (292) |
| **Deferred taxation expense** | | |
| UK | | |
| Origination and reversal of temporary differences | **(58)** | (103) |
| Adjustment in respect of prior years | **38** | 39 |
| Tax rate adjustment[1] | **–** | (5) |
| Overseas | | |
| Origination and reversal of temporary differences | **(47)** | 22 |
| Adjustment in respect of prior years | **13** | 4 |
| | **(54)** | (43) |
| **Taxation expense** | **(603)** | (335) |

1 The UK current tax rate was reduced from 30% to 28% with effect from 1 April 2008. In 2007, in line with this change, the rate applying to UK deferred tax assets and liabilities was also reduced from 30% to 28%, creating a rate adjustment, which was partly reflected in the Consolidated income statement and partly in the Consolidated statement of recognised income and expense.

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

| | 2008 £m | 2007 £m |
|---|---|---|
| **Profit before tax** | **2,371** | 1,235 |
| UK corporation tax rate | **28.5%** | 30.0% |
| Expected income tax expense | **(676)** | (371) |
| Effect of tax rates in foreign jurisdictions | **(45)** | (13) |
| Expenses not tax effected | **(40)** | (38) |
| Income not subject to tax | **55** | 70 |
| Research and development tax credits | **5** | 39 |
| Goodwill impairment | **(15)** | (44) |
| Chargeable gains | **(5)** | (28) |
| Utilisation of previously unrecognised tax losses | **74** | 23 |
| Current year losses not tax effected | **(9)** | (11) |
| Adjustments in respect of prior years | **93** | 22 |
| Adjustments in respect of equity accounted investments | **6** | 36 |
| Other | **(46)** | (20) |
| **Taxation expense** | **(603)** | (335) |

### Current tax taken in equity

| | 2008 £m | 2007 £m |
|---|---|---|
| Relating to financial instruments | **2** | (1) |
| Relating to share-based payments | **2** | 28 |
| Relating to pensions | **54** | 69 |
| | **58** | 96 |

## 8. Tax *continued*

### Deferred tax assets/(liabilities)

| | Deferred tax assets | | Deferred tax liabilities | | Net balance at 31 December | |
|---|---|---|---|---|---|---|
| | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| Property, plant and equipment | **1** | 1 | **(70)** | (71) | **(69)** | (70) |
| Intangible assets | **–** | – | **(509)** | (372) | **(509)** | (372) |
| Provisions and accruals | **459** | 271 | **(2)** | (2) | **457** | 269 |
| Goodwill impairment | **–** | – | **(34)** | (25) | **(34)** | (25) |
| Pension/retirement plans: | | | | | | |
| Deficits | **1,115** | 522 | **–** | – | **1,115** | 522 |
| Additional contributions | **66** | 106 | **–** | – | **66** | 106 |
| Share-based payments | **30** | 75 | **–** | – | **30** | 75 |
| Financial instruments | **–** | 6 | **(136)** | – | **(136)** | 6 |
| Other items | **42** | 16 | **(17)** | (7) | **25** | 9 |
| Rolled over capital gains | **–** | – | **(18)** | (18) | **(18)** | (18) |
| Capital losses carried forward | **18** | 18 | **–** | – | **18** | 18 |
| Trading losses carried forward | **1** | 7 | **–** | – | **1** | 7 |
| **Deferred tax assets/(liabilities)** | **1,732** | 1,022 | **(786)** | (495) | **946** | 527 |
| Set off of tax | **(706)** | (455) | **706** | 455 | **–** | – |
| **Net deferred tax assets/(liabilities)** | **1,026** | 567 | **(80)** | (40) | **946** | 527 |

### Movement in temporary differences during the year

| | At 1 January 2008 £m | Exchange movements £m | Acquisitions and disposals[2] £m | Other movements £m | Recognised in income £m | Recognised in equity £m | **At 31 December 2008 £m** |
|---|---|---|---|---|---|---|---|
| Property, plant and equipment | (70) | (17) | (2) | – | 20 | – | **(69)** |
| Intangible assets | (372) | (116) | (67) | – | 46 | – | **(509)** |
| Provisions and accruals | 269 | 92 | 45 | 1 | 50 | – | **457** |
| Goodwill impairment | (25) | (9) | 28 | – | (28) | – | **(34)** |
| Pension/retirement plans: | | | | | | | |
| Deficits | 522 | 115 | (35) | 1 | (98) | 610 | **1,115** |
| Additional contributions | 106 | – | 4 | – | (14) | (30) | **66** |
| Share-based payments | 75 | 4 | – | – | (23) | (26) | **30** |
| Financial instruments | 6 | – | – | – | (10) | (132) | **(136)** |
| Other items | 9 | (2) | 3 | 1 | 11 | 3 | **25** |
| Rolled over capital gains | (18) | – | – | – | – | – | **(18)** |
| Capital losses carried forward | 18 | – | – | – | – | – | **18** |
| Trading losses carried forward | 7 | – | 2 | – | (8) | – | **1** |
| | 527 | 67 | (22) | 3 | (54) | 425 | **946** |

| | At 1 January 2007 £m | Exchange movements £m | Acquisitions £m | Other movements £m | Recognised in income £m | Recognised in equity £m | At 31 December 2007 £m |
|---|---|---|---|---|---|---|---|
| Property, plant and equipment | (67) | – | (8) | 1 | 4 | – | (70) |
| Intangible assets | (143) | (5) | (272) | – | 47 | 1 | (372) |
| Provisions and accruals | 260 | (2) | 42 | (3) | (28) | – | 269 |
| Goodwill impairment | (17) | – | 18 | – | (26) | – | (25) |
| Pension/retirement plans: | | | | | | | |
| Deficits | 778 | (3) | 7 | – | (50) | (210) | 522 |
| Additional contributions | 158 | – | – | – | (1) | (51) | 106 |
| Share-based payments | 82 | – | – | – | 1 | (8) | 75 |
| Financial instruments | 25 | – | – | – | (7) | (12) | 6 |
| Other items | (28) | 2 | 7 | 1 | 25 | 2 | 9 |
| Rolled over capital gains | (19) | – | – | – | 1 | – | (18) |
| Capital losses carried forward | 19 | – | – | – | (1) | – | 18 |
| Unremitted overseas dividends | (1) | – | – | – | 1 | – | – |
| Trading losses carried forward | 15 | 1 | – | – | (9) | – | 7 |
| | 1,062 | (7) | (206) | (1) | (43) | (278) | 527 |

2 Acquisitions and disposals includes deferred tax assets on the acquisition of MTC (£16m) and Tenix Defence (£9m), and the finalisation of fair values relating to the Armor Holdings, Inc. acquisition in 2007 (£7m), less deferred tax liabilities on the acquisition of Detica (£23m) and the deferred tax asset transferred on formation of the BVT joint venture (£31m).

## 8. Tax *continued*

**Unrecognised deferred tax assets**
Deferred tax assets have not been recognised in respect of the following items:

| | **2008 £m** | 2007 £m |
|---|---|---|
| Deductible temporary differences | **23** | 22 |
| Capital losses carried forward | **58** | 59 |
| Trading and other losses carried forward | **90** | 140 |
| | **171** | 221 |

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be sufficiently accurately predicted at this time.

The aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures for which deferred tax liabilities have not been recognised is £332m (2007 £432m).

## 9. Disposals

**Continuing and discontinued operations for the year ended 31 December 2008**

| Name | Country of incorporation | Date of sale | Percentage share | Profit on disposal of businesses £m | Proceeds from sale of subsidiary undertakings £m | Proceeds from sale of equity accounted investments £m | Deferred consideration[4] £m |
|---|---|---|---|---|---|---|---|
| Surveillance and Attack division | USA | 22.02.08 | 100% | 61 | 118 | – | – |
| BAE Systems Surface Fleet Solutions Limited[2] | UK | 01.07.08 | 45% | 121 | – | – | – |
| Flagship Training Limited[1] | UK | 01.07.08 | 50% | 56 | – | 16 | 53 |
| Gregory backpack business | USA | 14.03.08 | 100% | – | 7 | – | – |
| Continuing operations | | | | 238 | 125 | 16 | 53 |
| Discontinued operations[3] – Mobile International business | USA | 14.02.08 | 100% | – | 6 | – | – |
| | | | | 238 | 131 | 16 | 53 |

**Continuing and discontinued operations for the year ended 31 December 2007**

| Name | Country of incorporation | Date of sale | Percentage share | Profit/(loss) on disposal of businesses £m | Proceeds from sale of subsidiary undertakings £m | Proceeds from sale of equity accounted investments £m |
|---|---|---|---|---|---|---|
| HR Enterprise Limited and its subsidiary Xchanging HR Services Limited (XHRS) | UK | 17.01.07 | 50% | – | – | 10 |
| Xchanging Procurement Services (Holdco) Limited (XPS) | UK | 06.03.07 | 50% | 44 | – | 47 |
| Customer Training Centre | UK | 13.12.07 | 100% | 4 | 6 | – |
| Inertial Products business | USA | 20.08.07 | 100% | (6) | 70 | – |
| TEMPEST products business | USA | 11.12.07 | 100% | (2) | 1 | – |
| Transaction costs | | | | – | (5) | – |
| Continuing operations | | | | 40 | 72 | 57 |
| Discontinued operations[5] – SELEX | UK | 30.03.07 | 25% | 22 | 24 | – |
| | | | | 62 | 96 | 57 |

1 Consideration of £67m has been deferred over three years, the discounted value of which is £53m.
2 On 1 July 2008, the Group exchanged a 45% shareholding in BAE Systems Surface Fleet Solutions Limited (SFSL) as consideration for the contribution to SFSL of 100% of VT Group plc's shipbuilding and naval support businesses to form the joint venture BVT Surface Fleet Limited.
3 The Group's Mobile International business was acquired with Armor Holdings, Inc. on 31 July 2007 with a view to immediate resale. Accordingly, it was classified as held for sale as at 31 December 2007. The sale was completed on 14 February 2008 for a cash consideration less transaction costs of £6m.
4 Included within other receivables (note 16 to the Group accounts).
5 On 30 March 2007, the sale of the Group's remaining 25% interest in SELEX was completed following the exercise by Finmeccanica SpA of its call option granted as part of the original disposal transaction in 2005. Net proceeds of £24m comprise the consideration of £277m, less £253m which was assigned to the BAE Systems 2000 Pension Plan in 2006. A profit of £22m was recognised during the year upon settlement of warranties and similar obligations on this transaction.

## 10. Earnings per share

| | 2008 | | | | 2007 (restated)[1] | | | |
|---|---|---|---|---|---|---|---|---|
| | £m | Basic pence per share | £m | Diluted pence per share | £m | Basic pence per share | £m | Diluted pence per share |
| Profit for the year attributable to equity shareholders | **1,745** | | **1,745** | | 901 | | 901 | |
| Interest on the debt instrument of the convertible preference shares | **–** | | **–** | | – | | 13 | |
| Profit for the year after adjusting for interest on the debt instrument of the convertible preference shares | **1,745** | **49.6** | **1,745** | **49.5** | 901 | 26.6 | 914 | 26.4 |
| Represented by: | | | | | | | | |
| *Continuing operations* | **1,745** | **49.6** | **1,745** | **49.5** | 879 | 26.0 | 892 | 25.8 |
| *Discontinued operations* | **–** | **–** | **–** | **–** | 22 | 0.6 | 22 | 0.6 |
| Add back/(deduct): | | | | | | | | |
| Profit on disposal of businesses, post tax | **(208)** | | **(208)** | | (30) | | (30) | |
| Uplift on acquired inventories, post tax | **–** | | **–** | | 9 | | 9 | |
| Net financing credit on pensions, post tax | **(39)** | | **(39)** | | (68) | | (68) | |
| Market value movements on derivatives, post tax | **(552)** | | **(552)** | | (29) | | (29) | |
| Amortisation and impairment of intangible assets, post tax | **184** | | **184** | | 110 | | 110 | |
| Impairment of goodwill – subsidiaries | **54** | | **54** | | 148 | | 148 | |
| Impairment of goodwill – equity accounted investments | **121** | | **121** | | – | | – | |
| **Underlying earnings post tax** | **1,305** | **37.1** | **1,305** | **37.0** | 1,041 | 30.7 | 1,054 | 30.4 |
| Represented by: | | | | | | | | |
| Continuing operations | **1,305** | **37.1** | **1,305** | **37.0** | 1,019 | 30.1 | 1,032 | 29.8 |
| Discontinued operations | **–** | **–** | **–** | **–** | 22 | 0.6 | 22 | 0.6 |
| | **1,305** | **37.1** | **1,305** | **37.0** | 1,041 | 30.7 | 1,054 | 30.4 |

| | 2008 Basic Millions | 2008 Diluted Millions | 2007 Basic Millions | 2007 Diluted Millions |
|---|---|---|---|---|
| Weighted average number of shares used in calculating basic earnings per share | **3,519** | **3,519** | 3,386 | 3,386 |
| Add: | | | | |
| Incremental shares in respect of employee share schemes | | **9** | | 24 |
| Incremental shares in respect of convertible preference shares | | **–** | | 56 |
| Weighted average number of shares used in calculating diluted earnings per share | | **3,528** | | 3,466 |

1 Restated following a change in the definition of underlying earnings to exclude profit/(loss) on disposal of businesses. See page 29.

Underlying earnings per share is presented in addition to that required by IAS 33 *Earnings per Share* to align the adjusted earnings measure with the performance measure reviewed by the directors. The directors consider that this gives a more appropriate indication of underlying performance.

In accordance with IAS 33, the diluted earnings per share are without reference to adjustments in respect of outstanding share options and convertible preference shares where the impact would be anti-dilutive.

## 11. Intangible assets

| | Goodwill £m | Other[1] £m | Total £m |
|---|---|---|---|
| **Cost or valuation** | | | |
| At 1 January 2007 | 9,204 | 657 | 9,861 |
| Additions: | | | |
| Acquired separately | – | 31 | 31 |
| Acquisition of subsidiaries (note 31) | 1,563 | 753 | 2,316 |
| Disposals | (31) | (4) | (35) |
| Asset reclassifications | (2) | 2 | – |
| Reclassified as non-current assets and disposal groups held for sale (note 19) | (42) | – | (42) |
| Exchange adjustments | (31) | 12 | (19) |
| At 31 December 2007 | 10,661 | 1,451 | 12,112 |
| Additions: | | | |
| Acquired separately | – | 30 | 30 |
| Internally developed | – | 2 | 2 |
| Acquisition of subsidiaries (note 31) | 903 | 213 | 1,116 |
| Adjustment on finalisation of provisional goodwill[3] | 6 | – | 6 |
| Disposals | (251) | (15) | (266) |
| Asset reclassifications | – | 5 | 5 |
| Exchange adjustments | 1,882 | 459 | 2,341 |
| At 31 December 2008 | 13,201 | 2,145 | 15,346 |
| **Amortisation and impairment** | | | |
| At 1 January 2007 | 2,071 | 195 | 2,266 |
| Disposals | (1) | (4) | (5) |
| Amortisation charge[2] | – | 149 | 149 |
| Impairment charge | 148 | – | 148 |
| Exchange adjustments | (5) | – | (5) |
| At 31 December 2007 | 2,213 | 340 | 2,553 |
| Disposals | (59) | (11) | (70) |
| Amortisation charge[2] | – | 247 | 247 |
| Impairment charge | 54 | 2 | 56 |
| Asset reclassifications | – | 3 | 3 |
| Exchange adjustments | 125 | 126 | 251 |
| At 31 December 2008 | 2,333 | 707 | 3,040 |
| **Net book value** | | | |
| **At 31 December 2008** | **10,868** | **1,438** | **12,306** |
| At 31 December 2007 | 8,448 | 1,111 | 9,559 |
| At 1 January 2007 | 7,133 | 462 | 7,595 |

1 Other intangibles includes internally funded development costs and intangible assets recognised on acquisition of subsidiary companies, of which the most significant are in respect of the acquired order book and of ongoing programme relationships.
2 Amortisation is included in operating costs in the income statement.
3 Adjustment on finalisation of provisional goodwill relating to the acquisition of Armor Holdings, Inc. in 2007. The amounts are not considered material for the restatement of comparative information.

The Group has no indefinite life intangible assets other than goodwill. The Group's approach to goodwill impairment testing is set out in the accounting policies on page 110.

The Group's goodwill of £10.9bn (2007 £8.4bn) is allocated across 16 cash-generating units. In order to calculate the recoverable amount of the Group's goodwill, all goodwill balances by cash-generating units have been considered with regard to value in use calculations. These calculations use risk-adjusted future cash flow projections based on the Group's five-year Integrated Business Plan (IBP) and include a terminal value based on the projections for the final year of that plan, with an inflationary growth rate assumption applied. Pre-tax discount rates derived from the Group's post-tax weighted average cost of capital of 8.19% (adjusted for risks specific to each cash-generating unit as appropriate) have been used in discounting these projected risk-adjusted cash flows.

The Group has two cash-generating units whose combined allocated goodwill exceeds 40% of the Group's total goodwill balance. These are both US operations within the Land & Armaments operating group acquired in 2005 and in 2007. The key assumption underpinning the cash flow projections for these operations is the continued demand in our home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support. Whilst there are no other cash-generating units with allocated goodwill balances exceeding 20% of the Group's total goodwill balance, the majority of the projected cash flows within the remaining cash-generating units are underpinned by the expected continuation of levels of US government spending on aerospace, defence and security.

