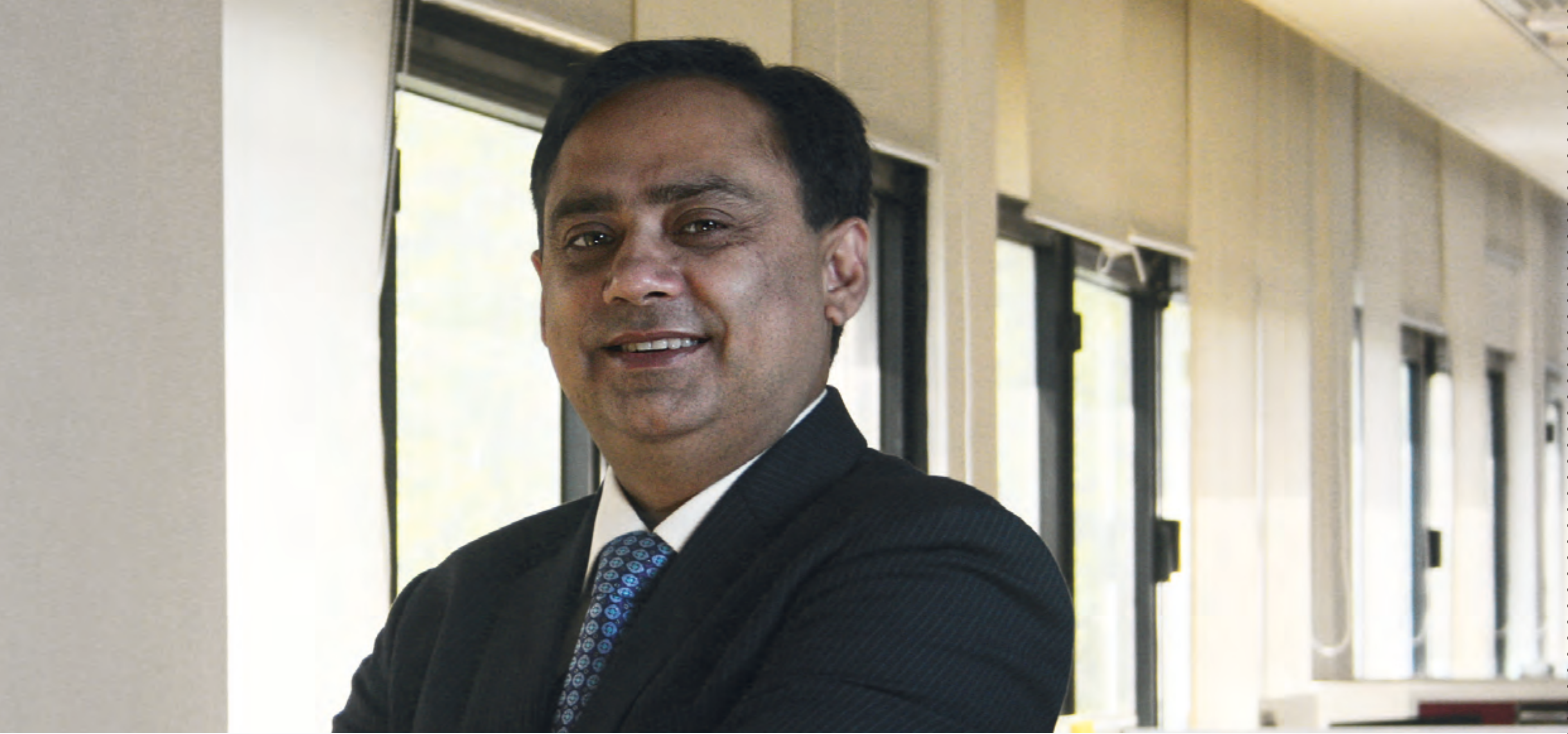


ANNUAL REPORT 2012

BAE SYSTEMS

BAE Systems continues to build on its position as one of the world's largest and most geographically diverse defence, aerospace and security companies.

BAE Systems is focused on delivering sustainable growth in shareholder value through its commitment to Total Performance.

Front cover: BAE Systems succeeds on the talent, commitment and dedication of every single employee.

For BAE Systems at a glance see overleaf ▶

Cautionary statement: All statements other than statements of historical fact included in this document, including, without limitation, those regarding the financial condition, results, operations and businesses of BAE Systems and its strategy, plans and objectives and the markets and economies in which it operates, are forward-looking statements. Such forward-looking statements which reflect management's assumptions made on the basis of information available to it at this time, involve known and unknown risks, uncertainties and other important factors which could cause the actual results, performance or achievements of BAE Systems or the markets and economies in which BAE Systems operates to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. BAE Systems plc and its directors accept no liability to third parties in respect of this report save as would arise under English law. Accordingly, any liability to a person who has demonstrated reliance on any untrue or misleading statement or omission shall be determined in accordance with schedule 10A of the Financial Services and Markets Act 2000. It should be noted that schedule 10A and section 463 Companies Act 2006 contain limits on the liability of the directors of BAE Systems plc so that their liability is solely to BAE Systems plc.

CONTENTS

Throughout the Annual Report we have used the following icons to help navigate to further information:

Links to pages within this report

Links to pages within our website

For further information visit: www.baesystems.com

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 by e-mail to: **investors@baesystems.com**

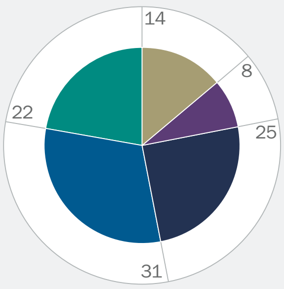
BAE SYSTEMS AT A GLANCE

BAE Systems is a global defence, aerospace and security company with approximately 88,200 employees[1] worldwide. The Group delivers a wide range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services.

Group

Sales[1,2,3] by reporting segment (%)

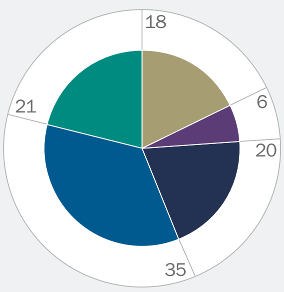
KPI



- Electronic Systems
- Cyber & Intelligence
- Platforms & Services (US)
- Platforms & Services (UK)
- Platforms & Services (International)

Underlying EBITA[1,3,4] by reporting segment (%)

KPI



- Electronic Systems
- Cyber & Intelligence
- Platforms & Services (US)
- Platforms & Services (UK)
- Platforms & Services (International)

See page 54 for more information on the Group's reporting segments

For more information visit www.baesystems.com/businesses

Electronic Systems

Principal operations

Electronic Systems comprises the US and UK-based electronics activities, including electronic warfare systems and electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems.

Operational key points

- Sustained a leadership position in the airborne electronic warfare market
- Strengthened position in high growth commercial aircraft electronics market
- Won key development contracts in the classified area
- Continued focus on increasing productivity and efficiency
- Business recovery complete following disruption from flood damage at the Johnson City facility

Sales[1,2]

£2,507m

Number of employees[1]

13,000

Cyber & Intelligence

Principal operations

Cyber & Intelligence comprises the US-based Intelligence & Security business and UK-headquartered BAE Systems Detica business, and covers the Group's cyber, secure government, and commercial and financial security activities.

Operational key points

- The US-based business continues to perform well on existing programmes and secured strategic contract awards with existing customers
- The US-based business continues to invest in differentiating technologies, such as activity-based intelligence and cybersecurity, including a leading-edge network operations and security centre environment, to support a pipeline of submitted bids of $2.9bn (£1.8bn) at the end of 2012
- BAE Systems Detica continues to invest in products and capability, including its Security Operations Centre
- BAE Systems Detica awarded a contract by Vodafone for next-generation enterprise secure networks for mobile devices

Sales[1,2]

£1,402m

Number of employees[1]

8,200

1 Including share of equity accounted investments.
2 Before elimination of intra-group sales.
3 Excluding HQ.
4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).

Platforms & Services (US)

Platforms & Services (US) comprises the US-headquartered Land & Armaments business, with operations in the US, UK, Sweden and South Africa, together with US-based services and sustainment activities, including ship repair and munitions services.

- Growth in US ship repair activities
- Executing munitions infrastructure and facility operations management contracts
- Strategic international win with Korean F-16 upgrade down-select
- Continued to protect Bradley franchise with $376m (£231m) in related awards
- Awarded a $750m (£462m) contract for CV90 armoured combat vehicles to Norway
- Letter of Request received from Indian government for 145 M777 howitzers
- Continued consolidation in the Land & Armaments business
- Business disposals of Safety Products, Safariland and Tensylon completed

£4,539m

21,300

Platforms & Services (UK)

Platforms & Services (UK) comprises the Group's UK-based air, maritime and combat vehicle activities, and certain shared services activities.

- 46 Typhoon Tranche 2 aircraft delivered to the partner nations
- £2.5bn Typhoon and Hawk contract for Oman secured
- £446m contract awarded for European support on Typhoon
- First F-35 Lightning II aircraft accepted by the UK Ministry of Defence (MoD)
- Fifth Type 45 destroyer accepted off-contract and support provided for all Royal Navy Type 45 deployments
- Settlement reached with the Government of the Republic of Trinidad and Tobago in respect of the cancelled Offshore Patrol Vessels (OPV) programme
- Two OPVs delivered to the Brazilian Navy
- £0.8bn of customer funding received for ongoing design and development of the Successor submarine, and continuing production of the fourth Astute Class submarine

£5,646m

27,900

Platforms & Services (International)

Platforms & Services (International) comprises the Group's businesses in Saudi Arabia, Australia, India and Oman, together with its 37.5% interest in the pan-European MBDA joint venture.

- Salam price escalation negotiations ongoing
- £5.0bn of orders received under the Saudi British Defence Co-operation Programme (SBDCP) for training aircraft and support to the end of 2016
- First Landing Helicopter Dock hull arrived in Australia for completion and second hull launched in Spain
- MBDA export order for MICA air-to-air missiles to India

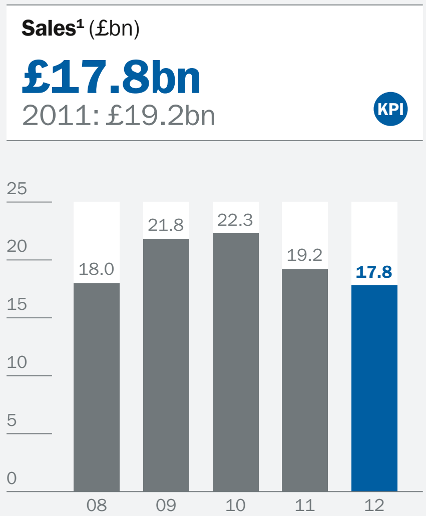
£4,071m

15,500

2012 SUMMARY AND OUTLOOK

Results in brief

	2012	2011
Results from continuing operations		
Sales[1] KPI	**£17,834m**	£19,154m
Underlying EBITA[2] KPI	**£1,895m**	£2,025m
Operating profit	**£1,640m**	£1,580m
Underlying earnings[3] per share: KPI		
– including R&D tax benefit	**n/a**	45.6p
– excluding R&D tax benefit	**38.9p**	39.7p
Basic earnings per share[4]	**32.8p**	37.0p
Order backlog[1,5]	**£42.4bn**	£39.1bn
Other results including discontinued operations		
Dividend per share	**19.5p**	18.8p
Operating business cash flow[6] KPI	**£2,692m**	£634m
Net cash/(debt) (as defined by the Group)[7]	**£387m**	£(1,439)m



KPI References Key Performance Indicators (KPIs) throughout the Annual Report

Financial key points

- Sales[1] reduced by 7%
- Underlying EBITA[2] reduced by 6% to £1,895m. Deferred recognition of sales and profit relating to the formalisation of price escalation on the Salam Typhoon programme
- Underlying earnings[3] per share down by 2% (excluding the benefit in 2011 of the UK tax settlement)
- Order backlog[1,5] increased by 8% to £42.4bn
- Non-US and UK order intake[1] increased to £11.2bn from £4.8bn in 2011
- Total dividend increased by 4% to 19.5p
- Operating business cash flow[6] increased to £2.7bn
- Net cash[7] balance of £387m
- Three-year share repurchase programme of up to £1bn initiated
- Longevity risk on £2.7bn of pension scheme liabilities transferred to the insurance market

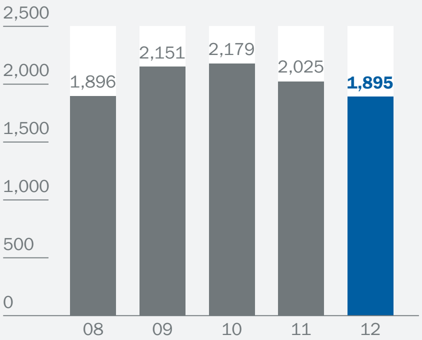
See page 30 for more information on the Group's financial performance

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
4 Basic earnings per share in accordance with International Accounting Standard 33, Earnings per Share.
5 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.
6 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
7 See page 32 and note 10 to the Group accounts.

Underlying EBITA[2] (£m)

£1,895m
2011: £2,025m

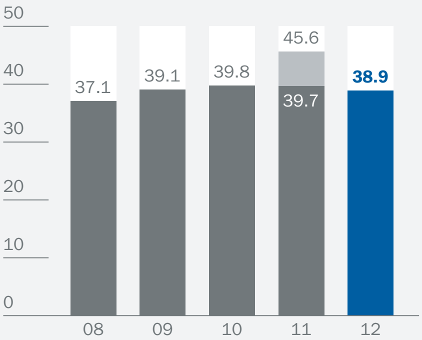
KPI



Underlying earnings[3] per share (pence)

38.9p
2011: 39.7p*

KPI

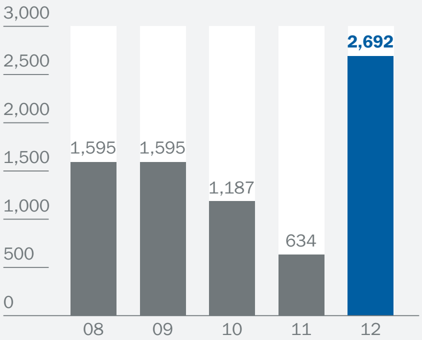


* Excluding R&D tax benefit
R&D tax benefit
Excluding R&D tax benefit

Operating business cash flow[6] (£m)

£2,692m
2011: £634m

KPI



See page 13 for more information on the Group's KPIs

Outlook

This outlook statement assumes US budgets are subject to Continuing Resolution for the first quarter of 2013 only and does not reflect the impact that might result from a US sequestration.

Subject to near-term uncertainties relating to US defence budgets, modest growth in underlying earnings[3] per share is anticipated for 2013. This excludes any benefit from the share repurchase programme in 2013. In addition, and assuming a satisfactory conclusion to Salam pricing negotiations this year, there would be a further increase of around 3 pence in underlying earnings[3] per share.

- Electronic Systems sales[1] are expected to be at a similar level to those in 2012 with margins expected to be slightly lower within a range of 12% to 14%.
- Cyber & Intelligence sales[1] are expected to be marginally lower than those in 2012 with margins expected to be within an 8% to 9% range.
- In Platforms & Services (US), Land & Armaments sales[1] are expected to be approximately 10% below the 2012 level with margins around 8%. Support Solutions sales[1] are expected to be marginally higher than in 2012, with slightly reduced margins.
- Platforms & Services (UK) sales[1] in 2013 are expected to increase by around 25%, assuming a price escalation settlement and resumption of aircraft deliveries on the Salam Typhoon contract. Margins are expected to be similar to those in 2012.
- Platforms & Services (International) sales[1] are expected to be marginally higher than in 2012. Margins are expected to benefit from the anticipated resolution of Salam Typhoon price escalation, and are expected to be at the top end of a 10% to 12% range.
- HQ costs are expected to be more than 10% lower than in 2012 and Group earnings[3] are expected to reflect marginally lower underlying finance costs. An effective tax rate within a 23% to 25% range is expected.

Notwithstanding cash inflows from an anticipated Salam price escalation settlement, significant cash utilisation is expected in 2013. This includes an expected high level of utilisation against the advances, received in 2012, on the Saudi trainer aircraft and Omani Typhoon and Hawk contracts and advances consumed on the European Typhoon production contracts.

"BAE Systems has delivered a robust performance in a challenging environment."

Dick Olver
Chairman

COMMITTED TO ENHANCING SHAREHOLDER VALUE

BAE Systems has delivered a robust performance in a challenging environment. The combination of rapid changes in defence priorities around the world, together with the economic pressures that constrain government customers, has hindered growth but I believe 2012 stands out as a year of validation of the direction and stature of the Group.

It is this consistently robust performance which enabled the Group to explore the possibility of a merger opportunity with EADS. The merger held the prospect of creating a combined business that would have been a global technology leader across both the commercial aerospace and defence sectors and which, we believe, would have delivered significantly enhanced value for shareholders.

Behind that consistent operational performance lies a soundly-based strategy that has been forged over the past decade and which has enabled the Group to develop as one of the global leaders in defence, aerospace and security.

BAE Systems today operates with a broad base of business across multiple international markets. The Group has a large order backlog of platform programmes addressing all three defence domains of air, sea and land. In addition, the Group has expanded to provide a range of services-based capabilities, complementing and, to a large extent derived from, its products-based positions. More recently, BAE Systems has expanded its services offering into the provision of capabilities for government intelligence communities as well as commercial customers seeking cybersecurity solutions.

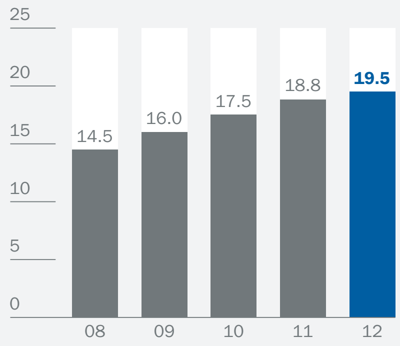
The Board reviews this strategy regularly and refreshes those actions that are required to deliver the strategy. That review considers many options, including the prospects for transformational transactions. It was against this backdrop that the option regarding a possible merger with EADS emerged.

The merger discussions were at no time seen as a replacement for the Group's established strategy. BAE Systems remains focused on its strategy and prospects for the business remain good. In particular, the outlook in international markets remains buoyant as evidenced by a two-fold increase in international order intake outside the US and UK markets in 2012. Further opportunities to mitigate or offset likely pressures on sales growth in US and UK markets remain.

BAE Systems is committed to enhancing shareholder value by maximising earnings performance. Efficiency measures continue to be implemented, aimed at delivering affordable solutions for customers and attractive returns for shareholders.

The combination of the Group's focus on cash generation and its capital allocation policy provides opportunities for further enhanced shareholder returns and, in February 2013, the Group announced a three-year share repurchase programme of up to £1bn. In addition to this accelerated return to shareholders, the Group's capital allocation policy will continue to reflect pension obligations, business development needs for the longer term and dividends.

Dividend (pence)



The Board has recommended a final dividend of 11.7p per share making a total of 19.5p per share for the year, an increase of 4% over 2011.

Governance

"Transparency is a critical element of good governance and in the Governance section of this report on pages 76 to 117, I and other directors report on how we have discharged the important responsibilities the Board has for the stewardship of the Company."

See page 80 for the Chairman's corporate governance letter

BAE Systems places great importance on the way it conducts its business. Alongside strategic and operational progress, the Group has also made huge strides over recent years in establishing high standards of governance.

The path to establishing high standards of governance has followed a complex and at times arduous journey. Rather than addressing the cosmetics of issues as they have arisen, we have sought to drive fundamental culture change throughout the organisation. The process can never be considered to be complete and best practice in governance will always remain an objective, but I believe BAE Systems is justified in now being regarded as a leader in this area.

Consistent with the drive for continuous improvement, the Group's core governance procedures and policies were again reviewed and updated during the year.

The Group continues to pursue an integrated approach to performance in all aspects of its business life. This Total Performance approach includes the setting of financial and non-financial objectives for management. Further details of this Total Performance approach, and the way it embraces all employees, can be found on page 17 of this report.

BAE Systems recognises the benefits derived from drawing on the talents of a diverse workforce. One important element of this is the Group's drive, through a structured programme of initiatives, to attract more women into the workplace. Although there is still much to do in this regard, across industry as a whole, the early stages of progress are now apparent within BAE Systems and are expected to provide the foundations for a better gender balance in future years. In addition to this progress, and consistent with our commitment to improve diversity, the Group again met its aspirational goal set pursuant to the Davies Report, with women representing more than 25% of the composition of the Group's Board.

Directors

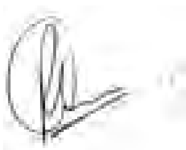
In May, Michael Hartnall, a non-executive director, stood down from the Board having served nearly nine years in that capacity.

As previously announced, Sir Peter Mason stepped down as the Board's Senior Independent Director in January 2013. Nick Rose, a non-executive director, succeeds Sir Peter as the Board's Senior Independent Director. Sir Peter will step down from the Board at the Annual General Meeting in May 2013. Sir Peter has been a great asset to the Board, over many years, sharing his wise counsel and extensive industrial experience. The Board is grateful to him for his support and, more generally, his contribution to the development of the Group.

As I near the start of my tenth year as Chairman, one of Nick Rose's tasks as the Board's new Senior Independent Director is to manage the succession for my own role. It is important that this process is driven by the objective of finding the right person, not just by the timetable. Notwithstanding the undoubted challenges the future holds, I believe I will be handing over the tiller of a well-managed, strong and successful company, that is operating to high standards of governance.

Dividend

The Board has recommended a final dividend of 11.7p per share making a total of 19.5p per share for the year, an increase of 4% over 2011. At this level, the annual dividend is covered 2.0 times by underlying earnings (2011 2.1 times excluding the UK tax agreement benefit). Subject to shareholder approval at the 2013 Annual General Meeting, the dividend will be paid on 3 June 2013 to holders of ordinary shares registered on 19 April 2013.



Dick Olver
Chairman

STRATEGIC REVIEW

In this section:

BAE Systems is focused on delivering sustainable growth in shareholder value. This section provides an overview of how we do it.

Creating cost-effective precision rockets takes some of the sharpest minds around

The Advanced Precision Kill Weapon System is a laser-guided rocket that provides a low-cost surgical strike capability. The Group produces the mid-body guidance kit, which changes a standard unguided rocket into a precision laser-guided missile.

"The Group's geographic breadth of business has provided, and is expected to continue to provide, resilience at a time when some of its markets are constrained by economic pressures."

Ian King
Chief Executive

DELIVERING ON A CLEAR STRATEGY

BAE Systems has continued to deliver on a clear strategy during 2012. The Group's geographic breadth of business has provided, and is expected to continue to provide, resilience at a time when some of its markets are constrained by economic pressures. Following a period of growth, defence budgets in the US have flattened and are expected to remain constrained in response to reducing overseas operations and measures to address federal deficits. In the UK, the defence market has stabilised following changes to programme priorities outlined in 2010 through the UK government's Strategic Defence and Security Review.

Growth opportunities in some segments of the US and UK markets are identified, but the overall outlook in both countries is expected to continue to be constrained.

In wider international markets, the Group is seeing good growth in order intake leading to anticipated growth in international sales. In 2012, order intake outside of the US and UK was £11.2bn, compared with £4.8bn in 2011.