## 11. Intangible assets *continued*

The directors have not identified any reasonably possible material changes relating either specifically to the global military vehicle market, or to the levels of defence spending in our home markets, particularly in the US, that would cause the carrying value of goodwill to exceed its recoverable amount. The result of the review of the carrying value of goodwill across the Group is an impairment charge of £54m (2007 £148m). This mainly reflects lower sales volumes in the US-based Products Group business (£40m against the £254m total goodwill), which was acquired with Armor Holdings, Inc. in 2007. The prior year charge included £145m in respect of the Insyte business.

In addition, an impairment of £120m has been taken in the year in respect of the Group's shareholding in Saab AB. See note 14.

## 12. Property, plant and equipment

| | Land and buildings £m | Plant and machinery £m | Aircraft £m | Total £m |
|---|---|---|---|---|
| **Cost** | | | | |
| At 1 January 2007 | 1,313 | 2,078 | 606 | 3,997 |
| Additions | 96 | 190 | 24 | 310 |
| Acquisition of subsidiaries (note 31) | 32 | 54 | 6 | 92 |
| Transfers from inventories | – | 5 | – | 5 |
| Transfers to inventories | – | (6) | (1) | (7) |
| Reclassified as non-current assets and disposal groups held for sale (note 19) | (11) | (16) | – | (27) |
| Disposals | (24) | (172) | (25) | (221) |
| Disposal of subsidiaries | (10) | (29) | – | (39) |
| Exchange adjustments | (10) | (9) | (8) | (27) |
| At 31 December 2007 | 1,386 | 2,095 | 602 | 4,083 |
| Additions | 269 | 209 | 42 | 520 |
| Acquisition of subsidiaries (note 31) | 40 | 72 | – | 112 |
| Transfers from inventories | 2 | – | – | 2 |
| Reclassification between balance sheet categories | 5 | (5) | – | – |
| Disposals | (15) | (69) | (12) | (96) |
| Disposal of subsidiaries | (46) | (76) | – | (122) |
| Exchange adjustments | 331 | 303 | 194 | 828 |
| At 31 December 2008 | 1,972 | 2,529 | 826 | 5,327 |
| **Depreciation and impairment** | | | | |
| At 1 January 2007 | 433 | 1,480 | 338 | 2,251 |
| Depreciation charge for the year | 67 | 155 | 32 | 254 |
| Impairment loss for the year[1] | 19 | 2 | 34 | 55 |
| Transfers to inventories | – | (4) | – | (4) |
| Reclassified as non-current assets and disposal groups held for sale (note 19) | (5) | (13) | – | (18) |
| Disposals | (15) | (170) | (10) | (195) |
| Disposal of subsidiaries | (4) | (21) | – | (25) |
| Exchange adjustments | (1) | (3) | (5) | (9) |
| At 31 December 2007 | 494 | 1,426 | 389 | 2,309 |
| Depreciation charge for the year | 68 | 167 | 55 | 290 |
| Impairment loss for the year | 2 | 29 | 9 | 40 |
| Reclassification between balance sheet categories | (3) | 3 | – | – |
| Disposals | (14) | (63) | (3) | (80) |
| Disposal of subsidiaries | (17) | (42) | – | (59) |
| Exchange adjustments | 75 | 170 | 136 | 381 |
| At 31 December 2008 | 605 | 1,690 | 586 | 2,881 |
| **Net book value** | | | | |
| **At 31 December 2008** | **1,367** | **839** | **240** | **2,446** |
| At 31 December 2007 | 892 | 669 | 213 | 1,774 |
| At 1 January 2007 | 880 | 598 | 268 | 1,746 |

1 In 2007, the directors revised the valuation methodology used to determine the value of regional aircraft with a £34m impairment charge arising and a £45m increase to provisions in respect of residual value guarantees.

The impairment in 2008 mainly comprises charges in respect of the spares and support business, and aircraft carrying values within the Regional Aircraft business (£32m). The impairment impacts the HQ & Other Businesses (£36m), Programmes & Support (£3m) and International (£1m) segments.

## 12. Property, plant and equipment *continued*

The amounts above include:

| | Land and buildings £m | Plant and machinery £m | Aircraft £m | Total £m |
|---|---|---|---|---|
| **Net book value of assets held as capitalised finance leases** | | | | |
| **At 31 December 2008** | **–** | **–** | **23** | **23** |
| At 31 December 2007 | 6 | 11 | 16 | 33 |
| **Assets in the course of construction (including investment property (note 13))** | | | | |
| **At 31 December 2008** | **355** | **107** | **–** | **462** |
| At 31 December 2007 | 88 | 68 | – | 156 |
| **Net book value at 31 December 2008 of:** | | | | |
| Freehold property | 1,242 | – | – | 1,242 |
| Long leasehold property | 45 | – | – | 45 |
| Short leasehold property | 80 | – | – | 80 |
| Plant and machinery | – | 744 | – | 744 |
| Fixtures, fittings and equipment | – | 95 | – | 95 |
| Aircraft | – | – | 240 | 240 |
| | 1,367 | 839 | 240 | 2,446 |

The aircraft fleet that is held under capitalised finance lease arrangements is leased to airline companies under operating leases. The leases have varying terms, escalation clauses and renewal rights.

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

| | **2008 £m** | 2007 £m |
|---|---|---|
| Receipts due: | | |
| Not later than one year | **104** | 93 |
| Later than one year and not later than five years | **241** | 234 |
| Later than five years | **62** | 63 |
| | **407** | 390 |

Under the terms of the lease agreements, no contingent rents are payable. Within the above lease income is £17m (2007 £15m) relating to assets held by the Group under capitalised finance leases.

## 13. Investment property

| | £m |
|---|---|
| **Cost** | |
| At 1 January 2007 | 167 |
| Disposals | (9) |
| At 31 December 2007 | 158 |
| Disposals | (5) |
| At 31 December 2008 | 153 |
| **Depreciation and impairment** | |
| At 1 January 2007 | 44 |
| Depreciation charge for the year | 4 |
| Disposals | (3) |
| At 31 December 2007 | 45 |
| Depreciation charge for the year | 1 |
| Disposals | (5) |
| At 31 December 2008 | 41 |
| **Net book value of investment property** | |
| **At 31 December 2008** | **112** |
| At 31 December 2007 | 113 |
| At 1 January 2007 | 123 |

| | |
|---|---|
| **Fair value of investment property** | |
| **At 31 December 2008** | **149** |
| At 31 December 2007 | 160 |

The fair values above are based on and reflect current market values as prepared by in-house professionals. The valuations were prepared by persons having the appropriate professional qualification and with recent experience in valuing properties in the location and the type of property being valued.

| | **2008 £m** | 2007 £m |
|---|---|---|
| Rental income from investment property | **21** | 20 |

## 14. Equity accounted investments

### Carrying value of equity accounted investments

| | Share of net assets £m | Purchased goodwill £m | Carrying value £m |
|---|---|---|---|
| At 1 January 2007 | 238 | 433 | 671 |
| Share of results after tax – continuing operations | 139 | – | 139 |
| Acquired | 1 | – | 1 |
| Adjustment to provisional fair values | 3 | (3) | – |
| Disposal | (10) | – | (10) |
| Dividends | (78) | – | (78) |
| Market value adjustments in respect of derivative financial instruments, net of tax | (2) | – | (2) |
| Actuarial gains on defined benefit pension schemes, net of tax | 17 | – | 17 |
| Foreign exchange adjustment | 13 | 30 | 43 |
| At 31 December 2007 | 321 | 460 | 781 |
| Share of results after tax – continuing operations | 139 | – | 139 |
| Acquired | 12 | 178 | 190 |
| Disposal | (13) | (4) | (17) |
| Impairment | – | (121) | (121) |
| Dividends | (89) | – | (89) |
| Market value adjustments in respect of derivative financial instruments, net of tax | (7) | – | (7) |
| Actuarial losses on defined benefit pension schemes, net of tax | (43) | – | (43) |
| Reclassified from trade and other receivables | 4 | – | 4 |
| Foreign exchange adjustment | 98 | 99 | 197 |
| **At 31 December 2008** | **422** | **612** | **1,034** |

The formation of the joint venture, BVT Surface Fleet Limited (BVT), was completed on 1 July 2008. The Group's 55% share of BVT's results has been equity accounted from the date of completion to 31 December 2008 reflecting the joint venture agreement in place that creates joint control. The reporting date of BVT is 31 March.

Fair values have been assigned to the share of net assets as part of the formation of the BVT joint venture. Fair value adjustments to the book values include intangible assets acquired as part of the transaction (£47m), comprising programmes, and adjustments to reflect loss provisions on export contracts (£53m). The net effect of these is a £6m reduction in the share of net assets acquired. Goodwill arising on the formation of the joint venture amounted to £177m.

As a result of the formation of BVT, the Group's shareholding in Fleet Support Limited increased to 55% (2007 50%).

The Group completed the sale of its 50% interest in Flagship Training Limited to VT Group plc on 1 July 2008.

Included within purchased goodwill is £94m (2007 £110m) relating to the goodwill arising on acquisitions made by the Group's equity accounted investments subsequent to their acquisition by the Group.

The market value of the Group's shareholding in Saab AB at 31 December 2008 was £140m (2007 £225m). As a result of the fall in market value, the carrying amount of goodwill relating to the Group's shareholding in Saab AB has been impaired by £120m during the year.

Goodwill impairment also includes £1m in respect of the Group's £1m investment in 50% of Diamond Detectors Limited during the year.

### Share of results of equity accounted investments by continuing operating group

| | **2008 £m** | 2007 £m |
|---|---|---|
| Share of results excluding finance costs and taxation expense: | | |
| Electronics, Intelligence & Support | **–** | 1 |
| Land & Armaments | **–** | – |
| Programmes & Support | **44** | 27 |
| International | **88** | 114 |
| HQ & Other Businesses | **–** | – |
| | **132** | 142 |
| Financial income | **44** | 35 |
| Taxation expense | **(37)** | (38) |
| | **139** | 139 |

## 14. Equity accounted investments *continued*

### Share of the assets and liabilities of equity accounted investments

| | 2008 £m | 2007 £m |
|---|---|---|
| Assets: | | |
| Non-current assets | **1,308** | 892 |
| Current assets | **3,768** | 3,032 |
| | **5,076** | 3,924 |
| Liabilities: | | |
| Non-current liabilities | **(807)** | (618) |
| Current liabilities | **(3,235)** | (2,525) |
| | **(4,042)** | (3,143) |
| **Carrying value** | **1,034** | 781 |

### Principal equity accounted investments

| Joint ventures | Principal activities | Group interest in allotted capital | Principally operates in | Country of incorporation |
|---|---|---|---|---|
| BVT Surface Fleet Limited *(Held by BAE Systems Surface Fleet Solutions (Holdings) Limited)* | Provider of surface warships and through-life support | 55% ordinary | UK | England and Wales |
| Eurofighter Jagdflugzeug GmbH *(Held by BAE Systems plc)* | Management and control of the Typhoon programme | 33% ordinary | Germany | Germany |
| MBDA SAS *(Held via BAE Systems Electronics Limited and BAE Systems (Overseas Holdings) Limited)* | Development and manufacture of guided weapons | 37.5% ordinary | Europe | France |
| Saab AB *(Held via BAE Systems (Sweden) AB)* | Defence and commercial aerospace activities | 20.5% Series A&B | Sweden | Sweden |

The Group comprises a large number of equity accounted investments and it is not practical to include all of them in the above list. The list therefore only includes those equity accounted investments which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2008 will be annexed to the Company's next annual return filed with the Registrar of Companies.

## 15. Other investments

| | 2008 £m | 2007 £m |
|---|---|---|
| **Non-current** | | |
| **Available-for-sale financial assets** | | |
| Equity securities | **6** | 6 |
| | **6** | 6 |
| **Current** | | |
| **Loans and receivables** | | |
| Term deposits | **–** | 164 |
| | **–** | 164 |

### Reconciliation of movements

| | 2008 £m | 2007 £m |
|---|---|---|
| **Non-current** | | |
| At 1 January | **6** | 11 |
| Additions | **–** | 1 |
| Disposals | **–** | (11) |
| Fair value movements | **–** | 5 |
| **At 31 December** | **6** | 6 |
| **Current** | | |
| At 1 January | **164** | 503 |
| Additions | **–** | 19 |
| Disposals | **(164)** | (358) |
| **At 31 December** | **–** | 164 |

## 16. Trade and other receivables

| | 2008 £m | 2007 £m |
|---|---|---|
| **Non-current** | | |
| Other receivables | **122** | 255 |
| Pension prepayment (note 22) | **37** | 57 |
| Prepayments and accrued income | **3** | 10 |
| | **162** | 322 |
| **Current** | | |
| Long-term contract balances | **6,215** | 4,389 |
| Less: attributable progress payments | **(5,410)** | (4,013) |
| Amounts due from contract customers | **484** | 208 |
| Amounts due from customers for contract work | **1,289** | 584 |
| Trade receivables | **1,653** | 1,608 |
| Amounts owed by equity accounted investments | **200** | 239 |
| Other receivables | **426** | 281 |
| Pension prepayment (note 22) | **3** | 2 |
| Prepayments and accrued income | **260** | 219 |
| | **3,831** | 2,933 |

Included within amounts due from customers for contract work:

| | 2008 £m | 2007 £m |
|---|---|---|
| Retentions outstanding against long-term contracts | **–** | 1 |

The ageing of trade receivables is detailed below:

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | Gross £m | Provision £m | Net £m | Gross £m | Provision £m | Net £m |
| Not past due and not impaired | **1,176** | **–** | **1,176** | 1,135 | – | 1,135 |
| Not past due and impaired | **2** | **(2)** | **–** | 13 | (13) | – |
| Up to 180 days overdue and not impaired | **175** | **–** | **175** | 190 | – | 190 |
| Up to 180 days overdue and impaired | **15** | **(15)** | **–** | 4 | (4) | – |
| Past 180 days overdue and not impaired | **302** | **–** | **302** | 283 | – | 283 |
| Past 180 days overdue and impaired | **33** | **(33)** | **–** | 36 | (36) | – |
| | **1,703** | **(50)** | **1,653** | 1,661 | (53) | 1,608 |

Within the debts overdue more than 180 days is an amount due of £277m relating to specific activities on a major programme with one of the Group's major customers. The payment profile for this element of debt was subject to final agreement during the year. The customer acknowledged in full the amounts due, and accordingly there was no risk associated with this amount to warrant impairment at the balance sheet date. Full payment of the sums due was received in early January 2009.

Trade receivables are disclosed net of a provision for impairment losses. Movement on the provision is as follows:

| | 2008 £m | 2007 £m |
|---|---|---|
| At 1 January | **53** | 31 |
| Created | **32** | 42 |
| Released | **(37)** | (22) |
| Exchange adjustments | **7** | – |
| Acquisitions | **–** | 3 |
| Utilised | **(5)** | (1) |
| **At 31 December** | **50** | 53 |

The other classes within trade and other receivables do not contain assets which are considered to be impaired.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, the provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk.

## 17. Other financial assets and liabilities

| | 2008 Assets £m | 2008 Liabilities £m | 2007 Assets £m | 2007 Liabilities £m |
|---|---|---|---|---|
| **Non-current** | | | | |
| Cash flow hedges – foreign exchange contracts | **309** | **(100)** | 34 | (20) |
| Other foreign exchange/interest rate contracts | **2** | **(283)** | 14 | (6) |
| Debt-related derivative financial instruments – assets[1] | **203** | **–** | – | – |
| | **514** | **(383)** | 48 | (26) |
| **Current** | | | | |
| Cash flow hedges – foreign exchange contracts | **502** | **(237)** | 63 | (44) |
| Other foreign exchange/interest rate contracts | **172** | **(88)** | 38 | (27) |
| Fair value of put option held by VT Group plc | **–** | **(37)** | – | – |
| | **674** | **(362)** | 101 | (71) |
| **Debt-related derivative financial instruments – liabilities[1]** | | | | |
| Other foreign exchange/interest rate contracts[1] | **–** | **–** | 17 | (190) |

1 The debt-related derivative financial instrument assets are presented as other financial assets. The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (note 20).

The ineffective portion recognised in the income statement that arises from fair value hedges amounts to a gain of £3m (2007 gain of £4m). The ineffective portion recognised in the income statement that arises from cash flow hedges amounts to £nil (2007 £nil).

The notional principal amounts of the outstanding contracts are detailed in note 32.

## 18. Inventories

| | 2008 £m | 2007 £m |
|---|---|---|
| Short-term work-in-progress | **424** | 304 |
| Raw materials and consumables | **370** | 285 |
| Finished goods and goods for resale | **132** | 112 |
| | **926** | 701 |

The Group recognised £46m (2007 £53m) as a write down of inventories to net realisable value in 2008.

## 19. Disposal groups

There are no disposal groups in 2008.

On 19 December 2007, the Group agreed the sale of its Surveillance and Attack business to Sensor and Antenna Systems, Lansdale, Inc., a subsidiary of Cobham Defence Electronic Systems Corporation, for a cash consideration, net of transaction costs, of $231m (£118m). Accordingly, the business was presented as held for sale on the balance sheet as at 31 December 2007. As discussed in note 9, the business was sold in 2008.

The Group's Mobile International business was acquired with Armor Holdings, Inc. on 31 July 2007 with a view to immediate resale. Accordingly, it was classified as held for sale in the acquisition balance sheet and as at 31 December 2007. As discussed in note 9, the business was sold in 2008.