BAE Systems has a clear strategy, focused on enhancing its position as a premier global defence, aerospace and security company. Consistent with that strategy, discussions between BAE Systems and EADS were held between June and October of 2012. The discussions involved extensive engagement with many of the Group's government stakeholders, including in the UK, US and Saudi Arabia, and we were grateful for the positive support received. The merger would have been an exciting development, but no agreement acceptable to all parties could be reached.

Focus on the underlying business performance was sustained as a priority while the merger discussions were underway. The Group's continued strategic aim is to drive shareholder value through a combination of meeting our customers' requirements, further improvements in financial performance and enhanced competitive positions across the business. The focus of the Group's Strategic Actions in pursuit of these goals includes: growth in its cyber, intelligence and security businesses; addressing growth opportunities in electronic systems; driving further value from the Group's broad base of platforms and services positions; and increased business in international markets outside of the UK and US.

The evolution of BAE Systems has seen the Group's business develop from an equipment supply-centred model to one that now embraces a services culture. In 2012, 50% of the Group's sales were generated in services across a wide range of activities and geographies.

Services activities include in-service support in the UK for the Royal Air Force's trainer aircraft and fast jet fleets, and the Royal Navy's surface fleet. In Australia and Saudi Arabia, the Group provides a broadly-based range of support services to the armed forces.

BAE Systems provides extensive support to US armed forces through provision of land vehicle reset and upgrade programmes, rotary wing and other aircraft support, and naval ship repair services. The Group also manages complex facilities including ammunition production in the US and the UK.

BAE Systems' services activities also include the provision of extensive cyber and intelligence capabilities. The Group's strategy includes growing its positions in the cyber and intelligence services markets for governments, and pursuing organic growth opportunities in commercial cyber and security applications and systems.

Affordability is a key consideration for all the Group's customers and BAE Systems has been successful in reducing costs over a sustained period. Whilst necessary to address lower demand in some business areas, cost reduction has also been targeted to achieve competitive advantage. A regrettable but unavoidable element of these cost reduction measures is the impact on employment. Excluding M&A activity, net employee headcount (including contractors) reduced by approximately 3,600 during the year, bringing the total net reduction across the past four years to approximately 26,000. In addition, site rationalisation has continued. These efficiency improvements lead to benefits for customers as well as underpinning the Group's value proposition for shareholders.

US

BAE Systems' business in the US contributed approximately 40% of Group sales in 2012. The US business has felt the dual pressure of reduced activity in support of deployed operations in Iraq and Afghanistan, and measures to reduce US federal budget deficits. In particular, the US land vehicles business has, as forecast, seen significant year-on-year reductions from the peak of activity in 2008.

The US elections have introduced some additional defence procurement uncertainty with the administration entering a six-month period of Continuing Resolution from the end of September 2012.

Overhanging the US defence sector into 2013 is the potential impact of a sequestration or other budget reductions that could result in indiscriminate funding cuts. The Group bases its plans on conservative assumptions and continues to address its cost base accordingly.

UK

Defence budgets in the UK are expected to remain flat, but the recent stabilising of equipment and services requirements and the budget outlook has established a more predictable planning environment.

The Group's UK maritime business is experiencing a high level of activity. Growth is anticipated in the submarines business on the back of the multi-year Astute Class submarine programme and the build-up in engineering workload for the Successor programme. BAE Systems received further Successor funding during the year, with approximately 1,000 people now working on the programme.

Also in the UK maritime business, the last ship of the six-ship Type 45 destroyer programme completed sea trials. Good progress continues to be made on the Queen Elizabeth Class Carrier programme with delivery of major blocks underway for the assembly of the first of these two ships. Work continues on the design of the Type 26 ships to replace the UK's Type 23 frigates from early in the next decade. Type 26 production is expected to utilise a lower level of UK ship build capacity following the currently high levels on the Carrier programme. Discussions continue with the UK government to determine how best to sustain the capability to deliver complex warships in the UK in the future.

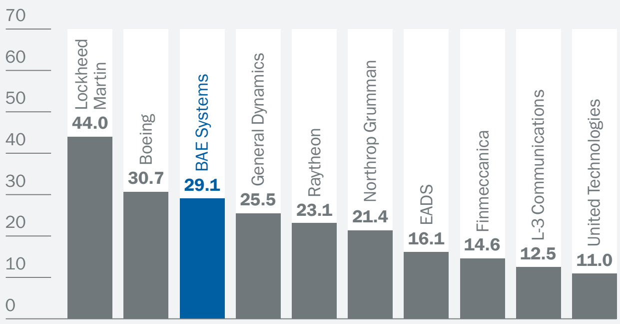
In the military air sector, European Tranche 2 Typhoon deliveries have continued and international prospects for Typhoon remain good with the potential to extend production into the next decade. The Group continues to deliver assemblies for the US-led F-35 Lightning II programme under Low-Rate Initial Production contracts.

International

In addition to its US and UK operations, BAE Systems continues to build on its positions in international markets. As well as established operations in Saudi Arabia, Australia and more recently India, the Group is pursuing multiple new business opportunities worldwide.

Defence remains a high priority in the Kingdom of Saudi Arabia. BAE Systems has a large involvement in the support of established

Our global defence market position ($bn)



Top ten global defence companies (based on 2011 defence revenue)
Source: Defense News

In 2011, BAE Systems was the third largest global defence supplier.

Total Performance

BAE Systems' Mission is to deliver sustainable growth in shareholder value through its commitment to Total Performance.

Total Performance encompasses:

- Customer Focus;
- Programme Execution;
- Financial Performance; and
- Responsible Behaviour.

Total Performance is explored in more detail throughout the Directors' Report.

See page 16 for the Group Strategic Framework for 2013

Royal Saudi Air Force (RSAF) and Royal Saudi Navy programmes in the Kingdom.

Deliveries of RSAF Typhoon aircraft are contracted to recommence in 2013, following a contract amendment to enable UK final assembly of the balance of 48 aircraft under the original contract for 72.

Discussions to formalise Typhoon price escalation under the Salam programme remain ongoing.

Discussions have commenced on the next phase of support, following on from the three-year agreement that formed part of the arrangements for initial entry into service of the Typhoon aircraft.

Under the Saudi British Defence Co-operation Programme, orders totalling £3.4bn were awarded for support through to 2016, including the provision of manpower, logistics and training to the RSAF. In addition, a £1.6bn contract was awarded in May to support the RSAF's future aircrew training requirements involving the supply of, and initial support for, Hawk Advanced Jet Trainer and Pilatus training aircraft.

BAE Systems is the leading provider of equipment and support to the Australian armed forces. The Group's largest programme in Australia is the Canberra Class programme to build two 27,000 tonne Landing Helicopter Dock vessels for the Royal Australian Navy.

BAE Systems continues to develop its business in India. The Indian government has recently confirmed its intention to buy the M777 artillery system and negotiations for a third batch of 20 locally assembled Hawk aircraft are expected to commence in 2013.

In Oman, a £2.5bn contract for 12 Typhoon and eight Hawk aircraft and associated training and support has been awarded, and we are progressing opportunities for Typhoon in Malaysia and the United Arab Emirates.

In June, the business was awarded a $750m (£462m) CV90 combat vehicle contract in Norway.

Balance sheet and capital allocation

The Group recognises the importance to investors of a clear capital allocation policy, consistent with sustaining a strong investment grade credit rating, as part of its value proposition.

In addition to meeting its pension funding obligations, the Group expects to continue organic investment in its businesses to sustain and grow, plans to continue to pay dividends in line with its policy of a long-term sustainable cover of around two times underlying earnings and to make accelerated returns of capital to shareholders when the balance sheet allows. Consistent with this approach, in February 2013, the Group initiated a three-year share repurchase programme of up to £1bn. Full implementation of this programme is subject to satisfactory resolution of Salam Typhoon price escalation negotiations. Discussions with the Group's UK pension scheme trustees have commenced to address any implications for deficit funding plans. Investment in value-enhancing acquisitions will continue to be considered where market conditions are right, where they deliver on the Group's strategy and where they offer greater value than repurchasing the Group's own shares.

M&A activity

The Group's business portfolio is reviewed regularly to determine whether greater value can be created from the sale of a business rather than its retention, and three small business disposals were made during the year for a combined consideration of approximately £111m.

In March, the Group completed the sale of BAE Systems Safety Products Inc. and Schroth Safety Products GmbH (Safety Products). In July, the Safariland, LLC (Safariland) business and the assets comprising BAE Systems Tensylon High Performance Materials Inc. (Tensylon) were sold.

BAE Systems continues to seek bolt-on acquisitions that enhance routes to market or which provide rapid access to relevant technologies and capabilities.

In November, the Group agreed the acquisition of Marine Hydraulics International, Inc., a US marine repair, overhaul and conversion company, for cash consideration of approximately $69m (£42m). The acquisition is expected to complete in the first quarter of 2013.

Pension funding

Triennial funding valuations of the Group's two largest UK pension schemes, the BAE Systems Pension Scheme and the BAE Systems 2000 Pension Plan, were completed as at 31 March 2011. In 2012, agreement on revised deficit funding plans was reached with the trustees of those schemes and the next valuation will commence in April 2014.

"The Group continues to build on the good progress in recent years to establish a Total Performance culture across its business operations."

Total Performance

The Group continues to build on the good progress in recent years to establish a Total Performance culture across its business operations. For BAE Systems, Total Performance is not just about what the Group does, but how it is done. Total Performance places emphasis on delivering shareholder value, meeting the needs of customers and, at all times, acting responsibly.

In addition to delivering against its Financial Performance objectives, the Group sets targets for the achievement of non-financial performance measures, including Customer Focus, Programme Execution and Responsible Behaviour.

BAE Systems is committed to achieving and sustaining high standards of business conduct and continues to reinforce a culture of responsible behaviour. Mandated policies and processes within the Group's Operational Framework are updated routinely to ensure they reflect the Group's Responsible Trading Principles. All employees receive training to help them apply the Group's global Code of Conduct, with mandatory refresher programmes undertaken during the year.

The Group's people strategy of through-career capability development and emphasis on promoting high levels of employee engagement seeks to maximise the contribution that its workforce makes to a culture of Total Performance. It enables every member of the team to fulfil their personal potential. The success of this strategy is measured ultimately in the success of the business as a whole.

BAE Systems has talented people who are committed to excellence, doing work that is truly inspired.

The safety of our employees and those using our products is critical to our business and a fundamental responsibility. I am deeply saddened to report the death of one of our employees whilst at work in Saudi Arabia in a road traffic accident.

Safety continues to be a priority for the Group, with businesses continuing to drive consistently high standards of safety. Performance in safety was underpinned this year by the Group achieving a 30% reduction in the Recordable Accident Rate.

Management

In June, Tom Arseneault was appointed Executive Vice President of the Product Sector businesses headquartered in the US and Chief Technology Officer for BAE Systems, Inc. Also in June, Lynn Minella was appointed Group Human Resources Director following the retirement of Alastair Imrie. On their appointment, both Tom and Lynn joined the Group's Executive Committee.

With effect from 30 March 2013, Larry Prior, Executive Vice President of the Service Sector businesses headquartered in the US and Chief Operating Officer for BAE Systems, Inc., and member of the Group's Executive Committee, will leave the Group to pursue other opportunities.

In February 2013, David Herr was appointed Executive Vice President of the Service Sector businesses and joined the Group's Executive Committee.

Summary

BAE Systems is a resilient business with talented people and the resources to continue to develop within a clear strategic framework. The strategy has seen the Group focus on defence, aerospace and security markets across a broad geographic base. BAE Systems aims to deliver attractive returns to its shareholders through its positions on priority programmes and in services with high relevance to its customers.