## 20. Loans and overdrafts

| | 2008 £m | 2007 £m |
|---|---|---|
| **Non-current** | | |
| European Investment Bank loan, final instalment 2009 | **–** | 4 |
| Alvis loan notes, redeemable 2009 | **–** | 1 |
| US$500m 4.75% bond, repayable 2010 | **361** | 254 |
| US$1bn 6.4% bond, repayable 2011 | **728** | 517 |
| Class B and Class G certificates, final instalments 2011/2013 | **547** | 498 |
| Euro-Sterling £100m 10¾% bond, repayable 2014 | **100** | 99 |
| US$750m 5.2% bond, repayable 2015 | **516** | 376 |
| US$500m 7.5% bond, repayable 2027 | **341** | 249 |
| Albertville Hangar Bond, repayable 2018 | **7** | – |
| Bank loans | **–** | 6 |
| Obligations under finance leases | **8** | 20 |
| Debt-related derivative financial instruments – liabilities | **–** | 173 |
| | **2,608** | 2,197 |
| **Current** | | |
| Bank loans and overdrafts | **35** | 41 |
| Euro-Sterling £150m 11⅞% bond, repayable 2008 | **–** | 150 |
| European Investment Bank loan, final instalment 2009 | **4** | 7 |
| Alvis loan notes, redeemable 2009 | **1** | – |
| Class B and Class G certificates, final instalment 2011/2013 | **121** | 87 |
| Obligations under finance leases | **12** | 14 |
| | **173** | 299 |

The maturity of the Group's borrowings is as follows:

| | Less than one year £m | Between one and five years £m | More than five years £m | Total £m |
|---|---|---|---|---|
| **At 31 December 2008** | | | | |
| Carrying amount[1] | 173 | 1,644 | 964 | 2,781 |
| Debt-related derivative financial instruments – assets | – | (87) | (116) | (203) |
| **Carrying amount including debt-related derivative financial instruments – assets** | **173** | **1,557** | **848** | **2,578** |
| **Contractual cash flows, including interest payments** | **292** | **1,881** | **1,314** | **3,487** |
| At 31 December 2007 | | | | |
| Carrying amount | 299 | 1,157 | 1,040 | 2,496 |
| Contractual cash flows, including interest payments | 484 | 1,649 | 1,370 | 3,503 |

1 The carrying amount of loans and overdrafts at 31 December 2008 excludes debt-related derivative financial assets of £203m presented as other financial assets.

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

The US$500m 4.75% bond, repayable 2010 was converted on issue to a floating rate bond by utilising an interest rate swap giving an effective rate during 2008 of 3.73%.

The US$1bn 6.4% bond, repayable 2011 has been partially converted to a floating rate bond by utilising a series of interest rate swaps. US$500m has been swapped to a floating rate until maturity of the bond in 2011. This has been overlaid by US$300m of floating to fixed interest rate swaps that fix the interest payments at a lower rate than the original coupon. The effective interest rate during 2008 was 5.76% with an interest rate split on the bond at 31 December 2008 being US$800m fixed and US$200m floating.

The Class B and Class G certificates are repayable in 2011 and 2013, respectively, with fixed US$ coupon rates of 7.16% and 6.66%, giving a weighted average interest rate of 6.88%. At 31 December 2008, the gross outstanding principal due is US$959m. Of this balance, US$273m has been converted to a sterling floating rate bond by utilising a series of cross-currency swaps which resulted in an effective interest rate during 2008 of 6.97% on this element.

The US$500m 7.5% bond, repayable 2027 was converted at issue to a sterling fixed rate bond by utilising a cross-currency swap and has an effective interest rate of 7.73%.

The Albertville Hangar Bond is a floating rate bond with an effective interest rate of 3.06%. This bond has been converted to a fixed rate using a floating to fixed rate swap, fixing the rate at 3.52%.

The European Investment Bank borrowing is fixed with an interest rate of 6.86%.

The debt-related derivative financial instruments represent the market value of certain interest rate and cross-currency derivatives which are specifically hedging loans disclosed within the above note. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

## 20. Loans and overdrafts *continued*

**Finance lease obligations**

The Group has a number of non-cancellable finance lease arrangements predominantly in respect of aircraft. The maturity of these lease liabilities from the balance sheet date is shown below.

| | 2008 £m | 2007 £m |
|---|---|---|
| Finance lease liabilities – minimum lease payments due: | | |
| Not later than one year | **13** | 15 |
| Later than one year and not later than five years | **9** | 22 |
| | **22** | 37 |
| Future finance charges on finance leases | **(2)** | (3) |
| **Present value of finance lease liabilities** | **20** | 34 |
| Present value of finance lease liabilities – payments due: | | |
| Not later than one year | **12** | 14 |
| Later than one year and not later than five years | **8** | 20 |
| | **20** | 34 |

Under the terms of the lease agreements, no contingent rents are payable.

The interest rate inherent in these finance leases is fixed at the contract date for all of the lease term. The average interest rate on finance lease payables at 31 December 2008 was 7% (2007 7%).

## 21. Trade and other payables

| | 2008 £m | 2007 £m |
|---|---|---|
| **Non-current** | | |
| Amounts due to long-term contract customers | **275** | 56 |
| Cash received on customers' account[1] for long-term contracts | **–** | 2 |
| Amounts owed to equity accounted investments | **–** | 7 |
| Other payables | **329** | 306 |
| Accruals and deferred income | **97** | 42 |
| | **701** | 413 |
| **Current** | | |
| Amounts due to long-term contract customers | **4,494** | 4,710 |
| Amounts due to other customers | **348** | 162 |
| Cash received on customers' account[1]: | | |
| Long-term contracts | **5** | 27 |
| Others | **2** | 1 |
| Trade payables | **1,004** | 913 |
| Amounts owed to equity accounted investments | **1,476** | 847 |
| Other taxes and social security costs | **67** | 58 |
| Other payables | **400** | 297 |
| Accruals and deferred income | **1,369** | 1,230 |
| | **9,165** | 8,245 |

| Included above: | 2008 £m | 2007 £m |
|---|---|---|
| Amounts due to long-term contract customers | **4,774** | 4,795 |

1 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payments guarantees unrelated to Group performance.

## 22. Retirement benefit obligations

**Pension plans**
BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans, and the assets are held in separate trustee administered funds. The plans in other countries are unfunded or defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19 deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries and updated to take account of the requirements of IAS 19 in order to assess the deficit of the plans at 31 December each year. Plan assets are shown at the bid value at 31 December each year.

**Post-retirement benefits other than pensions**
The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2008. These plans were rolled forward to reflect the information at 31 December 2008. The method of accounting for these is similar to that used for defined benefit pension plans.

**The financial assumptions used to calculate liabilities for the principal plans were:**

| | UK | | | US | | |
|---|---|---|---|---|---|---|
| | **2008 %** | 2007 % | 2006 % | **2008 %** | 2007 % | 2006 % |
| Inflation rate | **2.9** | 3.3 | 3.0 | **3.0** | 3.0 | 3.0 |
| Rate of increase in salaries | **3.9** | 4.3 | 4.0 | **5.5** | 5.8 | 5.8 |
| Rate of increase for pensions in payment | **2.2 – 3.4** | 2.3 – 3.3 | 2.9 – 3.0 | **–** | – | – |
| Rate of increase for deferred pensions | **2.9** | 3.3 | 3.0 | **n/a** | n/a | n/a |
| Discount rate | **6.3** | 5.8 | 5.2 | **6.5** | 6.5 | 5.9 |
| Long-term healthcare cost increases | **n/a** | n/a | n/a | **5.3** | 5.4 | 5.5 |

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid value of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of plan liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, as at 31 December are shown in the tables below.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2008, continued to use PA 00 medium cohort tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of plan members. In addition, this mortality has been subject to a minimum assumed rate of future annual mortality improvements of 1%. For its US pension arrangements, the mortality tables used for pensioners and non-pensioners are RP 2000 projected to 2010. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 19 to 23 years for current male pensioners at age 65 and 22 to 25 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 9% in 2008 reducing to 5% by 2015 for pre-retirement and 10% in 2008 reducing to 5% for post-retirement.

A summary of the movements in the retirement benefit obligations is shown overleaf. The full disclosures, as required by IAS 19, are provided in the subsequent information.

## 22. Retirement benefit obligations *continued*

**Additional disclosure – summary of movements of the retirement benefit obligations**

| | UK £m | US and other £m | **Total £m** |
|---|---|---|---|
| Deficit in defined benefit pension plans at 1 January 2008 | (1,908) | (91) | **(1,999)** |
| Transfers arising on acquisitions | (8) | – | **(8)** |
| Actual return on assets below expected return | (2,956) | (768) | **(3,724)** |
| Decrease/(increase) in liabilities due to changes in assumptions | 1,471 | (38) | **1,433** |
| One-off contributions | 104 | – | **104** |
| Recurring contributions in excess of service cost | 212 | 5 | **217** |
| Exchange translation | – | (240) | **(240)** |
| Other movements | 13 | 49 | **62** |
| Deficit in defined benefit pension plans at 31 December 2008 | (3,072) | (1,083) | **(4,155)** |
| US healthcare plans | – | (61) | **(61)** |
| **Total IAS 19 deficit** | (3,072) | (1,144) | **(4,216)** |
| Allocated to equity accounted investments and other participating employers[1] | 891 | – | **891** |
| **Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers** | (2,181) | (1,144) | **(3,325)** |

As a result of the recent fall in global stock markets the actual return on assets is below that expected.

The decrease in the liabilities due to changes in assumptions is primarily due to an increase in corporate bond yields which has increased the discount rates used to calculate the liabilities of the pension plans as at 31 December 2008. Global credit issues have resulted in current corporate bond yields being notably higher than in the recent past.

**Amounts recognised on the balance sheet**

| | **2008** | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | **UK defined benefit pension plans £m** | **US and other pension plans £m** | **US healthcare plans £m** | **Total £m** | UK defined benefit pension plans £m | US and other pension plans £m | US healthcare plans £m | Total £m |
| Present value of unfunded obligations | **(10)** | **(132)** | **(11)** | **(153)** | (1) | (97) | (13) | (111) |
| Present value of funded obligations | **(14,221)** | **(2,770)** | **(142)** | **(17,133)** | (15,099) | (1,912) | (103) | (17,114) |
| Fair value of plan assets | **11,159** | **1,819** | **92** | **13,070** | 13,192 | 1,918 | 95 | 15,205 |
| Total IAS 19 deficit, net | **(3,072)** | **(1,083)** | **(61)** | **(4,216)** | (1,908) | (91) | (21) | (2,020) |
| Allocated to equity accounted investments and other participating employers[1] | **891** | **–** | **–** | **891** | 450 | – | – | 450 |
| **Group's share of IAS 19 deficit, net** | **(2,181)** | **(1,083)** | **(61)** | **(3,325)** | (1,458) | (91) | (21) | (1,570) |
| Represented by: | | | | | | | | |
| Pension prepayments (within trade and other receivables) | **–** | **25** | **15** | **40** | 14 | 32 | 13 | 59 |
| Retirement benefit obligations | **(2,181)** | **(1,108)** | **(76)** | **(3,365)** | (1,472) | (123) | (34) | (1,629) |
| | **(2,181)** | **(1,083)** | **(61)** | **(3,325)** | (1,458) | (91) | (21) | (1,570) |
| **Group's share of IAS 19 deficit of equity accounted investments** | **(168)** | **–** | **–** | **(168)** | (49) | – | – | (49) |

**Amounts for the current and previous four years are as follows:**

| **Defined benefit pension plans** | **2008 £m** | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
|---|---|---|---|---|---|
| Defined benefit obligations | **(17,133)** | (17,109) | (17,456) | (17,767) | (14,482) |
| Plan assets at bid value | **12,978** | 15,110 | 14,289 | 12,461 | 10,143 |
| Total deficit before tax and allocation to equity accounted investments and other participating employers | **(4,155)** | (1,999) | (3,167) | (5,306) | (4,339) |
| Actuarial gain/(loss) on plan liabilities | **1,433** | 952 | 473 | (2,100) | (1,221) |
| Actuarial (loss)/gain on plan assets[2] | **(3,724)** | (156) | 521 | 1,138 | 265 |

1 Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during the year ended 31 December 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments.

2 At bid value.

## 22. Retirement benefit obligations *continued*

### Assets of defined benefit pension plans

| | 2008 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | UK | | | US | | | Total | |
| | £m | % | Expected return % | £m | % | Expected return % | £m | % |
| Equities | **6,964** | **62** | **8.25** | **1,110** | **61** | **9.25** | **8,074** | **62** |
| Bonds | **3,170** | **28** | **5.1** | **441** | **24** | **6.0** | **3,611** | **28** |
| Property | **846** | **8** | **6.0** | **193** | **11** | **7.0** | **1,039** | **8** |
| Other | **179** | **2** | **2.0** | **75** | **4** | **5.0** | **254** | **2** |
| **Total** | **11,159** | **100** | **7.1** | **1,819** | **100** | **8.07** | **12,978** | **100** |

| | 2007 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | UK | | | US | | | Total | |
| | £m | % | Expected return % | £m | % | Expected return % | £m | % |
| Equities | 8,296 | 63 | 8.0 | 1,384 | 72 | 9.25 | 9,680 | 64 |
| Bonds | 3,331 | 25 | 4.9 | 305 | 16 | 6.0 | 3,636 | 24 |
| Property | 1,142 | 9 | 6.0 | 115 | 6 | 7.0 | 1,257 | 8 |
| Other | 423 | 3 | 5.5 | 114 | 6 | 5.0 | 537 | 4 |
| Total | 13,192 | 100 | 7.0 | 1,918 | 100 | 8.25 | 15,110 | 100 |

When setting the overall expected rate of return on plan assets, historical markets are studied and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

### Changes in the fair value of plan assets are as follows:

| | UK defined benefit pension plans £m | US and other pension plans £m | US healthcare plans £m | Total £m |
|---|---|---|---|---|
| Value of plan assets at 1 January 2007 | 12,579 | 1,710 | 91 | 14,380 |
| Assets acquired on acquisitions[3] | – | 55 | – | 55 |
| *Expected return on assets* | 879 | 144 | 7 | 1,030 |
| *Actuarial (loss)/gain* | (171) | 15 | (3) | (159) |
| Actual return on assets | 708 | 159 | 4 | 871 |
| *Contributions by employer* | 384 | 103 | 8 | 495 |
| *Contributions by employer in respect of employee salary sacrifice arrangements* | 107 | – | – | 107 |
| Total contributions by employer | 491 | 103 | 8 | 602 |
| Members' contributions (including Department for Work and Pensions rebates) | 29 | 10 | – | 39 |
| Currency loss | – | (25) | (1) | (26) |
| Benefits paid | (615) | (94) | (7) | (716) |
| Value of plan assets at 31 December 2007 | 13,192 | 1,918 | 95 | 15,205 |
| Assets acquired on acquisitions[4] | 99 | – | – | 99 |
| *Expected return on assets* | 901 | 165 | 8 | 1,074 |
| *Actuarial loss* | (2,956) | (768) | (39) | (3,763) |
| Actual return on assets | (2,055) | (603) | (31) | (2,689) |
| *Contributions by employer* | 425 | 61 | 8 | 494 |
| *Contributions by employer in respect of employee salary sacrifice arrangements* | 112 | – | – | 112 |
| Total contributions by employer | 537 | 61 | 8 | 606 |
| Members' contributions (including Department for Work and Pensions rebates) | 42 | 11 | – | 53 |
| Currency gain | – | 533 | 25 | 558 |
| Benefits paid | (656) | (101) | (5) | (762) |
| **Value of plan assets at 31 December 2008** | **11,159** | **1,819** | **92** | **13,070** |

3 On 31 July 2007, the Group acquired Armor Holdings, Inc. and its associated pension plans (note 31).
4 Acquired on formation of BVT Surface Fleet Limited.

## 22. Retirement benefit obligations *continued*

**Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:**

| | UK defined benefit pension plans £m | US and other pension plans £m | US healthcare plans £m | Total £m |
|---|---|---|---|---|
| Defined benefit obligations at 1 January 2007 | (15,445) | (2,011) | (126) | (17,582) |
| Net liabilities assumed on acquisitions[3] | – | (77) | – | (77) |
| *Current service cost* | (142) | (55) | (2) | (199) |
| *Contributions by employer in respect of employee salary sacrifice arrangements* | (107) | – | – | (107) |
| Total current service cost | (249) | (55) | (2) | (306) |
| Members' contributions (including Department for Work and Pensions rebates) | (29) | (10) | – | (39) |
| Past service cost | (14) | – | (2) | (16) |
| Actuarial gain on liabilities | 817 | 135 | 12 | 964 |
| Interest expense | (795) | (115) | (7) | (917) |
| Currency gain | – | 30 | 2 | 32 |
| Benefits paid | 615 | 94 | 7 | 716 |
| Defined benefit obligations at 31 December 2007 | (15,100) | (2,009) | (116) | (17,225) |
| Net liabilities assumed on acquisitions[4] | (107) | – | – | (107) |
| *Current service cost* | (109) | (56) | (2) | (167) |
| *Contributions by employer in respect of employee salary sacrifice arrangements* | (112) | – | – | (112) |
| Total current service cost | (221) | (56) | (2) | (279) |
| Members' contributions (including Department for Work and Pensions rebates) | (42) | (11) | – | (53) |
| Past service cost | (23) | 21 | – | (2) |
| Actuarial gain/(loss) on liabilities | 1,471 | (38) | 8 | 1,441 |
| Interest expense | (865) | (137) | (8) | (1,010) |
| Currency loss | – | (773) | (40) | (813) |
| Benefits paid | 656 | 101 | 5 | 762 |
| **Defined benefit obligations at 31 December 2008** | **(14,231)** | **(2,902)** | **(153)** | **(17,286)** |

3 On 31 July 2007, the Group acquired Armor Holdings, Inc. and its associated pension plans (note 31).
4 Acquired on formation of BVT Surface Fleet Limited.