Ian King
Chief Executive

Executive Committee key objectives – 2013

The Board reviews and updates the Group Strategic Framework annually. The Group Strategic Framework integrates the Group's major goals and actions into a cohesive document defining the direction and shape of the Group over the long term. There are agreed annual objectives which focus on specific deliverables in support of both delivery of short-term results and the overall strategy. The Executive Committee has set the following objectives for 2013 and a review of performance against these objectives will be contained in the Annual Report 2013.

Target	Description
1. Financial Performance	Meet 2013 financial targets
2. Customer Focus and Programme Execution	Continued focus on improving customer satisfaction and programme execution
3. Responsible Behaviour	Progress towards recognised leading positions
4. Electronic Systems	Be agile, sustain revenues and deliver strong bottom line performance
5. Cyber, Intelligence and Security	Enhance and grow our positions in cyber, intelligence and security
6. Platforms & Services (US)	Drive value from our land portfolio and deliver sustainable, profitable growth in the services sector
7. Platforms & Services (UK)	Deliver sustainably profitable through-life businesses in the air, maritime and combat vehicles sectors
8. Platforms & Services (International)	Grow our Platforms & Services (International) business
9. Engagement	Inspire and engage our people to deliver success

See page 16 for the Group Strategic Framework for 2013

Executive Committee key objectives – 2012 performance

The Executive Committee set objectives for 2012 which focused on specific deliverables in support of both delivery of short-term results and the overall strategy. The specific in-year performance indicators used to measure performance against the Executive Committee's key objectives are discussed below.

Objective	2012 performance
Financial Performance **Meet 2012 financial targets** See page 30 for more information	The target for underlying earnings[1] per share was not achieved as formalisation of price escalation on the Salam Typhoon programme remains outstanding. The targets for average and year-end net cash/(debt)[2] were exceeded.
Customer Focus and Programme Execution **Continued focus on improving customer satisfaction and programme execution** See page 18 for more information	The Group continued to deliver on its commitments to customers and delivered an overall improvement in outturn margin across its major programmes.
Responsible Behaviour **Progress towards recognised leading positions** See page 39 for more information	The corporate responsibility agenda has been embedded further into the Group's operations in line with its commitment to Total Performance. Group targets in respect of business conduct, safety, diversity and inclusion, and environment have been achieved.
Electronic Systems **Be agile, sustain revenues and deliver strong bottom line performance** See page 56 for more information	Whilst sales[3] have been impacted by the Continuing Resolution and lower operational tempo-driven activity, order backlog[3] has increased[4] and return on sales was 14.2%. Programmes are back on schedule after recovery efforts following severe flooding at Johnson City, New York, in 2011. The Commercial Aircraft electronics business has achieved good growth. The business has continued to focus on cost reduction and the evolving priorities of its customers.
Cyber, Intelligence and Security **Establish a leading position in Cyber, Intelligence and Security** See page 60 for more information	The Intelligence & Security business in the US remains stable despite delays in awards on a significant bid pipeline of contract re-competes and new opportunities. Growth in BAE Systems Detica has been impacted by routes-to-market issues in the Global Communications Solutions business. BAE Systems Detica's Security Operations Centre became fully operational, providing services to detect and remediate advanced cyber attacks.
Platforms & Services (US) **Drive value from our land portfolio and deliver sustainable, profitable growth in the services sector** See page 64 for more information	In Land & Armaments, the cost base was reduced further to reflect the lower level of activity and business disposals were completed as portfolio streamlining continued. A $750m (£462m) contract was awarded for CV90 armoured combat vehicles to Norway. In Support Solutions, order backlog[3] increased[4] as the munitions facilities management, and aircraft sustainment and modernisation businesses achieved key contract wins. The $69m (£42m) acquisition of Marine Hydraulics International, Inc. is expected to complete in the first quarter of 2013, complementing the ship repair business.
Platforms & Services (UK) **Deliver in the UK sustainably profitable through-life businesses in the air and maritime sectors** See page 68 for more information	Order intake[3] in Platforms & Services (UK) was strong, including £2.5bn on Typhoon and Hawk aircraft for Oman and £1.6bn on Hawk aircraft for Saudi Arabia. Progress was made on Typhoon export campaigns to Malaysia and the United Arab Emirates, and rationalisation activity to address programme changes was implemented. In maritime, major UK programmes progressed in line with planned milestones and two of three Offshore Patrol Vessels were delivered to the Brazilian Navy.
Platforms & Services (International) **Increase our Platforms & Services (International) business** See page 72 for more information	In Saudi Arabia, orders were received under the Saudi British Defence Co-operation Programme for support to the end of 2016. Salam Typhoon price escalation and future support negotiations remain ongoing. In Australia, good progress was made on the Landing Helicopter Dock (LHD) and Air Warfare Destroyer programmes, with the first LHD hull arriving in Australia for completion. In India, the government confirmed its intention to buy 145 M777 howitzers.

1 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
2 See page 32 and note 10 to the Group accounts.
3 Including share of equity accounted investments.
4 Excluding the impact of exchange translation.

See page 13 for the Group's Key Performance Indicators for 2012
See page 16 for the Group Strategic Framework for 2013

KEY PERFORMANCE INDICATORS (KPIs)

The Board uses a range of quantitative financial and non-financial performance indicators, reported on a periodic basis, to monitor the Group's performance against its Total Performance and Executive Committee key objectives. Executive directors' remuneration is linked to certain of these measures.

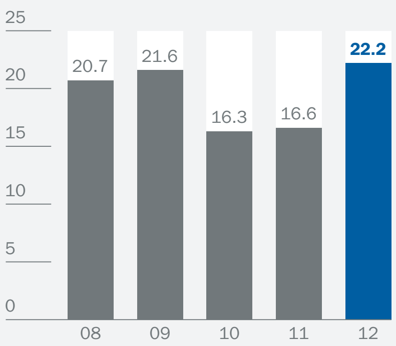
Financial Performance

The Group sets itself challenging financial targets through the Integrated Business Planning process to improve financial performance and drive shareholder value.

p12 2012 Executive Committee key objectives
p46 Principal risks
p30 Financial Performance
p84 Integrated Business Planning process

Funded order intake[1] (£bn)

£22.2bn
2011: £16.6bn



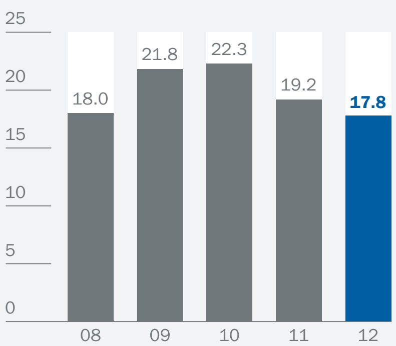
Definition
Funded order intake represents the value of funded orders received from customers in the year.

Funded order intake is a measure of in-year performance and supports future years' sales performance.

Comment
Funded order intake[1] increased by 34% on 2011 driven by a high level of awards in Saudi Arabia and a contract to supply Typhoon and Hawk aircraft to Oman. Non-US and UK funded order intake[1] increased to £11.2bn from £4.8bn in 2011.

Sales[1] (£bn)

£17.8bn **-7%**
2011: £19.2bn



Definition
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.

Comment
The 7% reduction in sales[1] this year mainly reflects the expected lower volume in the Land & Armaments business and the transition to UK final assembly arrangements under the Salam Typhoon programme. The next deliveries are in 2013.

Sales[1] in 2012 have been impacted by the deferral of trading relating to the finalisation of price escalation on the Salam Typhoon programme.

p31 Sales[1] bridge chart

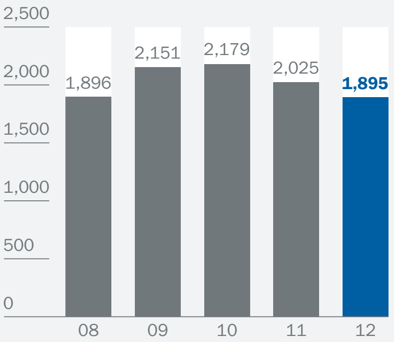
1 Including share of equity accounted investments.

Financial Performance (continued)

Underlying EBITA[2] (£m)

£1,895m **-6%**

2011: £2,025m



Definition

Underlying EBITA excludes amortisation and impairment of intangible assets, finance costs and taxation expense, and non-recurring items (for 2011 and 2012, these are profit/loss on disposal of businesses and regulatory penalties).

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

Comment

Underlying EBITA[2] in 2012 has been impacted by the deferral of trading relating to the finalisation of price escalation on the Salam Typhoon programme.

Return on sales was sustained at 10.6%.

p31 Non-recurring items

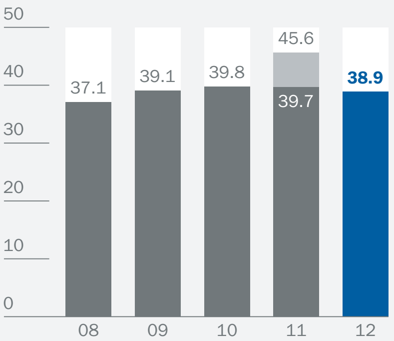
Underlying earnings[3] per share (pence)

38.9p **-2%*** **-15%**

2011: 45.6p (39.7p*)

Target[5] not achieved

Part of the executive directors' 2012 annual incentive



* Excluding R&D tax benefit
R&D tax benefit
Excluding R&D tax benefit

Definition

Underlying earnings represent profit for the year attributable to equity shareholders excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).

Underlying earnings per share provides a measure of shareholder return that is comparable over time.

Comment

Underlying earnings[3] per share in 2012 has been impacted by the deferral of trading relating to the finalisation of price escalation on the Salam Typhoon programme.

p32 Underlying earnings[3] per share bridge chart

p31 Non-recurring items

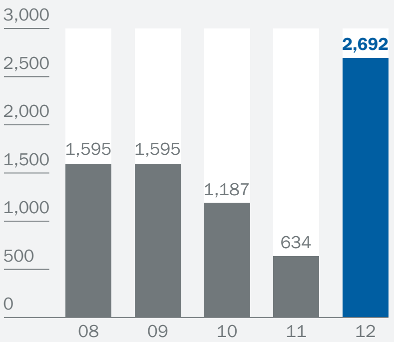
Operating business cash flow[4] (£m)

£2,692m

2011: £634m

Target[5] achieved

Part of the executive directors' 2012 annual incentive



Definition

Operating business cash flow represents net cash flow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

Operating business cash flow is the measure used to assess the operating cash generation of the Group.

Comment

The £2.1bn increase in operating business cash flow[4] primarily reflects down-payments received on new contracts to Saudi Arabia and Oman.

A significant cash receipt expected on the Salam Typhoon programme has been deferred until ongoing negotiations regarding price escalation have been concluded.

p32 Reconciliation of cash inflow from operating activities to operating business cash flow[4]

2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
4 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
5 The target is the Group's budget for the year, which represents the first year of the five-year Integrated Business Plan (see page 84).

Customer Focus[6]

The Group's priority is to understand its customers' evolving needs and expectations, and deliver on its commitments throughout the life of the products and services it delivers.

p12 2012 Executive Committee key objectives
p46 Principal risks
p84 Lifecycle Management (LCM)

Customer satisfaction

Performance
The Group targets an aggregated year-on-year improvement in customer satisfaction across its major contracts.

Customer satisfaction metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.

Definition
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.

Comment
The data for the customer satisfaction metric included 92 contracts reported in Contract Reviews prepared under LCM.

The year's target was achieved.

Target achieved

Part of the executive directors' 2012 annual incentive

Programme Execution

The Group's performance is dependent on the successful execution of its projects. It is important that the Group wins and contracts for high-quality new programmes, and delivers on those projects within tight tolerances of quality, time and cost performance.

p12 2012 Executive Committee key objectives
p46 Principal risks

Programme margin variation

Performance
The Group targets an aggregated year-on-year improvement in programme margin across its major contracts.

Programme margin variation metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.

Definition
Programme margin variation measures outturn projections of, and movements in, margin of key customer-funded projects. It provides an indicator of the Group's ability to effectively manage major programmes.

Comment
The data for the programme margin variation metric included 100 contracts reported in Contract Reviews prepared under LCM, representing over 60% of the Group's funded order backlog.

The year's target was achieved.

Target achieved

Part of the executive directors' 2012 annual incentive

Responsible Behaviour

High standards of business conduct are essential to the Group's Mission to deliver sustainable growth in shareholder value.

p12 2012 Executive Committee key objectives
p46 Principal risks
p39 Corporate responsibility review
p59 Performance by reporting segment

Safety[7]

Performance
In 2012, the Recordable Accident Rate reduced by 30% against 2011 performance.

Definition
The number of injuries per 100,000 employees is monitored, and actions taken to minimise the risk to the Group's employees and its operations, and drive continual performance improvement.

Comment
The Recordable Accident Rate is the principal metric used by the Group's businesses to monitor performance in safety. The Group also uses a five-level Safety Maturity Matrix to help its businesses around the world work towards consistently high safety standards.

Target achieved

Part of the executive directors' 2012 annual incentive

6 Prior to 2012, a schedule adherence metric, which measured the timing of achievement of key contract milestones, was a Customer Focus KPI. From 2012, this metric is no longer reviewed by the Executive Committee.
7 Prior to 2012, the safety KPI was the Lost Work Day Case Rate, calculated as the number of injuries resulting in days lost per 100,000 employees. From 2012, the KPI used to monitor safety performance is the Recordable Accident Rate, which focuses on the number of accidents rather than days lost, enabling inclusion of a wider scope of accidents within the Group's reviews, which is expected to lead to improvements in accident prevention.

OUR STRATEGY

Our Strategy defines the direction and shape of the Group over the long term.

Our Vision
Our Vision provides a clear definition of the future that we wish to attain.

While our Vision defines our destination, commitment to Total Performance guides our actions for the benefit of all stakeholders. This is embedded in our Mission.

Our Mission
Our Mission describes our overall goal and the philosophy that underpins our activities. Meeting our Mission is key to achieving our Vision.

Shareholder value is defined as share price appreciation and dividend growth, driven by increased earnings per share and strong cash generation.

Total Performance is demonstrated in every aspect of the way we do business – Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour.

We believe that by embodying the four elements of Total Performance wherever we operate, we will deliver growth in shareholder value and become the premier global defence, aerospace and security company.

Our Strategy
Our Strategy defines the direction and shape of the Group over the long term. This enables us to prioritise the deployment of our resources in a challenging environment. We are committed to implementing our Strategy in the most effective manner and will remain agile and adapt to the changing environment.

We anticipate that defence budgets in certain of our major markets will experience reductions. Our Strategy focuses on the growing importance of winning international business, where growth markets remain.

The key elements of our Strategy are to:

Support our customers in safeguarding their vital interests
We operate in the defence, aerospace and security markets, which

Our Vision is to be the premier global defence, aerospace and security company

Our Mission is to deliver sustainable growth in shareholder value through our commitment to Total Performance

Customer Focus | Programme Execution | Financial Performance | Responsible Behaviour

Our Values are Trusted, Innovative and Bold

Our Strategy

– Support our customers in safeguarding their vital interests

– Inspire and develop our people to drive our success

– Drive shareholder value by improving financial performance and competitive positions across the business

Strategic Actions

- **Improve profit and cash generation**
- **Grow our Cyber, Intelligence and Security business**
- **Grow Electronic Systems**
- **Drive value from our Platform and Services positions**
- **Increase our international business**

Integrated Business Plans

in turn have their own unique market drivers. Our Strategy is to understand and respond to the needs of our customers in each of these markets, and anticipate that these needs may be subject to rapid change. We need to be agile as an organisation, to enable us to identify and prioritise capabilities which support our customers' vital interests, creating demand for our products and services.

Inspire and develop our people to drive our success
We recognise that we can only deliver our Mission through the performance of our people. We believe that if we engage with our people we can inspire the will to succeed and develop skills to drive improvements in performance, enabling us to compete more effectively in an increasingly challenging environment.

See page 26 for more information on this new element of our Strategy

Drive shareholder value by improving financial performance and competitive positions across the business
The current environment is increasingly competitive and, to deliver growth in shareholder value, we need to focus on generating strong cash flows and profits. Improving efficiency in our operations will also make us more competitive to win future business. All our operations in the defence, aerospace and security markets must strive to increase value and eliminate non-value-added activity whilst maintaining our commitment to Total Performance.

Strategic Actions
This Strategy translates into the five Strategic Actions. These directly flow from our Vision, Mission and Strategy, and are designed to shape our business portfolio and strengthen performance over the long term. These actions translate the Group's over-arching strategy into operational plans that are delivered through our lines of business.

Integrated Business Plans
The Integrated Business Planning process is an annual, two-stage process that culminates in a five-year strategic and financial plan, which is used to shape the Strategic Actions.

See page 84 for more information on the Integrated Business Planning process

OUR BUSINESS MODEL

BAE Systems delivers a wide range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services.

Delivering sustainable growth in shareholder value through Total Performance…

1. Customer Focus
The Group's priority to all its customers is to understand their evolving needs and expectations, and deliver on its commitments throughout the life of the products and services it delivers. Customer satisfaction is a key indicator of Customer Focus.

See page 18 for more information

2. Programme Execution
The Group's performance is dependent on the successful execution of its projects. It is important that the Group wins and contracts for high-quality new programmes, and delivers on those projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner. Key indicators of performance include outturn projections of, and movements in, margin of key customer-funded projects and customer satisfaction.

See page 20 for more information

3. Financial Performance
The Group sets itself challenging financial targets through its Integrated Business Planning process. Financial Performance is measured through a range of key financial salients derived from the Group's consolidated financial statements, including funded order intake[1], sales[1], underlying EBITA[2], underlying earnings[3] per share and operating business cash flow[4].

See Financial Performance on page 30 for more information

4. Responsible Behaviour
Responsible Behaviour is embedded within the business. The Group's Code of Conduct is a summary of the principles and standards of business conduct expected of all employees. Together with the Group's Responsible Trading Principles, the Code of Conduct underpins its business activities. Metrics are used to measure safety, diversity and inclusion, and environmental impacts.

See Corporate responsibility review on page 39 for more information

…across multiple markets and opportunities…

BAE Systems benefits from a broad and diverse market base, focused on five home markets – the US, the UK, Saudi Arabia, Australia and India. In addition, export markets provide a significant ongoing opportunity for the Group.

See page 22 for more information

…by five reporting segments…

The Group has five principal reporting segments which align with the Group's strategic direction – Electronic Systems, Cyber & Intelligence, Platforms & Services (US), Platforms & Services (UK) and Platforms & Services (International).

See page 24 for more information

…underpinned by key resources…

The Group's key resources and arrangements include the people it employs, its relationships with suppliers, research and development, and intellectual property.

See pages 18 to 21 for more information

…and a strong governance framework.

The Operational Framework sets out how the Group does business, wherever it operates in the world, based on principles of good governance. It provides a stable foundation from which to deliver our Strategy, improve performance and develop our culture of Total Performance.

See page 84 for more information

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
4 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

Our business model
See page 17

CUSTOMER FOCUS

DELIVERING ON COMMITMENTS TO OUR CUSTOMERS

Customer Focus means the understanding of the customers' evolving needs and expectations, and delivering on our commitments throughout the life of the products and services we deliver.

The Group's strong relationships with its customers include joint development of major platforms, transitioning technology to operational use, and providing improved training and logistics support. The provision of support services to ensure mission accomplishment underpins the Group's focus. The Group often responds to urgent operational requirements driven by a customer need for an immediate solution that can be fielded rapidly.

Delivering savings in Type 45 programme costs for the UK Royal Navy customer

A new, more effective way of working between the UK Ministry of Defence and BAE Systems has demonstrated significant cost and schedule adherence benefits for the customer on the six-ship Type 45 contract. The focus has been on the project plan, budgets, quality and risk mitigation, working in tandem with the customer. Issues are identified early, and solutions sought and agreed, which both protect the programme and minimise cost. A culture of co-operation is reflected in the collaborative enterprise and joint acceptance teams, comprising major stakeholders who meet on a regular basis to resolve issues. The project team has consistently achieved its programme delivery dates and savings of £86m have so far been attributed to this partnering approach, which is also expected to enable savings on other major naval ships programmes, most notably on the Type 26 Global Combat Ship programme.

OUR KEY RESOURCES

The Group's key resources and arrangements include the people it employs, its relationships with suppliers, research and development, and intellectual property.

Significant investment in R&D…

The Group's Research & Development (R&D) activities cover a wide range of programmes, and include technological innovations and techniques to improve the manufacturing and service of products.

Examples include: BAE Systems' latest research on an advanced positioning system that exploits existing transmissions, such as Wi-Fi, TV, radio and mobile phone signals, to calculate the user's location to within a few metres; and BAE Systems' Headborne Energy Analysis and Diagnostic System (HEADS), a small sensor mounted inside a combat helmet that records the severity of blasts or impacts during an explosion, helping to identify potential combat-related head and brain injuries. HEADS was named a US Army greatest invention of 2011.

In 2012, R&D expenditure was £1,138m (2011 £1,149m) of which £150m (2011 £222m) was funded by the Group.

Utilising systems experience on F-16 aircraft to offer avionics upgrades for South Korea

BAE Systems is a leading provider of integration, avionics and mission computers for F-16 aircraft, and has been down-selected to be the sole source systems integration contractor for upgrading more than 130 F-16s for the government of the Republic of Korea. The Korean programme will build on BAE Systems' experience with the F-16, providing cost-effective upgrade solutions. The Group supports 270 of the US Air National Guard's upgraded F-16s and 50 of the Turkish Air Force's upgraded F-16s. For the Korean fleet, BAE Systems will perform a range of services, including systems engineering and integration, software and electronics engineering, obsolescence management and logistics support.

Supporting Typhoon aircraft in service with the Royal Saudi Air Force

The Saudi Typhoon support contract is an availability contract supporting the aircraft's entry into service with the first of the Royal Saudi Air Force's (RSAF) Typhoon squadrons. Working as 'One Team' with the customer on-base, the Group has supported the RSAF in establishing and successfully delivering all key elements of their Typhoon operational readiness, including air crew and ground crew training, maintenance facilities, technical support, spares and repairs, aircraft availability, and aircraft capability upgrades.

See page 15 for more information on the Group's Customer Focus KPI

…generating substantial intellectual property.

Intellectual property is important to the Group's success in obtaining and maintaining a competitive advantage.

Like any industrial concern, BAE Systems does not just produce products or provide services for its customers; in the process, intellectual property may be created which often has a value to the Group far greater than is reflected in the value of the particular contract or programme of work under which it was created. It takes many forms, including products, processes and knowhow.

The Group's Operational Framework mandates a policy to protect the Group's intellectual property (including patents, registered designs, and registered trade and service marks) 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 commercial and business innovations are adequately safeguarded.

In 2012, the Group filed patent applications covering approximately 250 new inventions. One of the Group's patented inventions has assisted in BAE Systems obtaining a development contract, which in turn will create valuable future opportunities for production contracts.

At 31 December 2012, BAE Systems had a total portfolio of patents and patent applications covering more than 2,000 inventions worldwide.