**Contributions**

The Group contributions made to the defined benefit plans in the year ended 31 December 2008 were £399m (2007 £403m) excluding those amounts allocated to equity accounted investments and participating employers (£87m). In 2009, the Group expects to make regular contributions at a similar level to those made in 2008. In addition, the Group expects to make incremental contributions of £200m in respect of the UK pension schemes and $250m (£172m) to the US pension schemes in 2009.

The Group incurred a charge in respect of the cash contributions of £84m (2007 £62m) paid to defined contribution plans for employees. Following the acquisitions the Group has made in 2008 (note 31), it expects to make a contribution of £132m to these plans in 2009.

## 22. Retirement benefit obligations *continued*

**The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:**

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | UK defined benefit pension plans £m | US and other pension plans £m | US healthcare plans £m | Total £m | UK defined benefit pension plans £m | US and other pension plans £m | US healthcare plans £m | Total £m |
| **Included in operating costs:** | | | | | | | | |
| Current service cost | (83) | (56) | (2) | (141) | (113) | (55) | (2) | (170) |
| Past service cost | (21) | – | – | (21) | (10) | – | (2) | (12) |
| | (104) | (56) | (2) | (162) | (123) | (55) | (4) | (182) |
| **Included in other income:** | | | | | | | | |
| Past service credit | – | 21 | – | 21 | – | – | – | – |
| | – | 21 | – | 21 | – | – | – | – |
| **Included in finance costs:** | | | | | | | | |
| Expected return on plan assets | 673 | 165 | 8 | 846 | 694 | 144 | 7 | 845 |
| Interest on obligations | (650) | (137) | (8) | (795) | (631) | (115) | (7) | (753) |
| | 23 | 28 | – | 51 | 63 | 29 | – | 92 |
| **Included in share of results of equity accounted investments:** | | | | | | | | |
| Group's share of equity accounted investments' operating costs | (8) | – | – | (8) | (6) | – | – | (6) |
| Group's share of equity accounted investments' finance costs | 2 | – | – | 2 | 2 | – | – | 2 |

**A one percentage point change in assumed healthcare cost trend rates would have the following effects:**

| | One percentage point increase £m | One percentage point decrease £m |
|---|---|---|
| Effect on the aggregate of service cost and interest cost | (0.2) | 0.2 |
| Effect on defined benefit obligations | (2) | 2 |

**A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect:**

| | 0.5 percentage point increase £bn | 0.5 percentage point decrease £bn |
|---|---|---|
| Effect on defined benefit obligations | 1 | (1) |

## 23. Provisions

| | Aircraft financing £m | Warranties and after-sales service £m | Reorganisations – continuing operations £m | Legal costs, environmental and other £m | Total £m |
|---|---|---|---|---|---|
| Non-current | 65 | 93 | 4 | 237 | 399 |
| Current | 20 | 64 | 24 | 302 | 410 |
| At 1 January 2008 | 85 | 157 | 28 | 539 | 809 |
| Created | 11 | 59 | 74 | 158 | 302 |
| Released | (2) | (29) | (4) | (139) | (174) |
| Utilised | (34) | (36) | (33) | (112) | (215) |
| Provisions and fair values arising on acquisitions (note 31) | – | 1 | – | 3 | 4 |
| Adjustment to provisional fair values (note 31)[1] | – | – | – | 14 | 14 |
| On disposals | – | – | (1) | – | (1) |
| Discounting | – | – | 1 | 11 | 12 |
| Exchange adjustments | 11 | 20 | 3 | 60 | 94 |
| **At 31 December 2008** | **71** | **172** | **68** | **534** | **845** |
| Represented by: | | | | | |
| Non-current | 30 | 104 | 10 | 315 | 459 |
| Current | 41 | 68 | 58 | 219 | 386 |
| | **71** | **172** | **68** | **534** | **845** |

1 Relates to the finalisation of fair values relating to the acquisition of Armor Holdings, Inc. in 2007.

**Aircraft financing**
The provision includes probable exposures under residual value guarantees issued by the Group on previous sales transactions. Further information is provided in note 24. Such costs are generally incurred within five years.

**Warranties and after-sales service**
Warranties and after-sales service are provided in the normal course of business with provisions for associated costs being made based on an assessment of future claims with reference to past experience. Such costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum but not the timing of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels and historical evidence indicates that the actual outflows are similar to the amounts provided.

**Reorganisations – continuing operations**
The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Such costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

**Legal costs, environmental and other provisions**
The Group holds provisions for expected legal, environmental and other costs that it expects to incur over an extended period. These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Included within legal costs, environmental and other is £26m (2007 £75m) in respect of the cash-settled elements of certain of the Group's share option schemes (note 26). The costs in respect of this liability are expected to occur over the next five years. Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

## 24. Contingent liabilities and commitments

### Aircraft financing contingent liabilities

Included within the aircraft financing provision of £71m (note 23) is an exposure of £58m as discussed below:

| | 2008 £m | 2007 £m |
|---|---|---|
| Potential future cash flow payments in respect of aircraft financing obligations | **97** | 134 |
| Anticipated aircraft values | **(37)** | (55) |
| Adjustments to net present values | **(2)** | (9) |
| **Net exposure provided** | **58** | 70 |

The Group has provided residual value guarantees (RVGs) in respect of certain commercial aircraft sold. At 31 December 2008, the Group's gross exposure to make future payments in respect of these arrangements was £97m (2007 £134m). The Group's net exposure to these guarantees is covered by the provisions held and the residual values of the related aircraft.

The Group is also exposed to actual and contingent liabilities arising from commercial aircraft financing and RVGs given by Saab AB. Provision is made against the expected net exposures on a net present value basis within the accounts of Saab. The Group's share of such exposure is limited to its percentage shareholding in Saab.

### Guarantees and performance bonds

The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business. Provision is made for any amounts that the directors consider may become payable under such arrangements.

### Operating lease commitments – where the Group is the lessee

The Group leases various offices, factories, shipyards and aircraft under non-cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

| | 2008 £m | 2007 £m |
|---|---|---|
| Payments due: | | |
| Not later than one year | **177** | 125 |
| Later than one year and not later than five years | **546** | 460 |
| Later than five years | **679** | 731 |
| | **1,402** | 1,316 |
| Total of future minimum sublease income under non-cancellable subleases | **259** | 249 |

### Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

| | 2008 £m | 2007 £m |
|---|---|---|
| Property, plant and equipment | **133** | 121 |
| Intangible assets | **7** | 6 |
| | **140** | 127 |

### Treasury contingent liabilities

Treasury contingent liabilities are set out in note 32.

### Other contingent liabilities

The Group is subject to an ongoing investigation by the UK Serious Fraud Office (the SFO) in connection with marketing of the Group's products. The Group is co-operating fully with the SFO.

At this stage management cannot determine whether or not it might lead to any proceedings being brought against the Group. Accordingly, the potential for fines or other penalties cannot currently be assessed, although the directors continue to consider that the Group has not acted unlawfully in relation to any of the matters under investigation. As the investigation is ongoing it is not possible to identify the timescale in which these issues might be resolved.

In addition, in June 2007, the US Department of Justice notified the Group that it had commenced a formal investigation relating to the Group's compliance with anti-corruption laws, including its business concerning the Kingdom of Saudi Arabia. Again, given the status of this matter it is not possible to provide any details of any possible future financial effects that might result from the investigation and any subsequent actions or events that might occur as a result of the investigation. Equally it is not possible to provide any timescale in which these issues might be resolved. The directors continue to consider that the Group has not acted unlawfully in relation to its dealings with the Kingdom of Saudi Arabia or in relation to anti-corruption laws.

Should any financial effects arise as a result of these investigations the directors consider it unlikely that there is any likelihood of reimbursement for such costs from any sources other than certain rights to recover reimbursement of the legal costs under the Group's insurance policies.

## 25. Share capital

| | Equity | | Non-equity | | Total |
|---|---|---|---|---|---|
| | Ordinary shares of 2.5p each | | Special Share of £1 | | |
| | Number of shares m | Nominal value £m | Number of shares | Nominal value £ | Nominal value £m |
| **Authorised** | | | | | |
| At 1 January 2008 | 4,450 | 111 | 1 | 1 | 111 |
| Authorised in the year | 350 | 9 | – | – | 9 |
| **At 31 December 2008** | **4,800** | **120** | **1** | **1** | **120** |
| **Issued and fully paid** | | | | | |
| At 1 January 2007 | 3,246 | 81 | 1 | 1 | 81 |
| Exercise of options | 29 | 1 | – | – | 1 |
| Placing of shares | 174 | 5 | – | – | 5 |
| Conversion of preference shares | 125 | 3 | – | – | 3 |
| At 1 January 2008 | 3,574 | 90 | 1 | 1 | 90 |
| Exercise of options | 8 | – | – | – | – |
| **At 31 December 2008** | **3,582** | **90** | **1** | **1** | **90** |

**Special Share**

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Enterprise and Regulatory Reform (the Special Shareholder). Certain parts of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These articles include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the Chief Executive and any executive chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

**Placing of shares**

On 11 May 2007, 174,418,605 new ordinary shares of 2.5p each were placed at a price of 430p, raising £750m before expenses (see note 27).

**Conversion of preference shares**

As at 1 January 2007, the Company had in issue 259,962,909 7.75p (net) cumulative redeemable preference shares of 25p each. During the prior year, the shares were converted into ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for each preference share, as a result of which 124,532,630 ordinary shares of 2.5p each were issued. There were, therefore, no preference shares in issue as at 31 December 2007 or 31 December 2008.

In accordance with IAS 32 *Financial Instruments: Disclosure and Presentation*, the convertible preference shares were considered to be a compound financial instrument consisting of both a debt element and an equity component which required separate accounting treatment. Following conversion to ordinary shares the amounts previously recognised within equity (note 27) and within loans and overdrafts (note 20) have been extinguished.

**Treasury shares**

As at 31 December 2008, 55,038,953 (2007 61,945,000) ordinary shares of 2.5p each with an aggregate nominal value of £1,375,974 (2007 £1,548,625) were held in treasury. During 2008, 6,906,047 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme.

## 26. Share-based payments

Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 75 to 93.

**Executive Share Option Scheme (ExSOS)**
Equity-settled options

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Number of shares '000 | Weighted average exercise price £ | Number of shares '000 | Weighted average exercise price £ |
| Outstanding at the beginning of the year | **31,728** | **3.33** | 56,202 | 2.80 |
| Granted during the year | **–** | **–** | 6,161 | 4.59 |
| Exercised during the year | **(6,921)** | **2.67** | (19,294) | 2.34 |
| Expired during the year | **(1,076)** | **4.19** | (11,341) | 3.07 |
| Outstanding at the end of the year | **23,731** | **3.49** | 31,728 | 3.33 |
| Exercisable at the end of the year | **13,628** | **2.78** | 9,922 | 2.68 |

Cash-settled share appreciation rights

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Number of shares '000 | Weighted average exercise price £ | Number of shares '000 | Weighted average exercise price £ |
| Outstanding at the beginning of the year | **16,993** | **2.67** | 35,805 | 2.82 |
| Exercised during the year | **(3,963)** | **2.71** | (8,512) | 2.48 |
| Expired during the year | **(363)** | **2.95** | (10,300) | 3.32 |
| Outstanding at the end of the year | **12,667** | **2.65** | 16,993 | 2.67 |
| Exercisable at the end of the year | **12,522** | **2.64** | 11,452 | 2.67 |

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Equity-settled | Cash-settled | Equity-settled | Cash-settled |
| Range of exercise price of outstanding options (£) | **1.72 – 4.79** | **2.01 – 4.21** | 1.72 – 4.87 | 1.72 – 4.21 |
| Weighted average remaining contracted life (years) | **6** | **4** | 7 | 6 |
| Weighted average fair value of options granted (£) | **–** | **–** | 1.46 | – |
| Expense/(credit) recognised for the year (£m) | **5** | **(18)** | 8 | 15 |

**Performance Share Plan (PSP)**
Equity-settled options

| | 2008 Number of shares '000 | 2007 Number of shares '000 |
|---|---|---|
| Outstanding at the beginning of the year | **20,952** | 25,608 |
| Granted during the year | **7,507** | 4,107 |
| Exercised during the year | **(6,433)** | (7,240) |
| Expired during the year | **(1,146)** | (1,523) |
| Outstanding at the end of the year | **20,880** | 20,952 |
| Exercisable at the end of the year | **2,151** | 963 |

## 26. Share-based payments *continued*

Cash-settled options

| | 2008 Number of shares '000 | 2007 Number of shares '000 |
|---|---|---|
| Outstanding at the beginning of the year | **7,949** | 12,701 |
| Exercised during the year | **(4,368)** | (4,053) |
| Expired during the year | **(438)** | (699) |
| Outstanding at the end of the year | **3,143** | 7,949 |

No options were exercisable at the end of the year.

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Equity-settled | Cash-settled | Equity-settled | Cash-settled |
| Weighted average remaining contracted life (years) | **5** | **3** | 4 | 4 |
| Weighted average fair value of options granted (£) | **3.78** | **–** | 2.29 | – |
| Expense/(credit) recognised for the year (£m) | **10** | **(1)** | 7 | 18 |

The exercise price for the PSP is £nil (2007 £nil).

**Restricted Share Plan (RSP)**
All awards are equity-settled.

| | 2008 Number of shares '000 | 2007 Number of shares '000 |
|---|---|---|
| Outstanding at the beginning of the year | **603** | 1,338 |
| Exercised during the year | **(385)** | (619) |
| Expired during the year | **(2)** | (116) |
| Outstanding at the end of the year | **216** | 603 |
| Exercisable at the end of the year | **3** | – |

| | 2008 | 2007 |
|---|---|---|
| Weighted average remaining contracted life (years) | **–** | 1 |
| Expense recognised for the year (£m) | **–** | 1 |

The exercise price for the RSP is £nil (2007 £nil).

**Share Matching Plan (SMP)**
All awards are equity-settled.

| | 2008 Number of shares '000 | 2007 Number of shares '000 |
|---|---|---|
| Outstanding at the beginning of the year | **463** | – |
| Granted during the year | **1,470** | 464 |
| Exercised during the year | **(110)** | – |
| Expired during the year | **(12)** | (1) |
| Outstanding at the end of the year | **1,811** | 463 |
| Exercisable at the end of the year | **–** | – |

| | 2008 | 2007 |
|---|---|---|
| Weighted average remaining contracted life (years) | **2** | 2 |
| Weighted average fair value of options granted (£) | **4.79** | 4.59 |
| Expense recognised for the year (£m) | **2** | – |

The exercise price for the SMP is £nil (2007 £nil).

## 26. Share-based payments *continued*

**Save-As-You-Earn (SAYE)**
Equity-settled options

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Number of shares '000 | Weighted average exercise price £ | Number of shares '000 | Weighted average exercise price £ |
| Outstanding at the beginning of the year | **9,477** | **1.25** | 21,174 | 1.71 |
| Exercised during the year | **(4,597)** | **0.94** | (10,873) | 2.10 |
| Expired during the year | **(244)** | **1.31** | (824) | 1.64 |
| Outstanding at the end of the year | **4,636** | **1.56** | 9,477 | 1.25 |
| Exercisable at the end of the year | **94** | **0.92** | 157 | 1.62 |

Cash-settled share appreciation rights

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Number of shares '000 | Weighted average exercise price £ | Number of shares '000 | Weighted average exercise price £ |
| Outstanding at the beginning of the year | **5,154** | **3.14** | 8,923 | 2.76 |
| Exercised during the year | **(1,949)** | **2.46** | (3,214) | 2.08 |
| Expired during the year | **(310)** | **3.53** | (555) | 3.18 |
| Outstanding at the end of the year | **2,895** | **3.56** | 5,154 | 3.14 |
| Exercisable at the end of the year | **2,895** | **3.56** | 1,865 | 2.40 |

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Equity-settled | Cash-settled | Equity-settled | Cash-settled |
| Range of exercise price of outstanding options (£) | **0.93 – 1.56** | **3.85** | 0.93 – 2.56 | 1.72 – 3.56 |
| Weighted average remaining contracted life (years) | **1** | **–** | 1 | 1 |
| Expense/(credit) recognised for the year (£m) | **1** | **(4)** | 2 | 7 |

**Details of options granted in the year**
The fair value of both equity-settled awards granted in the year has been measured using the weighted average inputs below and the following valuation models:
PSP – Monte Carlo
SMP – Dividend valuation model

| | 2008 | 2007 |
|---|---|---|
| Range of share price at date of grant (£) | **3.48 – 5.05** | 4.32 – 4.86 |
| Exercise price (£) | **–** | 0 – 4.79 |
| Expected option life (years) | **3 – 4** | 4 – 5 |
| Volatility | **25 – 32%** | 25 – 36% |
| Spot dividend yield | **3.0 – 4.4%** | 2.5 – 2.8% |
| Risk free interest rate | **2.4 – 3.9%** | 5.0 – 5.3% |

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £4.33 (2007 £4.52).

The liability in respect of the cash-settled elements of the schemes shown above and reported within liability provisions at 31 December 2008 is £26m (2007 £75m).

The intrinsic value of cash-settled options that have vested at 31 December 2008 is £15m (2007 £26m).

**Share Incentive Plan**
The Group also incurred a charge of £28m (2007 £16m) in respect of the all-employee free shares element of the Share Incentive Plan.

## 27. Reconciliation of movement in capital and reserves

| | Attributable to equity holders of the parent | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Issued share capital £m | Share premium £m | Equity option of preference shares £m | Other reserves £m | Retained earnings £m | Total £m | Minority interests £m | Total equity £m |
| Balance at 1 January 2007 | 81 | 841 | 76 | 4,330 | (1,211) | 4,117 | 17 | 4,134 |
| Total recognised income and expense | – | – | – | 72 | 1,291 | 1,363 | 21 | 1,384 |
| Placing of shares (net of costs) | 5 | – | – | – | 736 | 741 | – | 741 |
| Share-based payments | – | – | – | – | 34 | 34 | – | 34 |
| Share options: | | | | | | | | |
| Proceeds from shares issued | 1 | 63 | – | – | – | 64 | – | 64 |
| Purchase of own shares | – | – | – | – | (50) | (50) | – | (50) |
| Conversion of preference shares | 3 | 318 | (76) | 229 | (229) | 245 | – | 245 |
| Purchase of treasury shares | – | – | – | – | (152) | (152) | – | (152) |
| Other | – | – | – | – | – | – | (1) | (1) |
| Ordinary share dividends | – | – | – | – | (396) | (396) | (1) | (397) |
| At 31 December 2007 | 90 | 1,222 | – | 4,631 | 23 | 5,966 | 36 | 6,002 |
| Total recognised income and expense | – | – | – | 1,343 | 379 | 1,722 | 23 | 1,745 |
| Share-based payments | – | – | – | – | 51 | 51 | – | 51 |
| Share options: | | | | | | | | |
| Proceeds from shares issued | – | 16 | – | – | – | 16 | – | 16 |
| Purchase of own shares | – | – | – | – | (43) | (43) | – | (43) |
| Other | – | – | – | – | – | – | 7 | 7 |
| Ordinary share dividends | – | – | – | – | (478) | (478) | (11) | (489) |
| **At 31 December 2008** | **90** | **1,238** | **–** | **5,974** | **(68)** | **7,234** | **55** | **7,289** |

Other reserves include a merger reserve of £4,589m (2007 £4,589m), a statutory reserve of £202m (2007 £202m), a translation reserve of £787m (2007 £217m debit) and a hedging reserve of £396m (2007 £57m). The £1,343m credit to other reserves includes £1,004m to the translation reserve and £339m to the hedging reserve. Under Section 4 of the British Aerospace Act 1980 the statutory reserve may only be applied in paying up unissued shares of the Group to be allotted to members of the Group as fully paid bonus shares.

**Placing of shares**
On 11 May 2007, 174,418,605 new ordinary shares of 2.5p each were issued by a placing of shares (note 25). The placing structure utilised attracted merger relief under Section 131 of the Companies Act 1985, resulting in a credit to the merger reserve of £736m. Subsequent internal transactions required to complete the placing structure have resulted in this part of the merger reserve being transferred to the retained earnings reserve.

**Own shares held**
Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

**Conversion of preference shares**
During the prior year, 259,962,909 preference shares were converted into ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for each preference share (note 25).

**Treasury shares**
During the prior year, 33,270,000 ordinary shares of 2.5p each were repurchased under the buyback programme announced in October 2006. As at 31 December 2008, 55,038,953 (2007 61,945,000) ordinary shares of 2.5p each with an aggregate nominal value of £1,375,974 (2007 £1,548,625) were held in treasury.

**BAE Systems ESOP Trust**
The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2008.

At 31 December 2008, the ESOP held 2,093,818 (2007 1,552,015) ordinary shares of 2.5p each with a market value of £8m (2007 £8m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2008 and remains over shares within the Company’s Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and December 2008 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

## 28. Reconciliation of operating business cash flow

| | 2008 £m | 2007 £m |
|---|---|---|
| Cash inflow from operating activities | **2,009** | 2,162 |
| Purchases of property, plant and equipment | **(520)** | (307) |
| Purchases of intangible assets | **(32)** | (31) |
| Equity accounted investment funding | **–** | (4) |
| Proceeds from the sale of property, plant and equipment | **44** | 13 |
| Proceeds from the sale of investment property | **5** | 53 |
| Proceeds from the sale of non-current other investments | **–** | 15 |
| Purchase of non-current other investments | **–** | (1) |
| Dividends received from equity accounted investments | **89** | 78 |
| **Operating business cash flow** | **1,595** | 1,978 |
| | | |
| Electronics, Intelligence & Support | **380** | 302 |
| Land & Armaments | **467** | 10 |
| Programmes & Support | **651** | 807 |
| International | **163** | 678 |
| HQ & Other Businesses | **(66)** | 181 |
| **Operating business cash flow** | **1,595** | 1,978 |

## 29. Net cash as defined by the Group

| | 2008 £m | 2007 £m |
|---|---|---|
| Debt-related derivative financial instrument assets – non-current | **203** | – |
| Term deposits – current | **–** | 164 |
| Cash and cash equivalents | **2,624** | 3,062 |
| | **2,827** | 3,226 |
| Loans – non-current | **(2,608)** | (2,197) |
| *Loans – current* | **(154)** | (283) |
| *Overdrafts – current* | **(19)** | (16) |
| Loans and overdrafts – current | **(173)** | (299) |
| Cash received on customers' account[1] (included within payables) | **(7)** | (30) |
| | **(2,788)** | (2,526) |
| **Closing net cash as defined by the Group** | **39** | 700 |

### Movement in net cash as defined by the Group

| | 2008 £m | 2007 £m |
|---|---|---|
| Operating business cash flow | **1,595** | 1,978 |
| Interest and preference dividends | **(98)** | (65) |
| Taxation | **(261)** | (112) |
| Free cash inflow | **1,236** | 1,801 |
| Acquisitions and disposals | **(1,001)** | (1,574) |
| Debt acquired on acquisition of subsidiary undertakings | **(37)** | (538) |
| Proceeds from issue of share capital | **16** | 805 |
| Equity dividends paid | **(478)** | (396) |
| Dividends paid to minority interests | **(11)** | (1) |
| Preference share conversion | **–** | 245 |
| Purchase of treasury shares | **–** | (152) |
| Purchase of own shares | **(43)** | (50) |
| Cash outflow from matured derivative financial instruments | **(440)** | (14) |
| Cash inflow from reduction in cash collateral | **106** | 9 |
| Other non-cash movements | **339** | 62 |
| Foreign exchange | **(374)** | 36 |
| Movement in cash received on customers' account[1] | **26** | 32 |
| Movement in net cash as defined by the Group | **(661)** | 265 |
| Opening net cash as defined by the Group | **700** | 435 |
| **Closing net cash as defined by the Group** | **39** | 700 |

1 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payments guarantees unrelated to Group performance.

### Cash flows in relation to acquisitions and disposals

| | Subsidiaries | | | | | | | | Equity accounted investments | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | MTC £m | Tenix Defence £m | Detica £m | Other acquisitions[2] £m | **Total acquisitions £m** | Surveillance and Attack £m | Other disposals[2] £m | **Total disposals £m** | Flagship £m | Other £m | **Total £m** |
| Cash (consideration)/proceeds | (188) | (328) | (543) | (19) | **(1,078)** | 118 | 13 | **131** | 16 | (12) | **(943)** |
| Cash and cash equivalents net of overdrafts acquired/disposed | 2 | – | (4) | 4 | **2** | – | (60) | **(60)** | – | – | **(58)** |
| Acquisitions and disposals | (186) | (328) | (547) | (15) | **(1,076)** | 118 | (47) | **71** | 16 | (12) | **(1,001)** |
| Debt acquired on acquisition of subsidiary | (32) | – | (5) | – | **(37)** | – | – | **–** | – | – | **(37)** |
| | (218) | (328) | (552) | (15) | **(1,113)** | 118 | (47) | **71** | 16 | (12) | **(1,038)** |

2 Other acquisitions and disposals are described in notes 31 and 9, respectively.

## 30. Dividends

| Equity dividends | 2008 £m | 2007 £m |
|---|---|---|
| Prior year final 7.8p dividend per ordinary share paid in the year (2007 6.9p) | **274** | 221 |
| Interim 5.8p dividend per ordinary share paid in the year (2007 5.0p) | **204** | 175 |
| | **478** | 396 |

After the balance sheet date, the directors proposed a final dividend of 8.7p (2007 7.8p). The dividend, which is subject to shareholder approval, will be paid on 1 June 2009 to shareholders registered on 24 April 2009. The ex-dividend date is 22 April 2009.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 8 May 2009.

## 31. Acquisition of subsidiaries

The Group acquired MTC Technologies, Inc. (MTC) in the US on 9 June 2008, Tenix Defence in Australia on 27 June 2008 and Detica Group plc (Detica) on 25 September 2008. If the acquisitions had occurred on 1 January 2008, combined sales of Group and equity accounted investments would have been £19.0bn, revenue £17.2bn and profit for the year from continuing operations £1.8bn.

MTC

On 9 June 2008, the Group acquired 100% of the issued share capital of MTC in the US for a cash consideration including transaction costs of $375m (£188m). Goodwill arising on consolidation is £131m.

Based in Dayton, Ohio, MTC provides technical and professional services, and equipment integration and modernisation for the US military and intelligence agencies.

In the period from acquisition to 31 December, MTC contributed revenue and loss after tax of £98m and £1m, respectively, to the Group's consolidated results.

The acquisition of MTC complements the existing US business in the Electronics, Intelligence & Support operating group. It allows for synergies in professional services, aircraft integration centres, and modification and sustainment. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within the Electronics, Intelligence & Support operating group supporting the goodwill.

The MTC acquisition had the following effect on the Group's assets and liabilities:

| | Book value £m | Accounting policy alignments £m | Fair value adjustments £m | Fair value £m |
|---|---|---|---|---|
| Intangible assets | 12 | – | 13 | 25 |
| Property, plant and equipment | 14 | (1) | 5 | 18 |
| Inventories | 4 | – | 1 | 5 |
| Receivables | 48 | – | – | 48 |
| Deferred tax assets | 1 | – | 15 | 16 |
| Payables | (23) | – | (1) | (24) |
| Deferred tax liabilities | (4) | – | 4 | – |
| Provisions | – | – | (1) | (1) |
| Cash and cash equivalents | 2 | – | – | 2 |
| Loans | (32) | – | – | (32) |
| **Net assets/(liabilities) acquired** | **22** | **(1)** | **36** | **57** |
| **Goodwill** | | | | **131** |
| **Consideration** | | | | **188** |

| | |
|---|---|
| **Consideration satisfied by:** | |
| Cash | 184 |
| Directly attributable costs: | |
| Paid | 4 |
| | 188 |

The intangible assets acquired as part of the acquisition of MTC can be analysed as follows:

| | £m |
|---|---|
| Customer relationships | 21 |
| Technology | 4 |
| | 25 |

## 31. Acquisition of subsidiaries *continued*

### Tenix Defence

Tenix Defence Holdings Pty Limited (Tenix Defence), a leading Australian defence contractor, comprises four businesses in the Land, Aerospace, Electronic Systems and Marine sector.

On 27 June 2008, the Group acquired 100% of the issued share capital of Tenix Defence for a cash consideration including transaction costs paid of A$697m (£328m), subject to adjustment according to the level of working capital in the business at the acquisition date.

In the period from acquisition to 31 December 2008, Tenix Defence contributed revenue, EBITA[1] and loss after tax of £130m, £12m loss and £39m, respectively, to the Group's consolidated results. Included within the loss after tax of £39m is an amortisation expense on intangible assets of £29m.

The acquisition of Tenix Defence complements the existing Australian business enabling BAE Systems to establish a greater presence in the Australian defence market and in particular to expand into the Australian land and marine sectors. These opportunities do not translate into separately identifiable intangible assets, but represent much of the assessed value within Tenix Defence supporting the recognised goodwill.

Certain of the accounting policy alignments have not yet been finalised pending further review. In addition, certain of the fair values assigned to the net assets acquired are provisional. These will be amended as necessary in light of subsequent knowledge or events to the extent that these reflect conditions as at the date of acquisition.

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

The acquisition of Tenix Defence had the following effect on the Group's assets and liabilities:

| | Book value £m | Accounting policy alignments £m | Fair value adjustments £m | Fair value £m |
|---|---|---|---|---|
| Intangible assets | 5 | (2) | 91 | 94 |
| Property, plant and equipment | 36 | (2) | 43 | 77 |
| Receivables | 68 | – | – | 68 |
| Deferred tax assets | – | – | 9 | 9 |
| Payables | (99) | (21) | (118) | (238) |
| Provisions | (1) | (3) | 1 | (3) |
| **Net assets/(liabilities) acquired** | **9** | **(28)** | **26** | **7** |
| **Provisional goodwill** | | | | **323** |
| **Consideration** | | | | **330** |

| | |
|---|---|
| **Consideration satisfied by:** | |
| Cash | 323 |
| Directly attributable costs: | |
| Paid | 5 |
| Accrued | 2 |
| | 330 |

The fair value adjustment to payables of £118m is in respect of provisions for contract losses.

The intangible assets acquired as part of the acquisition of Tenix Defence can be analysed as follows:

| | £m |
|---|---|
| Programmes | 75 |
| Order backlog | 4 |
| Patents | 15 |
| | 94 |

## 31. Acquisition of subsidiaries *continued*

Detica

On 25 September 2008, the Group's offer for the acquisition of Detica for £543m including assumption of net debt became wholly unconditional. Detica is a specialist business and technology consultancy with expertise in information exploitation, security and resilience, threat intelligence and customer insight.

In the period from acquisition to 31 December 2008, Detica contributed revenue and profit after tax of £60m (UK £55m) and £1m, respectively, to the Group's consolidated results.

The acquisition of Detica provides access to UK and US government contracting opportunities in the intelligence, security and resilience market and significant cross-selling opportunities, particularly in our home markets. The combination of capabilities within Detica and BAE Systems will provide innovative solutions in this growing sector. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within BAE Systems supporting the recognised goodwill.

Certain of the fair values assigned to the net assets acquired are provisional. These will be amended as necessary in light of subsequent knowledge or events to the extent that these reflect conditions as at the date of acquisition.

The acquisition of Detica had the following effect on the Group's assets and liabilities:

| | Book value £m | Accounting policy alignments £m | Fair value adjustments £m | Fair value £m |
|---|---|---|---|---|
| Intangible assets | 3 | – | 91 | 94 |
| Property, plant and equipment | 15 | – | – | 15 |
| Inventories | 2 | – | – | 2 |
| Receivables | 69 | – | – | 69 |
| Deferred tax assets | 2 | – | – | 2 |
| Payables | (46) | – | – | (46) |
| Current tax liabilities | – | – | (1) | (1) |
| Deferred tax liabilities | (1) | – | (24) | (25) |
| Overdrafts | (4) | – | – | (4) |
| Loans | (5) | – | – | (5) |
| **Net assets acquired** | **35** | **–** | **66** | **101** |
| **Provisional goodwill** | | | | **442** |
| **Consideration** | | | | **543** |

**Consideration satisfied by:**

| | |
|---|---|
| Cash | 531 |
| Directly attributable costs: | |
| Paid | 12 |
| | 543 |

The intangible assets acquired as part of the acquisition of Detica can be analysed as follows:

| | £m |
|---|---|
| Order backlog | 22 |
| Customer relationships | 22 |
| Trademarks | 30 |
| Software | 20 |
| | 94 |

**Other acquisitions**

Other acquisitions include the acquisitions of 100% of the issued share capital of Tenix Toll Defence Logistics Pty Limited, formerly a joint venture between Tenix and Toll Holdings Pty Limited, for A$24m (£12m) and 100% of the issued share capital of IST Dynamics for £7m. As a result of these acquisitions, £7m of goodwill was generated in the year.

## 31. Acquisition of subsidiaries *continued*

**Acquisition of subsidiaries for the year ended 31 December 2007**

The Group made a number of acquisitions during the year ended 31 December 2007, the most significant of which was of Armor Holdings, Inc. in the US. The acquisitions took place throughout the year ended 31 December 2007, but if they had occurred on 1 January 2007, combined sales of Group and equity accounted investments would have been £16.7bn, revenue £15.3bn and profit for the year ended 31 December 2007 from continuing operations £928m.

Armor Holdings, Inc.

On 31 July 2007, the Group acquired 100% of the issued share capital of Armor Holdings, Inc. (Armor), in the US, for a consideration of £1,696m, excluding transaction costs incurred by the acquiree (£26m). Goodwill arising on consolidation amounted to £1,554m. Armor is a major manufacturer of tactical wheeled vehicles and a leading provider of vehicle and individual armour systems and survivability technologies for the military and for the law enforcement and commercial security markets.

In the period from acquisition to 31 December 2007, Armor contributed EBITA[1] of £77m and profit after tax of £18m to the Group's consolidated results.

Mobile International, a subsidiary of Armor, was acquired with a view to immediate resale. Accordingly, it was classified as held for sale in the acquisition balance sheet and as at 31 December 2007 (note 19).