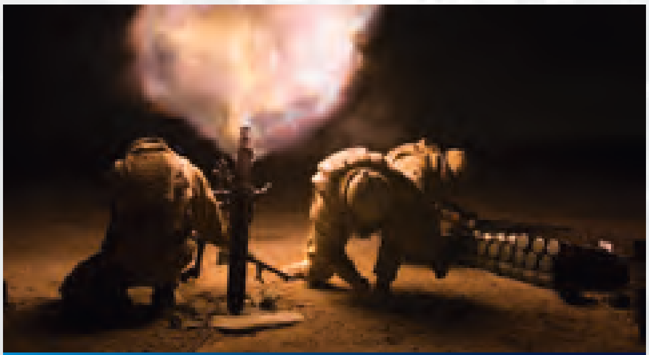
Our business model
See page 17

PROGRAMME EXECUTION

DELIVERING ON PROJECTS TO QUALITY, TIME AND COST

Programme Execution means delivering on projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner.

BAE Systems utilises Lifecycle Management (LCM) as part of its project management processes to ensure effective delivery of its programmes. LCM provides a benchmark approach which includes early engagement of business leadership, applying the full set of Group capabilities, and requiring experienced independent validation of project status and results. Early identification of risk, and implementing mitigation steps, are key features. Customer interaction is essential. Opportunities for improved results are identified and included in future project phases. Whether delivering a complex system enhancing a current capability, improved operational support or a customised solution, BAE Systems uses its world-class management processes and tools.



Transformation of UK munitions plants under a long-term partnering agreement

Munitions Acquisition Supply Solution is a 15-year partnering agreement with the UK Ministry of Defence (MoD) to transform three UK munitions manufacturing facilities into centres of excellence. Following investment by BAE Systems, two new facilities have been created at Radway Green and Washington, with a major modernisation at Glascoed. The transformation programme is reviewed jointly by the MoD and BAE Systems against critical milestones. All major milestones have been met. Key measures met to date include improved delivery of defined munitions products, and a reduction in labour costs and scrap/rework levels.

OUR KEY RESOURCES

The Group's key resources and arrangements include the people it employs, its relationships with suppliers, research and development, and intellectual property.

A skilled workforce of 88,200 employees[1]…

BAE Systems' investment in its current and future workforce is designed to give it the capabilities to deliver its strategy, and ensure that the Group is able to grow and develop talented people to meet its challenges and opportunities. Through the Group's ability to attract, retain and engage its people, BAE Systems is able to deliver on its Total Performance goals.

See page 26 for more information

1 Including share of equity accounted investments.

Providing maintenance and modification services to the US Navy customer

BAE Systems Ship Repair in Norfolk, Virginia, is home to approximately 1,600 employees primarily working on US Navy vessels. Located at the Group's Norfolk site is the Titan drydock, the largest floating drydock on the East Coast of the US. In January 2012, the first ever tandem drydocking of two US Navy Aegis guided missile destroyers, USS Mason and USS Bulkeley, was undertaken. This unique and highly cost-effective use of the facility enabled both destroyers to stay in drydock until the end of April 2012 for routine maintenance and modifications.

Upgrading Saudi aircraft under the Tornado Sustainment Programme

In partnership with the Royal Saudi Air Force (RSAF), the Tornado Sustainment Programme (TSP) has successfully upgraded all of the RSAF Tornado fleet. Central to the upgrade is a new digital weapons and avionics system. New RSAF facilities were contractually placed in the custodianship of BAE Systems Saudi Arabia until completion of the TSP embodiment programme. At peak throughput, a Tornado was delivered back to the RSAF every 12 working days, all on schedule. Concurrently, 29 additional aircraft underwent major maintenance under this complex and technically challenging combined maintenance and upgrade package.

See page 15 for more information on the Group's Programme Execution KPI

…and thousands of suppliers who share our values.

The Group buys a wide range of major equipment, services, materials and components that contribute to the products and services it provides to customers, and it depends on its suppliers to help it deliver these both on time and to a high quality, and to provide innovative, cost-effective solutions. The Group expects these suppliers to work to the same or equivalent standards as BAE Systems on issues ranging from responsible trading and ethical conduct to health and safety, and encourages them to adopt sustainable environmental best practices.

In the UK, the Group is the largest manufacturer and provider of complex military and security equipment and technology. It works with approximately 7,500 UK suppliers, of which approximately 2,200 are small and medium-sized enterprises (SMEs). BAE Systems has a strong interest in supporting the SME sector and promoting innovation by investing in their businesses where appropriate. Many play a key role in the Group's business by supplying unique goods and expertise. In turn, they benefit from access to new markets and the financial security inherent in the long-term nature of many of the Group's projects.

BAE Systems is a founding member of the ADS Group's (Aerospace, Defence, Security and Space industries association) 21st Century Supply Chains (SC21) programme designed to improve efficiency in the UK aerospace, defence, security and space supply chains.

Our business model
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TOP TEN CONTRACTOR TO THE US DEPARTMENT OF DEFENSE

BAE Systems is a top ten US defence contractor, offering a balanced portfolio of products and services in defence, aerospace and security domains, including the operational support of equipment used around the world by US forces and their allies.

US 34,500 EMPLOYEES[1]

AN INTERNATIONAL BUSINESS

POSITIONS IN FIVE HOME MARKETS WITH EXPORT OPPORTUNITIES

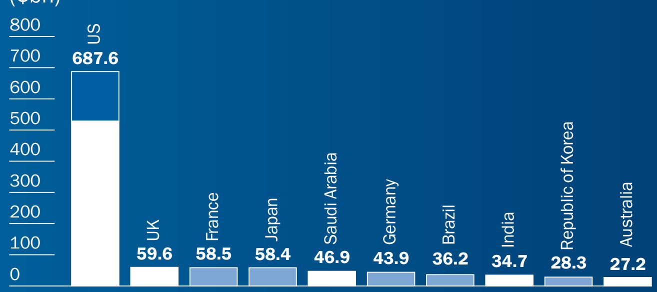
Today, our business is based around five home markets – the US, the UK, the Kingdom of Saudi Arabia, Australia and India.

OUR MARKETS

BAE Systems has a broad geographic base with business operations in five home markets around the world, in the US, the UK, the Kingdom of Saudi Arabia, Australia and India. These home markets are identified as having a significant and sustained commitment to defence and security. They are countries that welcome foreign investment to develop and sustain a domestic defence industrial capability, building long-term and trusted customer relationships. Importantly, they are also markets where BAE Systems can achieve and demonstrate high standards of business conduct.

Established positions in five home markets...

Top 10 defence markets accessible for business by the Group
($bn)



■ Home markets □ Overseas Contingency Operations budget

Source: BAE Systems' internal analysis (based on 2011 total defence expenditure)

BAE Systems is an established part of the defence industrial capability in the US, the UK, the Kingdom of Saudi Arabia and Australia where its principal operations are based, and continues to develop its position in India, the Group's newest home market.

1 Including share of equity accounted investments.

LARGEST SUPPLIER TO THE UK MINISTRY OF DEFENCE

BAE Systems plays a vital role in the UK's defence capabilities across air, maritime and land platforms, including military and technical service contracts. BAE Systems also plays a key role in security and intelligence with customers in both government and commercial markets.

UK
32,800
EMPLOYEES[1]

SUPPLIER TO THE INDIAN MINISTRY OF DEFENCE

India continues to develop as a home market. BAE Systems is investing in its presence through technology sharing and inward investment in this growing defence and security market.

INDIA
200
EMPLOYEES[1]

KINGDOM OF SAUDI ARABIA
5,900
EMPLOYEES[1]

LEADING IN-COUNTRY DEFENCE SUPPLIER

BAE Systems is a leading in-country defence supplier, supporting the operational capability of the Royal Saudi air and naval forces, and investing in the development of Saudi indigenous defence capabilities.

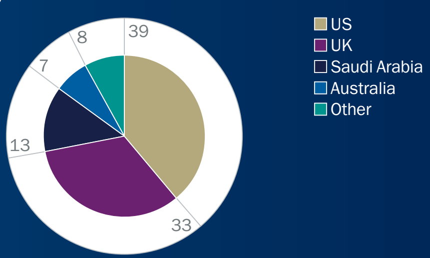
LARGEST IN-COUNTRY DEFENCE SUPPLIER

In Australia, BAE Systems supplies leading capability across air defence, land combat systems, naval systems and security.

AUSTRALIA
5,500
EMPLOYEES[1]

...delivering a broadly-based business portfolio...

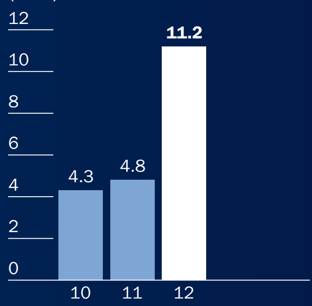
Sales[1] by home market
(%)



With near-term budget pressures in some markets, the Group's broad geographic base provides a resilient business portfolio.

...with export opportunities in growth markets.

Non-US and UK funded order intake[1]
(£bn)



BAE Systems has a strong international market presence with well-established relationships, supported by regional offices. The Group's strategy continues to focus on the importance of winning international business, where growth markets remain. Success in these international defence and security markets is evident in the increasing order intake[1] in markets outside the US and UK.

OUTSTANDING CAPABILITIES

The Group has five principal reporting segments which align with the Group's strategic direction.

Electronic Systems

Electronic Systems has advanced technology, high integrity electronics capabilities with a large portfolio of annually-funded contracts, and significant Group-funded research and development invested in the business.

Electronic Combat combines the Electronic Protection, Electronic Warfare and Electronic Attack product lines, and provides a depth of capability in integrated electromagnetic systems for airborne applications.

Survivability & Targeting includes situational awareness, targeting and survivability systems, such as electro-optic sensor products, guidance systems, handheld targeting and infrared countermeasures systems for soldiers and vehicles.

Communications & Control has a strong footing in radio frequency communication and datalinks, and provides military aircraft controls and displays, together with platform integration capabilities.

Intelligence, Surveillance & Reconnaissance (ISR) addresses the market for airborne persistent surveillance, identification systems, signals intelligence and space products.

Commercial Aircraft electronics addresses the commercial aircraft electronics market, including fly-by-wire flight controls, full authority digital engine controls, cockpit controls, head-up displays, cabin management systems and power management systems.

HybriDrive® propulsion delivers power and energy management solutions, including vehicle hybrid drive systems.

Cyber & Intelligence

Cyber & Intelligence comprises government-focused intelligence-based services, and government and commercial cybersecurity activities. Intelligence-based services include IT-based services and the provision of analysts and analysis-based services. Cybersecurity activities include product provision, service output and consulting contracts.

Intelligence & Security delivers a broad range of services, including IT, cybersecurity and intelligence analysis to enable the US military and government to recognise, manage and defeat threats.

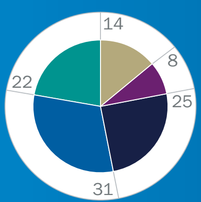
The business delivers:

- cost-effective IT solutions that solve complex problems of collaboration and security for the US national security community;
- real-time threat assessments that rapidly inform critical security actions; and
- automated, efficient and reliable intelligence processing, data management systems and imagery mapping tools for the US intelligence and defence communities.

BAE Systems Detica collects, manages and exploits information to enable government and commercial clients to reveal intelligence, maintain security, optimise performance and manage risk. Alongside its secure government-focused activities, the business is a supplier of information assurance products and services to the financial services and telecommunications sectors. Primary operations are in the UK, Denmark, Ireland and the US.

A STRONG PORTFOLIO OF PRODUCTS AND SERVICES

Sales[1,2,3] by reporting segment (%) KPI



1 Including share of equity accounted investments.
2 Before elimination of intra-group sales.
3 Excluding HQ.

See page 56 for more information

See page 60 for more information

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Platforms & Services (US)

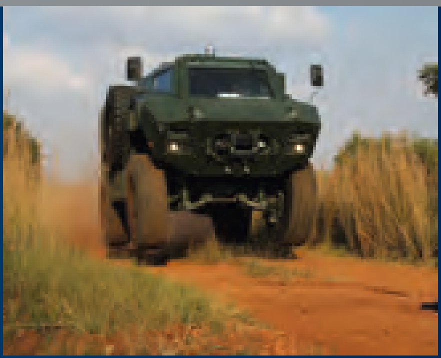
Platforms & Services (US) comprises the Land & Armaments business which includes a range of funded development activity and fixed-price production and services contracts, and US-based services, sustainment and systems integration activities which may be contracted over multi-year arrangements.

Support Solutions is a major supplier of ship repair services to the US Navy and complex munitions facilities management for the Holston and Radford facilities. Other support activities in the US include fixed and rotary wing aircraft support services.

Land & Armaments is engaged in the design, development, production, support and upgrade of armoured combat vehicles, tactical wheeled vehicles, artillery systems, naval guns, missile launchers and munitions.

Vehicle Systems focuses on the tracked, wheeled and amphibious vehicle markets, servicing both US and international customers.

Weapons Systems & Support focuses on weapons, munitions and field support markets, servicing US, UK and international customers. Weapons include the manufacture of artillery systems, such as the M777 howitzer, as well as naval guns and missile launchers. The business is the principal supplier of munitions to the British armed forces.



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Platforms & Services (UK)

Platforms & Services (UK) is the focus for the Group's UK prime contracting platform and systems integration contracts, with a large order backlog of multi-year development, production and services contracts.

Military Air & Information includes programmes for the production of Typhoon combat and Hawk trainer aircraft, F-35 Lightning II fuselage and empennage manufacture, support for Typhoon, Tornado and Hawk aircraft, and development of next-generation Unmanned Air Systems and defence information systems, such as the Falcon secure deployable communication system.

Maritime programmes include the manufacture of two new Queen Elizabeth class aircraft carriers for the Royal Navy, the Type 45 anti-air warfare destroyers and the Astute class submarines, the design of the Successor submarine and Type 26 frigate, and in-service support.

Combat Vehicles (UK) includes the UK-based armoured vehicle and support services business transferred from Land & Armaments on 1 October 2012. The principal programme is for the design and manufacture of 60 Terrier combat engineer vehicles for the British Army.

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Platforms & Services (International)

Platforms & Services (International) comprises businesses in Saudi Arabia, Australia, India and Oman, as well as a 37.5% shareholding in MBDA.

In **Saudi Arabia**, the business provides operational capability support to the country's air and naval forces on UK/Saudi government-to-government contracts. Contracts, such as the Saudi British Defence Co-operation Programme, tend to be multi-year and fixed price.

In **Australia**, the business delivers production, upgrade and support programmes for the Australian government across the air, maritime and land domains. Services contracts include the provision of support and upgrades. Platforms contracts include naval ships, such as the Landing Helicopter Dock programme for the Navy. Contracts are often multi-year and fixed price.

In **India**, the Group continues to develop its software joint venture and build on its long-standing relationship with Hindustan Aeronautics Limited, which is manufacturing Hawk aircraft under licence in India.

The business is developing its position in **Oman**, building on a long history of relationships with the Omani armed forces, with resulting orders placed with the relevant reporting segments.

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INSPIRE AND DEVELOP...

...OUR PEOPLE TO DRIVE OUR SUCCESS

The Group's people strategy of through-career capability development and emphasis on high levels of employee engagement seeks to maximise the contribution that its 88,200 strong workforce[1] makes to the Total Performance of the business.

The people strategy enables every member of the team to fulfil their personal potential. The success of this strategy is measured ultimately in the success of the business as a whole.

Leadership development

The Group continues to focus on the development of its current and future leaders with structured global programmes linked to Total Performance Leadership, an integrated performance management and leadership development framework. In 2012, leaders took part in development programmes designed to help participants succeed as leaders and provide a strong talent pipeline to meet the demands of changing markets. A common Management Resource Review, which includes succession and development planning, is conducted at Group and business level.

Continuous professional and personal development

The Group has continued to demonstrate its commitment to the continuous professional and personal development of its workforce. Development planning is supported by flexible training and education programmes that encourage a culture of lifelong learning and help employees to develop their skills to maximise their potential.

In 2012, the Group continued to invest in learning programmes for all employees that support its culture of responsible business conduct. Extensive use is made of e-learning media, classroom training and partnerships with academic institutions to provide development and learning offerings.

Sustaining and developing capability relies on developing the existing workforce and hiring talented people to meet current and future skills requirements.

Developing current and future leaders...

Group development programmes complement business activities, such as the Mustakbal Management Development Programme for Saudi nationals, supporting the future sustainment of leadership talent in the Kingdom of Saudi Arabia.

...recruiting talented people...

Veterans of the armed services are an important source of talent for the business. In the US, for example, GI Jobs Magazine rated BAE Systems in its top 100 list of military friendly employers.

1 Including share of equity accounted investments.

Employee engagement

The Group recognises the importance of engaging its employees to help them make their fullest contribution to the business. Through a variety of media, the Group's leadership seeks to listen to employees' views and opinions, and keep them informed about developments and prospects for the business. In 2012, there was more frequent use of leadership blogs and other e-enabled communication channels.

A major focus for engagement has been the fostering of a more diverse and inclusive working environment. Specific development programmes have been produced to assist leaders in engaging further with their teams and demonstrating the contribution that each individual can make to the success of the Group.

When redundancies have been necessary to align with customer requirements for products and services, management works with employees, trade unions, and local and national bodies to mitigate the impact on people and communities affected.

Education and early careers programmes

The Group works with the education sectors in each of its home markets to help shape the workforce of the future with a particular emphasis on encouraging young people to pursue careers in science, technology, engineering and mathematics.

In the US, BAE Systems is partnering with the National Math and Science Initiative to support the development of science, technology, engineering and maths curricula to engage young students, with the goal of inspiring them to become future engineers.

In the UK, the Group has teamed with the Royal Air Force in staging a Schools Road Show, taking a theatre-based class to over 250 schools, engaging 25,000 pupils in 2012 about careers in engineering.

In Saudi Arabia, BAE Systems has established a University Collaboration Agreement with King Saud University in Riyadh, under which it will sponsor 30 engineering undergraduates.

In Australia, the business sponsors school pupils to participate in the FIRST (For Inspiration and Recognition of Science and Technology) LEGO League and FIRST Robotics Competition, both aimed at encouraging more young people to engage in science, technology, engineering and maths.

In India, BAE Systems has entered into a long-term partnership agreement with Smile Foundation, a national level development organisation with an outreach of over 200,000 underprivileged children, women and youth across 25 states. The partnership enables the Group to support development programmes in the areas of primary education and healthcare.

...improving engagement...

In 2012, the Group piloted the use of the 'Great Place to Work' Trust Index with sample surveys in each of the home markets. The Great Place to Work Institute is a globally recognised organisation that identifies, creates and sustains great workplaces, and provides a benchmark measure that supports the Group's ambition to maximise employee engagement and contribution.

...and investing in the future.

During 2012, the Group recruited 650 people globally to join its apprenticeship and graduate programmes to enrich its future workforce, some of whom may potentially form part of its future leadership population.

See Corporate responsibility review on page 39 for more information

See pages 59 to 75 for more information on how the Group's reporting segments are inspiring and developing our people

Most people don't see a cyber attack until it's too late. We are not most people

Understanding and counteracting illegal cyber activities is crucial in preventing future cyber attacks and helping law enforcement professionals locate cyber criminals. Digital forensics is the process of collecting physical evidence from a digital device. Digital forensic analysis requires systematic processing, documentation and strict adherence to the chain-of-custody process.

As technology continues to advance, so do the techniques used by the digital forensic experts at BAE Systems. Digital forensic professionals stay ahead of the proliferation of new operating systems, software applications and mobile devices.

GROUP PERFORMANCE REVIEW

In this section:

This section provides a commentary on the Group's financial and non-financial performance, and its approach to the management of corporate responsibility and risk.

FINANCIAL PERFORMANCE

Our business model
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Peter Lynas
Group Finance Director

This section of the report covers Financial Performance from a Group perspective.

See pages 54 to 75 for details on Financial Performance by reporting segment

Financial highlights

- **Order backlog[1,2] increased by 8% to £42.4bn**
- **Non-US and UK order intake[1] increased to £11.2bn from £4.8bn in 2011**
- **Sales[1] reduced by 7%**
- **Underlying EBITA[3] reduced by 6% to £1,895m. Deferred recognition of sales and profit relating to the formalisation of price escalation on the Salam Typhoon programme**
- **Underlying earnings[4] per share down by 2% (excluding the benefit in 2011 of the UK tax settlement)**
- **Total dividend increased by 4% to 19.5p**
- **Operating business cash flow[7] increased to £2.7bn**
- **Net cash[6] balance of £387m**
- **Three-year share repurchase programme of up to £1bn initiated**
- **Longevity risk on £2.7bn of pension scheme liabilities transferred to the insurance market**

Summary income statement

Summary income statement – continuing operations	2012 £m	2011 £m
Sales[1] KPI	**17,834**	19,154
Underlying EBITA[3] KPI	**1,895**	2,025
Return on sales	**10.6%**	10.6%
Profit/(loss) on disposal of businesses	**103**	(29)
Regulatory penalties	**–**	(49)
EBITA	**1,998**	1,947
Amortisation of intangible assets	**(226)**	(239)
Impairment of intangible assets	**(86)**	(109)
Finance costs[1]	**(275)**	(106)
Taxation expense[1]	**(337)**	(233)
Profit for the year	**1,074**	1,260

Exchange rates – average		
£/$	**1.585**	1.604
£/€	**1.233**	1.153
£/A$	**1.531**	1.553

The results of the Regional Aircraft line of business are shown within discontinued operations (see note 7 to the Group accounts).

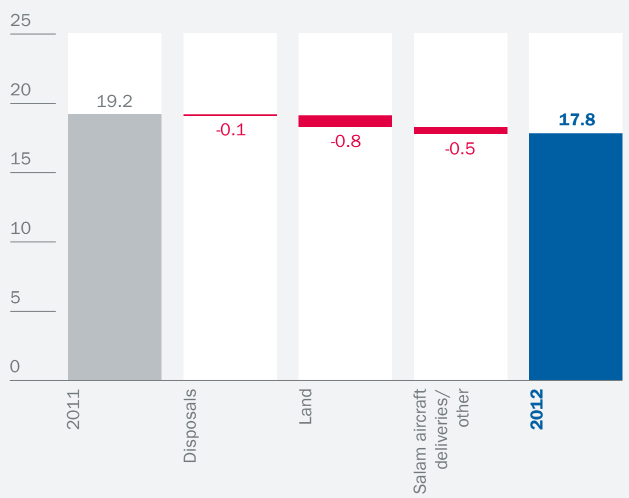
Order backlog[1,2]

Order backlog[1,2] has increased by 8% to £42.4bn driven by a high level of awards in Saudi Arabia and a contract to supply Typhoon and Hawk aircraft to Oman. Non-US and UK funded order intake[1] increased to £11.2bn from £4.8bn in 2011.

Income statement

Sales[1] reduced by 7% reflecting lower volumes in the Land & Armaments business, and there being no contracted Typhoon aircraft deliveries in the year under the Salam Typhoon programme. The Group's sales[1] performance is illustrated in the bridge chart below.

Sales[1] bridge (£bn)



Underlying EBITA[3] Management uses an underlying profit measure to monitor the year-on-year profitability of the Group defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Underlying EBITA[3] was £1,895m (2011 £2,025m) giving a return on sales of 10.6% (2011 10.6%).

Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature. **Profit on disposal of businesses** of £103m in 2012 includes the disposals of Safety Products and Safariland, and assets comprising the Tensylon business, which were part of the Land & Armaments business. The loss of £29m in 2011 arose on the disposals of the Advanced Ceramics and Swiss-Photonics businesses.