The acquisition of Armor complements the existing US business in the Land & Armaments business group creating synergy potential. It allows for continued development of the Mine Resistant Ambush Protected (MRAP) vehicles and Family of Medium Tactical Vehicles (FMTV) programmes, as well as advanced ceramics for body armour. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within the Land & Armaments business group supporting the recognised goodwill.

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

The acquisition had the following effect on the Group's assets and liabilities:

| | Book value £m | Accounting policy alignments £m | Fair value adjustments £m | Fair value £m |
|---|---|---|---|---|
| Intangible assets | 172 | – | 581 | 753 |
| Property, plant and equipment | 85 | (1) | 8 | 92 |
| Inventories | 163 | (5) | (4) | 154 |
| Receivables | 158 | (1) | (1) | 156 |
| Current tax receivable | 33 | – | 2 | 35 |
| Deferred tax assets | 23 | 3 | – | 26 |
| Payables | (204) | (1) | (20) | (225) |
| Deferred tax liabilities | (87) | – | (145) | (232) |
| Retirement benefit obligations | (24) | 4 | (2) | (22) |
| Provisions | (13) | – | (57) | (70) |
| Cash and cash equivalents | 6 | – | – | 6 |
| Loans | (386) | (5) | (147) | (538) |
| Held for sale | 14 | – | (7) | 7 |
| **Net (liabilities)/assets acquired** | **(60)** | **(6)** | **208** | **142** |
| **Goodwill** | | | | **1,554** |
| **Consideration** | | | | **1,696** |

**Consideration satisfied by:**

| | |
|---|---|
| Cash | 1,682 |
| Directly attributable costs: | |
| Paid | 14 |
| | 1,696 |

The intangible assets acquired as part of the acquisition of Armor can be analysed as follows:

| | £m |
|---|---|
| Programmes | 551 |
| Customer relationships | 129 |
| Trademarks | 69 |
| Patents | 4 |
| | 753 |

## 31. Acquisition of subsidiaries *continued*

Certain of the fair values assigned to the net assets at the date of acquisition were provisional, and in accordance with IFRS 3 *Business Combinations*, the Group has adjusted the fair values attributable to legal provisions and associated deferred taxation in the year ended 31 December 2008, resulting in a net increase in goodwill on acquisition of £6m. This has not had a material impact on the consolidated accounts and, as such, the Group has not restated the balance sheet at 31 December 2007.

**Other acquisitions in 2007**

Other acquisitions included the acquisition of Pitch Technologies AB and iSC for a consideration of £5m and £4m, respectively. In each case, 100% of the shares were acquired. As a result of these acquisitions, an additional £9m of goodwill was generated in the year.

## 32. Financial risk management

A discussion of the Group's treasury objectives and policies and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net cash/(debt) (note 29) together with other financial assets and other financial liabilities (note 17) and other instruments deemed to be financial instruments under IAS 32 *Financial Instruments: Disclosure and Presentation*, including non-current receivables, non-current payables and non-current provisions.

**Hedging instruments**

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

| | **31 December 2008** | | | | 31 December 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| **Foreign exchange contracts** | **Not exceeding one year £m** | **Between one year and five years £m** | **More than five years £m** | **Total £m** | Not exceeding one year £m | Between one year and five years £m | More than five years £m | Total £m |
| Net forward (sales)/purchase contracts | | | | | | | | |
| US dollar | **(1,199)** | **248** | **8** | **(943)** | (2,366) | 141 | (12) | (2,237) |
| Euro | **2,286** | **620** | **4** | **2,910** | 1,277 | 425 | (1) | 1,701 |
| Other | **132** | **2** | **–** | **134** | 131 | 3 | – | 134 |
| | **1,219** | **870** | **12** | **2,101** | (958) | 569 | (13) | (402) |

| | **31 December 2008** | | | | 31 December 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| **Interest rate contracts** | **Not exceeding one year £m** | **Between one year and five years £m** | **More than five years £m** | **Total £m** | Not exceeding one year £m | Between one year and five years £m | More than five years £m | Total £m |
| Interest rate swap contracts | | | | | | | | |
| US dollar | **–** | **896** | **–** | **896** | – | 654 | – | 654 |
| Sterling | **33** | **146** | **–** | **179** | 30 | 120 | 31 | 181 |
| | **33** | **1,042** | **–** | **1,075** | 30 | 774 | 31 | 835 |

| | **31 December 2008** | | | | 31 December 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| **Cross-currency swap contracts** | **Not exceeding one year £m** | **Between one year and five years £m** | **More than five years £m** | **Total £m** | Not exceeding one year £m | Between one year and five years £m | More than five years £m | Total £m |
| Net forward (sales)/purchase contracts | | | | | | | | |
| US dollar | **58** | **303** | **345** | **706** | 38 | 176 | 339 | 553 |
| Swedish krona | **–** | **–** | **–** | **–** | (143) | – | – | (143) |
| | **58** | **303** | **345** | **706** | (105) | 176 | 339 | 410 |

## 32. Financial risk management *continued*

**Fair value of financial instruments**
The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;
- the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates; and
- the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date[1].

| | **Net carrying amount 2008 £m** | **Estimated fair value 2008 £m** | Net carrying amount 2007 £m | Estimated fair value 2007 £m |
|---|---|---|---|---|
| **Assets** | | | | |
| **Non-current** | | | | |
| Other receivables[2] | **125** | **125** | 265 | 265 |
| Other financial assets | **514** | **514** | 48 | 48 |
| **Current** | | | | |
| Other investments | **–** | **–** | 164 | 164 |
| Other financial assets | **674** | **674** | 101 | 101 |
| Cash and cash equivalents | **2,624** | **2,624** | 3,062 | 3,062 |
| **Liabilities** | | | | |
| **Non-current** | | | | |
| Loans | **(2,608)** | **(3,090)** | (2,197) | (2,399) |
| Other financial liabilities | **(383)** | **(383)** | (26) | (26) |
| **Current** | | | | |
| Loans and overdrafts | **(173)** | **(173)** | (299) | (308) |
| Other financial liabilities | **(362)** | **(362)** | (71) | (71) |

1 The estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date.
2 Net carrying amount approximates to estimated fair value as there is no active market.

**Interest rate risk**
Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

| | 2009 £m | 2010 £m | 2011 £m | 2012 £m | 2013 £m | Beyond 2013 £m |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| **Current** | | | | | | |
| Cash and cash equivalents | 2,624 | – | – | – | – | – |
| **Liabilities** | | | | | | |
| **Non-current** | | | | | | |
| Loans | (651) | (651) | (279) | (110) | (80) | – |
| **Current** | | | | | | |
| Loans and overdrafts | (50) | – | – | – | – | – |

## 32. Financial risk management *continued*

**Collateral**
As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2008 totalled £nil (2007 £109m).

**Committed undrawn borrowing facilities**
At 31 December 2008 the Group had a committed Revolving Credit Facility (RCF) of £1.5bn, which expires in more than two years but less than five years (2007 £1.5bn which expires in more than two years but less than five years). Of the £1.5bn, £45m relates to Lehman Brothers Commercial Paper Inc. The RCF was originally contracted for five years until 2010. However, it has been extended by the agreement of two one-year extensions until 2012, although the available amount for the final year has been reduced from £1.5bn to £1.3bn. The RCF remained undrawn throughout the year.

**Interest rate fluctuations**
The objective of interest rate risk management is to reduce the exposure to interest rate fluctuations on borrowings and deposits. This is achieved through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps. The Group’s current interest rate management policy is that a minimum of 25% (2007 25%) and a maximum of 75% (2007 75%) of debt is maintained at fixed interest rates. At 31 December 2008, the Group had 73% (2007 75%) of fixed rate debt and 27% (2007 25%) of floating rate debt based on a gross debt of £2.6bn including debt-related derivative financial assets (2007 £2.5bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2008, the Group had a total of $1.3bn (2007 $1.3bn) of this type of swap outstanding with a weighted average duration of 2.4 years (2007 3.2 years). In respect of the fixed rate debt the weighted average period in respect of which interest is fixed was seven years (2007 seven years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 5.2% (2007 6.7%), 3.5% on US dollars and 8% on sterling (2007 6.3% on US dollars and 7.3% on sterling). The cost of the fixed rate debt was 6.8% (2007 7.1%). A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £6m (2007 £7m).

In respect of cash deposits, given the fluctuation in the Group’s working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £12m (2007 £23m).

**Credit risk on cash and cash equivalents**
The Group is exposed to credit risk on its cash and cash equivalents to the extent of non-performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. BAE Systems has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2008 of £2,624m (2007 £3,062m) was invested with 14 (2007 26) financial institutions. The system assigns a maximum exposure based on the counterparty’s size, a composite credit rating and Credit Default Swap price. These limits are regularly monitored and updated. The Group has material receivables due from the UK and US governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 2% of the balance (2007 3%).

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has reduced its exposure to credit risk and managed its price risk through this process.

**Currency risk**
In order to protect itself against currency fluctuations, the Group’s policy is to hedge all material firm transactional exposures. Further explanation is set out in the Risk management and principal risks section of the Directors’ report on page 61.

## 33. Related party transactions

The Group has a related party relationship with its directors and key management (as disclosed in the Remuneration report on pages 75 to 93 and in note 7), its equity accounted investments (note 14) and the pension plans (note 22).

Transactions occur with the equity accounted investments in the normal course of business and are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

| | Sales to related party | | Purchases from related party | | Amounts owed by related party | | Amounts owed to related party | | Lease income/ (expense) with related party | | Other | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Related party | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m | **2008 £m** | 2007 £m |
| BVT Surface Fleet Limited | **74** | – | **1** | – | **4** | – | **54** | – | **–** | – | **–** | – |
| Eurofighter Jagdflugzeug GmbH | **889** | 1,063 | **–** | – | **61** | 107 | **221** | – | **–** | – | **–** | – |
| Flagship Training Limited | **–** | – | **–** | 1 | **–** | – | **–** | 7 | **–** | – | **–** | – |
| Fleet Support Limited | **–** | 1 | **–** | 2 | **–** | 1 | **–** | – | **–** | – | **–** | – |
| Gripen International KB | **1** | – | **–** | – | **114** | 109 | **161** | 136 | **–** | – | **–** | – |
| MBDA SAS | **56** | 143 | **10** | 11 | **9** | 20 | **1,034** | 709 | **–** | 2 | **–** | – |
| Panavia Aircraft GmbH | **57** | 71 | **127** | 132 | **11** | 1 | **4** | – | **–** | – | **–** | – |
| Saab AB | **4** | 3 | **9** | – | **1** | – | **2** | – | **–** | – | **–** | 1 |
| CTA International SAS | **–** | – | **–** | 2 | **–** | – | **–** | – | **–** | – | **–** | – |
| Flight Control System Management GmbH | **–** | – | **–** | – | **–** | 1 | **–** | 1 | **–** | – | **–** | – |
| | **1,081** | 1,281 | **147** | 148 | **200** | 239 | **1,476** | 853 | **–** | 2 | **–** | 1 |

## 34. Group entities

| Principal subsidiary undertakings | Principal activities | Group interest in allotted capital | Principally operates in | Country of incorporation |
|---|---|---|---|---|
| BAE Systems (Operations) Limited *(Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)* | Defence and commercial aerospace activities | 100% Ordinary | UK | England and Wales |
| BAE Systems Information and Electronic Systems Integration Inc. *(Held via BAE Systems, Inc.)* | Designs, develops and manufactures electronic systems and subsystems | 100% Common | US | US |
| BAE Systems Controls Inc. *(Held via BAE Systems, Inc.)* | Designs, develops and manufactures military defence electronics equipment | 100% Common | US | US |
| BAE Systems Land & Armaments LP *1525 Wilson Boulevard, Suite 700, Arlington VA 22209, USA (Partners: BAE Systems Land & Armaments Inc. and BAE Systems Land & Armaments Holdings Inc.)* | Manufactures and supports military vehicles | 100% | US | US |
| BAE Systems AH Inc. *(formerly Armor Holdings, Inc.) (Held via BAE Systems, Inc.)* | Manufacture of military vehicles and supply of vehicle and armour systems | 100% Common | US | US |
| BAE Systems Tactical Vehicle Systems LP *5000 Interstate 10 West, Sealy, TX 77474, USA (Partners: BAE Systems TVS Holdings LLC and BAE Systems TVS Inc.)* | Mobility and protection systems | 100% | US | US |

The Group comprises a large number of subsidiary undertakings and it is not practical to include all of them in the above list. The list therefore only includes those subsidiary undertakings which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2008 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group consolidation.

## 35. Events after the balance sheet date

In connection with the joint venture company BVT Surface Fleet Limited (BVT), which was established on 1 July 2008, VT Group plc (VT) holds a put option exercisable from 1 July 2009 to sell its 45% interest in BVT to the Group for a minimum of £380m (subject to adjustments). In addition, on completion of that put option, deferred consideration of £65m (plus interest) in respect of the sale to VT of the Group's 50% shareholding in Flagship Training Limited becomes payable (subject to adjustment).

In January 2009, VT announced that it had decided to exercise this put option and that it expects to be in a position to exercise that option by 1 July 2009.

# Company balance sheet
as at 31 December

| | Notes | 2008 £m | 2007 £m |
|---|---|---|---|
| **Fixed assets** | | | |
| Tangible assets | 2 | **5** | 6 |
| **Investments** | | | |
| Investments in subsidiary undertakings | 3 | **5,663** | 5,596 |
| | | **5,668** | 5,602 |
| **Current assets** | | | |
| Debtors due within one year | 4 | **9,339** | 7,670 |
| Debtors due after one year | 4 | **3** | 116 |
| Investments | 5 | **–** | 130 |
| Other financial assets due within one year | 6 | **383** | 139 |
| Other financial assets due after one year | 6 | **249** | 63 |
| Cash at bank and in hand | | **1,988** | 2,360 |
| | | **11,962** | 10,478 |
| **Liabilities falling due within one year** | | | |
| Loans and overdrafts | 7 | **(49)** | (188) |
| Creditors | 8 | **(12,873)** | (11,607) |
| Other financial liabilities | 6 | **(277)** | (129) |
| | | **(13,199)** | (11,924) |
| **Net current liabilities** | | **(1,237)** | (1,446) |
| **Total assets less current liabilities** | | **4,431** | 4,156 |
| **Liabilities falling due after one year** | | | |
| Loans | 7 | **(258)** | (448) |
| Creditors | 8 | **(6)** | (9) |
| Other financial liabilities | 6 | **(346)** | (57) |
| | | **(610)** | (514) |
| **Provisions for liabilities and charges** | 9 | **(120)** | (70) |
| | | **3,701** | 3,572 |
| **Capital and reserves** | | | |
| Issued share capital | 11 | **90** | 90 |
| Share premium account | 13 | **1,238** | 1,222 |
| Statutory reserve | 14 | **202** | 202 |
| Other reserves | 13 | **164** | 118 |
| Profit and loss account | 13 | **2,007** | 1,940 |
| **Equity shareholders' funds** | | **3,701** | 3,572 |

Approved by the Board on 18 February 2009 and signed on its behalf by:

**I G King**
Chief Executive

**G W Rose**
Group Finance Director

## 1. Accounting policies

**Basis of preparation**
The financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss, and in accordance with applicable accounting standards in the United Kingdom (UK GAAP). The going concern basis has been applied in these accounts.

In the Company's accounts, all fixed asset investments (including subsidiary undertakings and joint ventures) are stated at cost (or valuation in respect of certain listed investments) less provisions for impairments. Dividends received and receivable are credited to the Company's profit and loss account. In accordance with Section 230(4) of the Companies Act 1985 the Company is exempt from the requirement to present its own profit and loss account. The amount of profit for the financial year of the Company is disclosed in note 13 to these accounts.

Relief under Sections 131 and 133 of the Companies Act 1985 is taken wherever possible. Accordingly, where such relief is available, the difference between the fair value and aggregate nominal value of shares is not recognised in either shareholders' funds or cost of investment.

**Changes in accounting policies**
Amendments to FRS 26 *Financial Instruments: Recognition and Measurement,* and FRS 29 *Financial Instruments: Disclosures,* have been made that would permit the reclassification of certain financial instruments from 1 July 2008. The amendment has been issued as part of the response to the deterioration of the world's financial markets. This does not have any impact on the Company's accounts.

FRS 8 *Related Party Disclosures* has been amended to reflect changes to the law introduced by The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. This amendment is effective for accounting periods beginning on or after 6 April 2008. The Company is exempt from presenting FRS 8 disclosures as full equivalent disclosures are presented on a Group basis within the consolidated financial statements.

The following amendments to existing standards are effective for accounting periods beginning on or after 1 January 2009:

– Amendments to FRS 20 *Share-based Payment: Vesting Conditions and Cancellations*; and

– Improvements to FRSs 2008.

These amendments are not expected to have a significant impact on the Company's accounts.

Urgent Issues Task Force (UITF) Abstract 44 *FRS 20, Group and Treasury Share Transactions,* is applicable for the year ended 31 December 2008. This did not have a significant impact on the Company's accounts.

UITF Abstract 46 (International Financial Reporting Interpretations Committee (IFRIC) interpretation 16), *Hedges of a Net Investment in a Foreign Operation* will be applicable for the year ending 31 December 2009. It is not expected to have any significant impact on the Company's accounts.

**Cash flow statement**
The Company is exempt under the terms of FRS 1 from the requirement to publish its own cash flow statement, as its cash flows are included within the consolidated cash flow statement of the Group.

**Foreign currencies**
Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the profit and loss account unless they qualify for hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

**Tangible fixed assets**
Depreciation is provided, normally on a straight-line basis, to write off the cost or valuation of tangible fixed assets over their estimated useful economic lives to any estimated residual value using the following rates:

| | |
|---|---|
| Buildings | up to 50 years, or the lease term if shorter |
| Computing equipment, motor vehicles and short life works equipment | 3 to 5 years |

No depreciation is provided on freehold land and assets in the course of construction.

Impairment reviews are undertaken if there are indications that the carrying values may not be recoverable.

**Leases**
Assets obtained under finance leases are included in tangible fixed assets at cost and are depreciated over their useful economic lives, or the term of their lease, whichever is shorter. Future instalments under such leases, net of finance charges, are included within loans. Rental payments are apportioned between the finance element, which is charged as interest to the profit and loss account, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant rate of charge on the outstanding obligation.

Rental payments under operating leases are charged to the profit and loss account on a straight-line basis in arriving at operating profit.

**Investments**
The Company's investment in shares in group companies are stated at cost less provision for impairment.

**Tax**
The charge for taxation is based on the profit for the year and takes account of taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes. Deferred tax is recognised on an undiscounted basis in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date where there is an obligation to pay more tax, or a right to pay less tax, in the future.

**Pensions and other post-retirement benefits**
The Company contributes to Group pension plans operated in the UK. Details of the principal plans and the financial assumptions used are contained in the consolidated accounts of BAE Systems plc. As permitted by FRS 17 *Retirement Benefits*, the plans are accounted for as defined contribution plans, as the employer cannot identify its share of the underlying assets and liabilities of the plans. The employer's contributions are set in relation to the current service period and also to fund a series of agreed measures to address the pension scheme deficits.

## 1. Accounting policies *continued*

### Share options and own shares held

The Company issues equity-settled share options to Group employees. In accordance with the requirements of FRS 20 *Share-based Payment*, the Company has applied FRS 20 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005. Equity-settled share options are measured at fair value at the date of grant using an option pricing model. The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of the number of shares that will actually vest.

In accordance with UITF Abstract 25 *National Insurance Contributions on Share Option Gains*, the Company provides in full for the employer's national insurance liability estimated to arise on the future exercise of share options granted, except where the employee has agreed to settle the employer's national insurance liability as a condition of the grant of the options.

As required under UITF Abstract 38 *Accounting for ESOP Trusts*, the cost to the Company of own shares held is shown as a deduction from shareholders' funds within the profit and loss account. Consideration paid or received for the purchase or sale of the Company's own shares in the ESOP trust is shown separately in the reconciliation of movements in shareholders' funds.

### Preference share capital

During the prior year, the Company's 7.75p (net) cumulative preference shares of 25p each were converted into the Company's ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for every preference share.

In accordance with FRS 25 *Financial Instruments: Disclosure and Presentation*, the preference shares were considered a compound financial instrument and, accordingly, split into an underlying debt instrument, classified within loans and overdrafts, and an equity conversion option, classified within equity.

The underlying debt instrument was presented on an amortised cost basis until extinguished on conversion.

The equity conversion option was presented at its historic fair value, based on the date of original issue of the preference shares. On conversion of the preference shares into ordinary shares, the equity component was reclassified to share capital and share premium.

### Dividends

Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared.

## 2. Tangible fixed assets

| | Land and buildings £m | Plant and equipment £m | Total £m |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2008 and 31 December 2008 | 9 | 27 | 36 |
| **Depreciation and impairment** | | | |
| At 1 January 2008 | 6 | 24 | 30 |
| Depreciation | – | 1 | 1 |
| At 31 December 2008 | 6 | 25 | 31 |
| **Net book value** | | | |
| **At 31 December 2008** | **3** | **2** | **5** |
| At 31 December 2007 | 3 | 3 | 6 |

The amounts above at 31 December 2008 include:

| | Land and buildings £m | Plant and equipment £m | Total £m |
|---|---|---|---|
| **Capitalised finance leases** | | | |
| Cost | – | 24 | 24 |
| Accumulated depreciation | – | 24 | 24 |
| **Assets let under operating leases** | | | |
| Cost | – | – | – |
| Accumulated depreciation | – | – | – |
| **Net book value of:** | | | |
| Long leasehold property | 3 | – | 3 |
| Fixtures, fittings and equipment | – | 2 | 2 |
| | **3** | **2** | **5** |

Land and buildings comprise:

- freehold and long leasehold land and buildings owned by the Company as at 30 June 1996, excluding certain overseas properties, revalued at that date. The majority of the Group's operational properties at that time were valued on a depreciated replacement basis, owing to their specialisation, with the remainder on an existing use value basis. Other non-operational properties were valued on the basis of open market value;
- short leaseholds at cost;
- additions subsequent to 30 June 1996 at cost; and
- land and buildings owned by subsidiary undertakings acquired since 30 June 1996 at fair value at the date of acquisition.

## 3. Fixed asset investments

| | Subsidiary undertakings £m | Other £m | Total £m |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2008 | 5,659 | – | 5,659 |
| Additions | 65 | – | 65 |
| At 31 December 2008 | 5,724 | – | 5,724 |
| **Impairment provisions** | | | |
| At 1 January 2008 | 64 | (1) | 63 |
| Released | (3) | 1 | (2) |
| At 31 December 2008 | 61 | – | 61 |
| **Net carrying value** | | | |
| **At 31 December 2008** | **5,663** | **–** | **5,663** |
| At 31 December 2007 | 5,595 | 1 | 5,596 |

## 4. Debtors

| | 2008 £m | 2007 £m |
|---|---|---|
| **Due within one year** | | |
| Corporation tax recoverable | **98** | 34 |
| Amounts owed by subsidiary undertakings | **9,197** | 7,580 |
| Amounts owed by Group joint ventures | **6** | 3 |
| Other debtors | **8** | 23 |
| Prepayments and accrued income | **30** | 30 |
| | **9,339** | 7,670 |
| **Due after one year** | | |
| Other debtors | **3** | 116 |
| | **3** | 116 |

Other debtors includes cash collateral of £nil (2007 £109m).

## 5. Current asset investments

| | 2008 £m | 2007 £m |
|---|---|---|
| Other securities | **–** | 130 |

## 6. Other financial assets and liabilities

| | 2008 Assets £m | 2008 Liabilities £m | 2007 Assets £m | 2007 Liabilities £m |
|---|---|---|---|---|
| **Due within one year** | | | | |
| Cash flow hedges – foreign exchange contracts | **211** | **(220)** | 62 | (41) |
| Other foreign exchange/interest rate contracts | **172** | **(57)** | 77 | (88) |
| | **383** | **(277)** | 139 | (129) |
| **Due after one year** | | | | |
| Cash flow hedges – foreign exchange contracts | **98** | **(100)** | 34 | (20) |
| Other foreign exchange/interest rate contracts | **2** | **(246)** | 29 | (37) |
| Debt-related derivative financial instruments – assets[1] | **149** | **–** | – | – |
| | **249** | **(346)** | 63 | (57) |
| **Debt-related derivative financial instruments – liabilities[1]** | | | | |
| Other foreign exchange/interest rate contracts | **–** | **–** | – | (191) |

1 The debt-related derivative financial instrument assets are presented as other financial assets. The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (note 7).

Full disclosures relating to the Group's other financial assets and liabilities and financial risk management strategies are given in the Financial review section of the Directors' report and note 32 to the Group accounts.

## 7. Loans and overdrafts

| | 2008 £m | 2007 £m |
|---|---|---|
| **Due within one year** | | |
| Bank loans and overdrafts | **20** | 15 |
| Euro-Sterling £150m 11⅞% bond, repayable 2008 | **–** | 150 |
| European Investment Bank loans, final instalment 2009 | **4** | 7 |
| SYSTEMS 2001 Asset Trust Option Aircraft bond | **25** | 16 |
| | **49** | 188 |
| **Due after one year** | | |
| European Investment Bank loan, final instalment 2009 | **–** | 4 |
| Euro-Sterling £100m 10¾% bond, repayable 2014 | **100** | 99 |
| SYSTEMS 2001 Asset Trust Option Aircraft bond, final instalment 2013 | **158** | 153 |
| Debt-related derivative financial instruments – liabilities | **–** | 191 |
| Alvis loan notes, redeemable 2009 | **–** | 1 |
| | **258** | 448 |

Bank loans and overdrafts are at a floating rate of interest.

The European Investment Bank borrowing is fixed with an interest rate of 6.86%.

The SYSTEMS 2001 Asset Trust bonds are at a floating rate of interest, having been converted to a sterling floating rate bond by utilising a cross-currency swap which resulted in an effective interest rate during 2008 of 6.97% (2007 6.75%).

Loans and overdrafts are repayable as follows:

| | Less than one year £m | Between one and two years £m | Between two and five years £m | More than five years £m | Total £m |
|---|---|---|---|---|---|
| **At 31 December 2008** | | | | | |
| Carrying amount[1] | 49 | 25 | 133 | 100 | 307 |
| Debt-related derivative financial instruments – assets | – | – | (32) | (117) | (149) |
| **Carrying amount including debt-related derivative financial instruments – assets** | **49** | **25** | **101** | **(17)** | **158** |
| At 31 December 2007 | | | | | |
| Carrying amount | 188 | 26 | 87 | 335 | 636 |

1 The carrying amount of loans and overdrafts at 31 December 2008 excludes debt-related derivative financial assets of £149m presented as other financial assets.

The total amount of loans repayable by instalments, where any instalment is due after five years, is £188m (2007 £169m).

## 8. Creditors

| | 2008 £m | 2007 £m |
|---|---|---|
| **Due within one year** | | |
| Amounts owed to subsidiary undertakings | **11,196** | 10,584 |
| Amounts owed to Group joint ventures | **1,468** | 844 |
| Other creditors | **173** | 141 |
| Accruals and deferred income | **36** | 38 |
| | **12,873** | 11,607 |
| **Due after one year** | | |
| Other creditors | **6** | 9 |
| | **6** | 9 |

## 9. Provisions for liabilities and charges

| | Contracts and other £m |
|---|---|
| At 1 January 2008 | 70 |
| Created | 55 |
| Transfers from subsidiary undertakings | 20 |
| Utilised | (9) |
| Released | (20) |
| Discounting | 4 |
| **At 31 December 2008** | **120** |

Provisions created mainly relate to legal costs and the termination of adviser agreements.

## 10. Contingent liabilities and commitments

**Company guaranteed borrowings**

Borrowings by subsidiary undertakings totalling £2,621m (2007 £1,981m) which are included in the Group's borrowings have been guaranteed by the Company.

## 11. Share capital

| | Equity | | Non-equity | | Total |
|---|---|---|---|---|---|
| | Ordinary shares of 2.5p each | | Special Share of £1 | | |
| | Number of shares m | Nominal value £m | Number of shares | Nominal value £ | Nominal value £m |
| **Authorised** | | | | | |
| At 1 January 2008 | 4,450 | 111 | 1 | 1 | 111 |
| Authorised in the year | 350 | 9 | – | – | 9 |
| **At 31 December 2008** | **4,800** | **120** | **1** | **1** | **120** |
| **Issued and fully paid** | | | | | |
| At 1 January 2007 | 3,246 | 81 | 1 | 1 | 81 |
| Exercise of options | 29 | 1 | – | – | 1 |
| Placing of shares | 174 | 5 | – | – | 5 |
| Conversion of preference shares | 125 | 3 | – | – | 3 |
| At 1 January 2008 | 3,574 | 90 | 1 | 1 | 90 |
| Exercise of options | 8 | – | – | – | – |
| **At 31 December 2008** | **3,582** | **90** | **1** | **1** | **90** |

**Special Share**

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Enterprise and Regulatory Reform (the Special Shareholder). Certain parts of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These articles include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the Chief Executive and any executive chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

**Placing of shares**

On 11 May 2007, 174,418,605 new ordinary shares of 2.5p each were placed at a price of 430p, raising £750m before expenses.

**Conversion of preference shares**

As at 1 January 2007, the Company had in issue 259,962,909 7.75p (net) cumulative redeemable preference shares of 25p each. During the prior year, the shares were converted into ordinary shares of 2.5p each on the basis of 0.47904 ordinary shares for each preference share, as a result of which 124,532,630 ordinary shares of 2.5p each were issued. There were, therefore, no preference shares in issue as at 31 December 2007 or 31 December 2008.

In accordance with FRS 25 *Financial Instruments: Disclosure and Presentation,* the convertible preference shares were considered to be a compound financial instrument consisting of both a debt element and an equity component which required separate accounting treatment. Following conversion to ordinary shares the amounts previously recognised within equity and within loans and overdrafts have been extinguished.

**Treasury shares**

As at 31 December 2008, 55,038,953 (2007 61,945,000) ordinary shares of 2.5p each with an aggregate nominal value of £1,375,974 (2007 £1,548,625) were held in treasury. During 2008, 6,906,047 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme.

## 12. Employee share schemes

Options over shares of the ultimate parent undertaking, BAE Systems plc, have been granted to employees of the Company under various schemes. Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 75 to 93 of this report.

| | Executive Share Option Scheme | | | | Save-As-You-Earn | | | |
|---|---|---|---|---|---|---|---|---|
| | **2008** | | 2007 | | **2008** | | 2007 | |
| | **Number of shares '000** | **Weighted average exercise price £** | Number of shares '000 | Weighted average exercise price £ | **Number of shares '000** | **Weighted average exercise price £** | Number of shares '000 | Weighted average exercise price £ |
| Outstanding at the beginning of the year | **15,046** | **3.35** | 27,513 | 2.84 | **296** | **1.25** | 654 | 1.78 |
| Granted during the year | **–** | **–** | 2,994 | 4.59 | **–** | **–** | – | – |
| Exercised during the year | **(3,164)** | **2.69** | (9,840) | 2.31 | **(145)** | **0.95** | (351) | 2.23 |
| Expired during the year | **(620)** | **4.37** | (5,621) | 3.34 | **(9)** | **1.26** | (7) | 1.44 |
| Outstanding at the end of the year | **11,262** | **3.48** | 15,046 | 3.35 | **142** | **1.56** | 296 | 1.25 |
| Weighted average remaining life (years) | | **6** | | 7 | | **1** | | 1 |
| Weighted average fair value of options granted (£) | | **–** | | 1.47 | | **–** | | – |
| Range of exercise price of outstanding options (£) | | **1.72 – 4.79** | | 1.72 – 4.87 | | **1.56** | | 0.93 – 2.57 |
| Expense recognised for the year (£m) | | **3** | | 4 | | **–** | | – |

| | Share Matching Plan | | Performance Share Plan | | Restricted Share Plan | |
|---|---|---|---|---|---|---|
| | **2008 Number of shares '000** | 2007 Number of shares '000 | **2008 Number of shares '000** | 2007 Number of shares '000 | **2008 Number of shares '000** | 2007 Number of shares '000 |
| Outstanding at the beginning of the year | **280** | – | **9,874** | 12,197 | **351** | 882 |
| Granted during the year | **819** | 281 | **2,665** | 1,996 | **–** | – |
| Exercised during the year | **(110)** | – | **(3,316)** | (3,742) | **(270)** | (508) |
| Expired during the year | **(2)** | (1) | **(715)** | (577) | **(1)** | (23) |
| Outstanding at the end of the year | **987** | 280 | **8,508** | 9,874 | **80** | 351 |
| Weighted average remaining life (years) | **2** | 2 | **4** | 4 | **–** | – |
| Weighted average fair value of options granted (£) | **4.79** | 4.59 | **3.85** | 2.31 | **–** | – |
| Expense recognised for the year (£m) | **1** | – | **5** | 3 | **–** | – |

The exercise price for the Share Matching Plan, Performance Share Plan and Restricted Share Plan is £nil (2007 £nil).

Information on options granted in the year can be found on page 146 (note 26 to the Group accounts).

## 13. Reserves

| | Share premium account £m | Other reserves £m | Profit and loss account £m |
|---|---|---|---|
| At 31 December 2007 | 1,222 | 118 | 1,940 |
| Profit for the year | – | – | 537 |
| Dividends paid | – | – | (478) |
| Share-based payments | – | – | 51 |
| Exercise of options | 16 | – | – |
| Purchase of own shares | – | – | (43) |
| Movements in hedging reserve | – | 46 | – |
| **At 31 December 2008** | **1,238** | **164** | **2,007** |

**Other reserves**
Other reserves for the Company comprise: capital reserve £24m (2007 £24m); hedging reserve £54m (2007 £8m); and non-distributable reserve arising from property disposals to other Group undertakings £86m (2007 £86m). The non-distributable reserve arising from property disposals to other Group undertakings relates to the revaluation surplus realised by the Company on properties which were sold to other Group companies as part of operational reorganisations in prior years. Amounts within this reserve will be transferred to the profit and loss account as distributable when the related properties are disposed of outside the Group, or written down following impairment.

**Own shares held**
Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

**Treasury shares**
During the prior year, 33,270,000 ordinary shares of 2.5p each were repurchased under the buyback programme announced in October 2006. As at 31 December 2008, 55,038,953 (2007 61,945,000) ordinary shares of 2.5p each with an aggregate nominal value of £1,375,974 (2007 £1,548,625) were held in treasury.

**BAE Systems ESOP Trust**
The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2008.

At 31 December 2008, the ESOP held 2,093,818 (2007 1,552,015) ordinary shares of 2.5p each with a market value of £8m (2007 £8m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2008 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and December 2008 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

**Company profit**
The Company's profit for the financial year was £537m (2007 £92m).

## 14. Statutory reserve

Under Section 4 of the British Aerospace Act 1980 this reserve may only be applied in paying up unissued shares of the Company to be allotted to members of the Company as fully paid bonus shares.

## 15. Other information

**Employees**
The total number of employees of the Company at 31 December 2008 was 655 (2007 520). Total staff costs, excluding charges for share options, were £99m (2007 £68m).

Total directors' emoluments, excluding company pension contributions, were £9,509,000 (2007 £8,583,000). These emoluments were paid for their services on behalf of the BAE Systems Group. No emoluments related specifically to their work for the Company.

**Company audit fee**
Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,333,000 (2007 £1,111,000).

# Five-year summary

| Income statement[1,2,3,4] | 2008 £m | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
|---|---|---|---|---|---|
| **Sales including Group's share of equity accounted investments** | | | | | |
| Electronics, Intelligence & Support | **4,459** | 3,916 | 4,007 | 3,697 | 3,063 |
| Land & Armaments | **6,407** | 3,538 | 2,115 | 1,270 | 482 |
| Programmes & Support | **4,638** | 5,327 | 4,615 | 4,660 | – |
| International | **3,333** | 3,359 | 3,428 | 3,138 | – |
| Programmes | **–** | – | – | – | 2,219 |
| Customer Solutions & Support | **–** | – | – | – | 2,856 |
| Integrated Systems & Partnerships | **–** | – | – | – | 2,022 |
| HQ & Other Businesses | **235** | 243 | 295 | 471 | 464 |
| Intra-operating group sales | **(529)** | (673) | (695) | (655) | (417) |
| | **18,543** | 15,710 | 13,765 | 12,581 | 10,689 |
| **Underlying EBITA[6] (restated)** | | | | | |
| Electronics, Intelligence & Support | **506** | 437 | 429 | 324 | 256 |
| Land & Armaments | **566** | 324 | 168 | 86 | (8) |
| Programmes & Support | **491** | 456 | 331 | 261 | – |
| International | **435** | 435 | 412 | 403 | – |
| Programmes | **–** | – | – | – | 10 |
| Customer Solutions & Support | **–** | – | – | – | 497 |
| Integrated Systems & Partnerships | **–** | – | – | – | 95 |
| HQ & Other Businesses | **(101)** | (203) | (146) | (117) | (50) |
| | **1,897** | 1,449 | 1,194 | 957 | 800 |
| Profit/(loss) on disposal of businesses | **238** | 40 | 13 | (4) | – |
| Uplift on acquired inventories | **–** | (12) | – | (44) | – |
| **EBITA[5]** | **2,135** | 1,477 | 1,207 | 909 | 800 |
| Amortisation and impairment of intangible assets | **(424)** | (297) | (139) | (122) | (110) |
| Finance costs including share of equity accounted investments | **697** | 93 | (174) | (196) | (132) |
| **Profit before taxation** | **2,408** | 1,273 | 894 | 591 | 558 |
| Taxation expense including share of equity accounted investments | **(640)** | (373) | (248) | (147) | (219) |
| **Profit for the year from continuing operations** | **1,768** | 900 | 646 | 444 | 339 |
| **Profit/(loss) for the year from discontinued operations** | **–** | 22 | 993 | 111 | (336) |
| **Profit for the year** | **1,768** | 922 | 1,639 | 555 | 3 |
| | | | | | |
| **Balance sheet** | | | | | |
| Intangible assets | **12,306** | 9,559 | 7,595 | 8,217 | 6,115 |
| Property, plant and equipment, and investment property | **2,558** | 1,887 | 1,869 | 1,922 | 1,901 |
| Non-current investments | **1,040** | 787 | 678 | 1,730 | 1,535 |
| Inventories | **926** | 701 | 395 | 485 | 498 |
| Payables (excluding cash on customers' account) less receivables | **(5,866)** | (5,373) | (4,298) | (4,596) | (3,891) |
| Other financial assets and liabilities | **240** | 52 | 6 | (7) | – |
| Retirement benefit obligations | **(3,365)** | (1,629) | (2,499) | (4,101) | (3,210) |
| Provisions | **(845)** | (809) | (695) | (718) | (491) |
| Net tax | **256** | 63 | 648 | 1,012 | 876 |
| Net cash/(debt) | **39** | 700 | 435 | (1,277) | (668) |
| Disposal groups held for sale | **–** | 64 | – | 137 | – |
| Minority interests | **(55)** | (36) | (17) | (16) | (10) |
| **Total equity attributable to equity holders of the parent** | **7,234** | 5,966 | 4,117 | 2,788 | 2,655 |

| Movement in net cash/(debt) as defined by the Group | 2008 £m | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
|---|---|---|---|---|---|
| Cash flow from operating activities | **2,009** | 2,162 | 778 | 2,099 | 2,350 |
| Net capital expenditure[7] | **(503)** | (262) | (141) | (250) | (285) |
| Dividends from equity accounted investments | **89** | 78 | 145 | 88 | 69 |
| Operating business cash flow | **1,595** | 1,978 | 782 | 1,937 | 2,134 |
| Acquisitions and disposals | **(1,038)** | (2,112) | 1,330 | (1,836) | (630) |
| Finance costs | **(98)** | (65) | (207) | (152) | (179) |
| Tax and dividends | **(750)** | (509) | (431) | (342) | (312) |
| Other movements[8] | **5** | 57 | (11) | (52) | 9 |
| (Purchase)/issue of equity shares | **(27)** | 603 | (71) | 373 | – |
| Preference share conversion | **–** | 245 | 6 | – | – |
| Exchange movements | **(374)** | 36 | 323 | (219) | 129 |
| Net (decrease)/increase in net funds | **(687)** | 233 | 1,721 | (291) | 1,151 |
| Movement in cash on customers' account | **26** | 32 | (9) | (35) | (13) |
| Movement in net cash/(debt) | **(661)** | 265 | 1,712 | (326) | 1,138 |
| Opening net cash/(debt) | **700** | 435 | (1,277) | (668) | (870) |
| Impact of IFRS adoption | **–** | – | – | (283) | (936) |
| Closing net cash/(debt) | **39** | 700 | 435 | (1,277) | (668) |

| Other information | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|
| Basic earnings/(loss) per share – total (pence) | **49.6** | 26.6 | 50.7 | 17.4 | (0.6) |
| Basic earnings per share – underlying[9] (pence) | **37.1** | 30.1 | 23.5 | 18.5 | 13.6 |
| Dividend per ordinary share (pence) | **14.5** | 12.8 | 11.3 | 10.3 | 9.5 |
| Number of employees, excluding share of employees of equity accounted investments, at year end | **94,000** | 88,000 | 79,000 | 80,000 | 73,300 |
| Capital expenditure including leased assets (£m) | **552** | 341 | 538 | 347 | 359 |
| Order book including the Group's share of equity accounted investments (£bn) | **46.5** | 38.6 | 31.7 | 30.8 | 29.5 |

1 For the year ended 31 December 2004, the operating group information presented under IFRS has not been restated to reflect the changes made to the operating groups in 2005, 2006 and 2007.
2 For the years ended 31 December 2004 to 2006, Airbus SAS is presented as a discontinued operation under IFRS.
3 For the years ended 31 December 2004 and 2005, the Avionics business is presented as a discontinued operation under IFRS.
4 For the years ended 31 December 2005 and 2006, the operating group information presented under IFRS has been restated to reflect changes made to the Group's organisational structure.
5 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
6 EBITA excluding profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.
7 Includes expenditure on property, plant and equipment, investment property, intangible assets and other investments.
8 Other movements include cash flows from matured derivative financial instruments, cash flows from movement in cash collateral and other non-cash movements. See page 149.
9 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, profit/(loss) on disposal of businesses and uplift on acquired inventories. Restated to exclude profit/(loss) on disposal of businesses. See page 29.

# Shareholder information

**Registered office**
6 Carlton Gardens
London SW1Y 5AD
United Kingdom
Telephone: +44 (0)1252 373232
Company website: www.baesystems.com

Registered in England and Wales, No. 1470151

**Registrars**
Equiniti Limited (0140)
Aspect House, Spencer Road, Lancing
West Sussex BN99 6DA
United Kingdom

Telephone: 0871 384 2044
Calls to the above number are charged at 8p per minute from a BT landline. Other telephony providers' costs may vary.

Telephone number from outside the UK: +44 121 415 7058

If you have any queries regarding your shareholding, please contact the registrars.

**Shareview service**
The Shareview service from our registrar, Equiniti, gives shareholders:

- direct access to data held on their behalf on the share register including recent share movements and dividend details; and
- the ability to change their address or dividend payment instructions online.

To sign up for Shareview you need the 'shareholder reference' printed on your proxy form or dividend stationery. There is no charge to register.

When you register with the site, you can register your preferred format (post or e-mail) for shareholder communications. If you select 'e-mail' as your mailing preference, you will be sent shareholder communications, such as proxy forms and annual results, by e-mail instead of post, as long as this option is available.

If you have your dividends paid straight to your bank account, and you have selected 'e-mail' as your mailing preference, you can also collect your tax voucher electronically. Instead of receiving the paper tax voucher, you will be notified by e-mail with details of how to download your electronic version.

However, if you choose 'post' as your preference, you will be sent paper documents as usual.

Visit the website at www.shareview.co.uk for more details.

Details of software and equipment requirements are given on the website.

**Dividend reinvestment plan**
The Company offers holders of its ordinary shares the option to elect to have their dividend reinvested in shares purchased in the market instead of cash. If you would like to make this election, please request a dividend reinvestment plan mandate from our registrars:

Equiniti Financial Services Limited
Aspect House, Spencer Road, Lancing
West Sussex BN99 6DA
United Kingdom

Telephone: 0871 384 2268
Calls to the above number are charged at 8p per minute from a BT landline. Other telephony providers' costs may vary.

Telephone number from outside the UK: +44 121 415 7058

**ShareGift**
The Orr Mackintosh Foundation operates a charity donation scheme for shareholders with small parcels of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at www.sharegift.org or by telephone on 020 7930 3737.

**Share price information**
The middle market price of the Company's ordinary shares on 31 December 2008 was 376.75p and the range during the year was 302.5p to 507p.

**American Depositary Receipts**
The BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares.

JPMorgan Chase Bank, N.A. is the depositary.

If you should have any queries, please contact:

JPMorgan Chase & Co.
PO Box 64504
St Paul
MN 55164-0504
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Email: jpmorgan.adr@wellsfargo.com

Telephone number for general queries: (800) 990 1135
Telephone number from outside the US: +1 651 453 2128

Website: www.adr.com

## Financial calendar

| | |
|---|---|
| Financial year end | 31 December |
| Annual General Meeting | 6 May 2009 |
| 2008 final ordinary dividend payable | 1 June 2009 |
| 2009 half-yearly results announcement | 30 July 2009 |
| 2009 interim ordinary dividend payable | 30 November 2009 |
| 2009 full year results – preliminary announcement | February 2010 |
| – report and accounts | April 2010 |
| 2009 final ordinary dividend payable | June 2010 |

## Analysis of share register at 31 December 2008

| | Ordinary shares of 2.5p | | | |
|---|---|---|---|---|
| | Accounts | | Shares | |
| | Number '000 | % | Number million | % |
| **By category of shareholder** | | | | |
| Individuals | 105.4 | 92.1 | 103.0 | 2.9 |
| Nominee companies | 8.0 | 7.0 | 3,377.4 | 94.3 |
| Banks | – | – | 2.7 | 0.1 |
| Other | 1.0 | 0.9 | 98.7 | 2.7 |
| | 114.4 | 100.0 | 3,581.8 | 100.0 |
| **By size of holding** | | | | |
| 1 – 99 | 23.4 | 20.4 | 1.1 | – |
| 100 – 499 | 32.3 | 28.2 | 8.7 | 0.2 |
| 500 – 999 | 23.6 | 20.7 | 16.8 | 0.5 |
| 1,000 – 9,999 | 32.6 | 28.5 | 77.1 | 2.2 |
| 10,000 – 99,999 | 1.4 | 1.3 | 39.1 | 1.1 |
| 100,000 – 999,999 | 0.7 | 0.6 | 260.5 | 7.3 |
| 1,000,000 and over | 0.4 | 0.3 | 3,178.5 | 88.7 |
| | 114.4 | 100.0 | 3,581.8 | 100.0 |

# Glossary

**AGM**
Annual General Meeting.

**ATTAC**
Availability Transformation: Tornado Aircraft Contract.

**BvS10 Viking**
Amphibious armoured all-terrain vehicle.

**CVF**
The UK's future aircraft carrier.

**CVR(T)**
Combat Vehicle Reconnaissance (Tracked) family of armoured fighting vehicles.

**DIS**
Defence Industrial Strategy. Published by the UK government in December 2005 following consultation with industry, recognises the skills and capabilities that will be needed to equip and support the UK armed forces and ensure the UK defence industry remains world-leading.

**EPS**
Earnings per Share.

**EU**
European Union.

**FAP**
Final Average Pay.

**FMTV**
Family of Medium Tactical Vehicles.

**FPP**
Final Pensionable Pay.

**FRIP**
Financial Risk Insurance Programme.

**FRS**
Financial Reporting Standard.

**GAAP**
Generally Accepted Accounting Principles.

**GDP**
Gross Domestic Product.

**HERTI**
Highly autonomous medium-altitude long-endurance unmanned air system.

**HMMWV**
High Mobility Multi-purpose Wheeled Vehicle.

**Home market**
A home market is one in which the Group has a strong domestic presence and is a key part of the defence industry capability in that country. BAE Systems has six home markets: Australia; Saudi Arabia; South Africa; Sweden; the UK and the US.

**IAS**
International Accounting Standard.

**IBP**
Integrated Business Plan.

**IFRIC**
International Financial Reporting Interpretations Committee.

**IFRS**
International Financial Reporting Standard.

**JAVELIN**
Joint Approach to VC-10 Engineering and Logistics Integration with the UK's Royal Air Force.

**JLTV**
Joint Light Tactical Vehicle.

**JTRS**
Joint Tactical Radio Systems.

**JUMP**
Joint Upgrade and Maintenance Programme on the Harrier.

**KPI**
Key Performance Indicator.

**LCM**
Lifecycle Management.

**LHD**
Landing Helicopter Dock.

**Line leader**
An individual with specific profit and loss accountability for a business.

**LRIP**
Low-Rate Initial Production.

**LTA**
Lifetime allowance.

**LTIP**
Long-Term Incentive Plan.

**LTPA**
Long-Term Partnering Agreement.

**M777**
A lightweight 155mm field howitzer.

**MASS**
Munitions Acquisition – the Supply Solution.

**MMPV**
Medium Mine Protected Vehicle.

**MoD**
UK's Ministry of Defence.

**MRAP**
Mine Resistant Ambush Protected wheeled vehicle.

**NLOS-C**
Non-Line-of-Sight Cannon.

**OAS**
Operational Assurance Statement: a six-monthly review of internal controls and risk management processes.

**OPV**
Offshore Patrol Vessel.

**PMP**
Performance Management Process.

**PCL**
Performance Centred Leadership: a leadership and performance management system used throughout the Group.

**QBR**
Quarterly Business Review.

**RAF**
The UK's Royal Air Force.

**RCF**
Revolving Credit Facility.

**R&S**
Readiness and sustainment. The provision of through-life operational capability for the armed forces.

**RSAF**
The Royal Saudi Air Force.

**RG31**
Mine protected armoured personnel carrier.

**SMM**
Safety Maturity Matrix.

**STOVL**
Short Take-Off and Vertical Landing.

**TACP**
Tactical Air Control Party.

**TAS**
Typhoon Availability Service.

**TSR**
Total Shareholder Return.

**TRMC**
Treasury Review Management Committee.

**UAS**
Unmanned Aircraft Systems.

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## Key benefits

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**Access the Notice of Meeting and vote online**
You will find the Notice of Meeting for our 2009 Annual General Meeting available here. You can also vote electronically on the resolutions proposed at the meeting.

**Download our corporate reporting literature**
All BAE Systems' corporate reports will be available as downloadable pdfs from this section of the website.

**Links to further information**
From the Shareholder Reporting section of our website you can link to other areas of interest, including the Annual Report, financial calendar and much more.

**Download the latest presentations**
Keep up to date with our presentations on performance from our Results Centre.

**www.baesystems.com/reporting/**

**Shareholder feedback**
If you would like to give us any feedback on this year's Annual Report, please send your written comments to our investor relations team at:
BAE Systems plc
6 Carlton Gardens
London SW1Y 5AD
United Kingdom
or by e-mail to andrew.wrathall@baesystems.com

**Cover image**
The Detica NerveCentre is a dynamic, state-of-the-art facility for interactive working. Featuring high-definition touch screens, interactive and secure glass whiteboards, digital data capture and multi-terabyte data storage, the Detica NerveCentre stimulates creative exploration of "the art of the possible" in information intelligence.

**Production of this report**
The printer is a CarbonNeutral® company and its Environmental Management System is certified to ISO14001:2004. 100% of the electricity used is generated from renewable sources, 95% of press chemicals are recycled for further use and on average 99% of any waste associated with this production will be recycled. The paper contains 50% recycled fibre and 50% virgin fibre. The pulp for each paper is bleached using an Elemental Chlorine Free (ECF) process. The paper is FSC certified.

Mixed Sources
Product group from well-managed forests, controlled sources and recycled wood or fiber
FSC www.fsc.org Cert no. SGS-COC-2842
© 1996 Forest Stewardship Council

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