Amortisation of intangible assets is £13m lower at £226m mainly reflecting the completion of deliveries under the Family of Medium Tactical Vehicles (FMTV) contract in 2011.

Impairment of intangible assets, including goodwill, of £86m mainly relates to the Safariland and Tensylon businesses sold in July 2012, and the Commercial Armored Vehicles business expected to be sold in the first quarter of 2013. In 2011, charges included those taken against the Safety Products (£66m) and Naval Ships (£34m) businesses.

Finance costs[1] were £275m (2011 £106m). The underlying interest charge, which excludes pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements, was £204m. In the prior year, the underlying interest charge of £199m included £28m relating to the early redemption of debt in connection with the disposal of the Regional Aircraft Asset Management business. Costs in 2012 include interest on the £400m debt refinancing completed in June and a higher level of net present value charges on long-term liabilities.

Taxation expense[1] reflects an effective tax rate of 25%. In 2011, excluding the benefit of an agreement with the UK tax authorities addressing a number of items, including research and development tax credits, the effective tax rate was 26%. The calculation of the effective tax rate is shown below:

Calculation of the effective tax rate	2012 £m	2011 £m
Profit before taxation	**1,411**	1,493
(Deduct)/add back:		
(Profit)/loss on disposal of businesses	**(103)**	29
Regulatory penalties	**–**	49
Goodwill impairment	**57**	94
	1,365	1,665
Taxation expense[1] (excluding 2011 UK tax agreement)	**337**	430
UK tax agreement	**–**	(197)
Taxation expense[1]	**337**	233
Effective tax rate	**25%**	14%
Effective tax rate (excluding 2011 UK tax agreement)	**25%**	26%

The underlying tax rate for 2013 is expected to be between 23% and 25%, with the final number dependent on the geographical mix of profits.

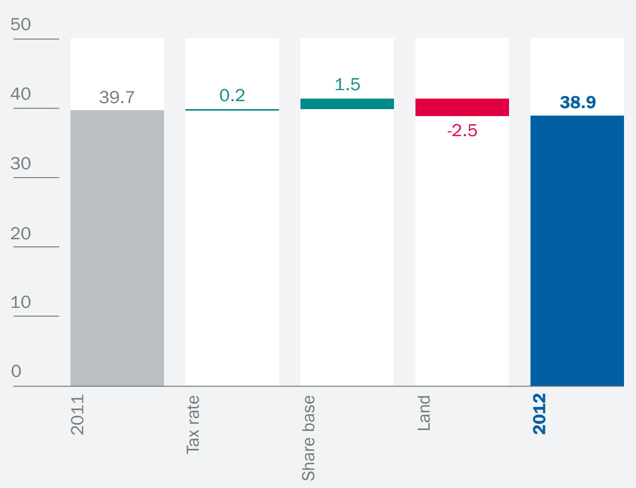
1 Including share of equity accounted investments.
2 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.
3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
4 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
6 See note 10 to the Group accounts.
7 See note 9 to the Group accounts.

Earnings per share

Reconciliation from underlying EBITA[3] to underlying earnings[4] – continuing operations	2012 £m	2011 £m
Underlying EBITA[3] KPI	**1,895**	2,025
Underlying interest charge (see note 5 to the Group accounts)	**(204)**	(199)
	1,691	1,826
Taxation	**(417)**	(472)
UK tax agreement	**–**	197
Non-controlling interests	**(11)**	(16)
Underlying earnings[4]	**1,263**	1,535
Weighted average number of shares	**3,244m**	3,365m
Underlying earnings[4] per share	**38.9p**	45.6p
Underlying earnings[4] per share (excluding 2011 UK tax agreement) KPI	**38.9p**	39.7p

Underlying earnings[4] per share was 38.9p, a decrease of 2% on 2011 (excluding the UK tax agreement benefit). The decrease is illustrated in the bridge chart below.

Underlying earnings[4] per share bridge (pence)



Basic earnings per share, in accordance with International Accounting Standard (IAS) 33, Earnings per Share, was 32.8p compared with 37.0p in 2011 (including the UK tax agreement benefit).

Dividends and share repurchase

The Board is recommending a final dividend of 11.7p per share (2011 11.3p), bringing the total dividend for the year to 19.5p per share (2011 18.8p), an increase of 4%.

The total dividend for the year is covered 2.0 times by underlying earnings[4] from continuing operations (2011 2.1 times excluding the UK tax agreement benefit).

In February 2013, the Group initiated a three-year share repurchase programme of up to £1bn. Full implementation of this programme is subject to satisfactory resolution of Salam Typhoon price escalation negotiations. Discussions with the Group's UK pension scheme trustees have commenced to address any implications for deficit funding plans.

Cash flow

Reconciliation of cash inflow from operating activities[5] to net cash/(debt) (as defined by the Group)[6]	2012 £m	2011 £m
Cash inflow from operating activities[5]	**2,916**	951
Capital expenditure (net) and financial investment	**(293)**	(268)
Dividends received from equity accounted investments	**94**	88
Assets contributed to Trust	**(25)**	(137)
Operating business cash flow[7] KPI	**2,692**	634
Interest	**(147)**	(180)
Income from financial assets at fair value through profit or loss	**–**	4
Taxation	**(115)**	(257)
Free cash flow	**2,430**	201
Acquisitions and disposals	**96**	(256)
Purchase of equity shares (net)	**(16)**	(509)
Equity dividends paid	**(620)**	(606)
Dividends paid to non-controlling interests	**(11)**	(22)
Cash outflow from matured derivative financial instruments	**(119)**	(34)
Movement in cash collateral	**(2)**	–
Movement in cash received on customers' account[8]	**1**	13
Foreign exchange translation	**92**	(20)
Other non-cash movements	**(25)**	36
Total cash inflow/(outflow)	**1,826**	(1,197)
Opening net debt (as defined by the Group)[6]	**(1,439)**	(242)
Closing net cash/(debt) (as defined by the Group)[6]	**387**	(1,439)

The components of net cash/(debt) (as defined by the Group)[6] are as follows:

Components of net cash/(debt) (as defined by the Group)[6]	2012 £m	2011 £m
Debt-related derivative financial assets	**22**	56
Cash and cash equivalents	**3,355**	2,141
Loans – non-current	**(2,967)**	(2,682)
Loans and overdrafts – current	**(21)**	(518)
Less: Cash received on customers' account[8]	**(2)**	(3)
Less: Assets held in Trust	**–**	(403)
Less: Cash held for charitable contribution to Tanzania	**–**	(30)
Net cash/(debt) (as defined by the Group)[6]	**387**	(1,439)

Cash inflow from operating activities[5] was £2,916m (2011 £951m), which includes down-payments received on new contracts to Saudi Arabia and Oman, and contributions in excess of service costs for the UK and US pension schemes totalling £507m (2011 £375m).

The outflow from **net capital expenditure and financial investment** of £293m (2011 £268m) was only marginally higher than 2011.

Dividends received from equity accounted investments, primarily MBDA, Advanced Electronics Company, FNSS and Eurofighter, totalled £94m (2011 £88m). This excludes a £424m non-cash special dividend received from MBDA during the year (see opposite).

1 Including share of equity accounted investments.
2 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.
3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
4 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
5 Excludes the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net cash/(debt).

Assets contributed to Trust comprise £25m of payments made into Trust for the benefit of the BAE Systems 2000 Pension Plan. In 2011, £137m was paid into Trust for the benefit of the Group's main pension scheme.

Taxation payments were £142m lower at £115m primarily reflecting tax refunds following the 2011 UK tax settlement and timing differences on UK and US tax payments, and reflect the level of pension deficit funding to the UK schemes.

Net cash inflow in respect of **acquisitions and disposals** of £96m mainly comprises the disposals of Safety Products and Safariland, and assets comprising the Tensylon business. The prior year outflow of £256m mainly comprised the acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, Norkom Group plc, ETI A/S, Fairchild Imaging, Inc. and stratsec.net Pty Limited (£524m), less the net proceeds from the disposal of the Regional Aircraft Asset Management business (£98m) and the Group's residual shareholding in Saab AB (£152m).

The **net purchase of equity shares** of £509m in the prior year included 184 million shares purchased under the buyback programme at a cost of £500m (excluding transaction costs of £3m).

As a consequence of movements in US dollar and Euro exchange rates during the year, there has been a **cash outflow from matured derivative financial instruments** of £119m (2011 £34m) from rolling hedges on balances with the Group's subsidiaries and equity accounted investments.

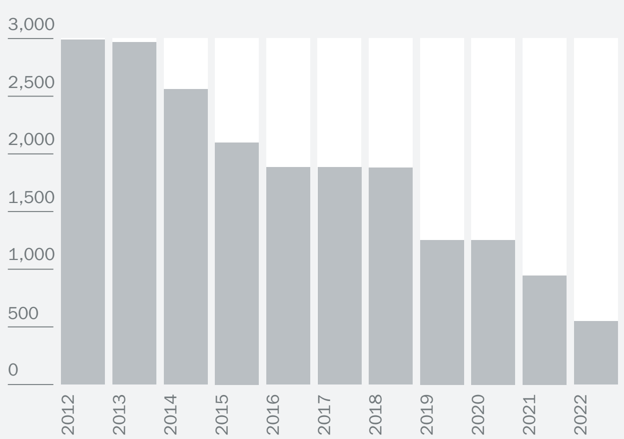
Foreign exchange translation primarily arises in respect of the Group's US dollar-denominated borrowing.

Net cash (as defined by the Group)[6] is £387m, a net inflow from the net debt[6] position of £1,439m at the start of the year. Cash and cash equivalents of £3,355m (2011 £2,141m) are held primarily for pension deficit funding, payment of the 2012 final dividend, the share repurchase programme and management of working capital.

In June 2012, the Group issued a £400m, ten-year bond with an annual coupon of 4.125% intended for general corporate purposes, including the repayment of debt securities at maturity in 2014.

The maturity profile of the borrowings component of net cash is illustrated in the chart below. Details of the Group's objectives and policies regarding net cash/(debt) are provided on page 36.

Maturity profile of the Group's borrowings (£m)



6 See note 10 to the Group accounts.
7 See note 9 to the Group accounts.
8 Cash received 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. It is included within trade and other payables in the consolidated balance sheet.

Balance sheet

Summary balance sheet	2012 £m	2011 £m
Intangible assets	**10,928**	11,465
Property, plant and equipment, and investment property	**2,407**	2,626
Equity accounted investments and other investments	**270**	788
Other financial assets and liabilities (net)	**(50)**	(219)
Tax assets and liabilities (net)	**951**	975
Pension deficit (as defined by the Group)	**(4,560)**	(4,217)
Working capital	**(6,557)**	(5,677)
Net cash/(debt) (as defined by the Group)[6]	**387**	(1,439)
Net liabilities of disposal group held for sale	**(2)**	(3)
Net assets	**3,774**	4,299
Exchange rates – year end		
£/$	**1.624**	1.554
£/€	**1.232**	1.197
£/A$	**1.564**	1.516

The £537m reduction in **intangible assets** to £10.9bn (2011 £11.5bn) mainly reflects amortisation (£226m), impairments (£86m) and exchange translation (£273m).

Property, plant and equipment, and investment property reduced to £2.4bn (2011 £2.6bn) mainly reflecting the sale of certain properties to the BAE Systems Pension Scheme and exchange translation.

The reduction in **equity accounted investments and other investments** reflects the receipt of a £424m non-cash special dividend from MBDA.

The movement in the **pension deficit (as defined by the Group)** during the year was as follows:

Movement in the pension deficit (as defined by the Group)	£m
Total IAS 19 deficit at 1 January 2012	**(5,585)**
Actual return on assets above expected return	**689**
Increase in liabilities due to changes in assumptions	**(1,723)**
Additional contributions from assets held in Trust	**428**
Additional contributions from property disposals	**75**
Other additional contributions in excess of service cost	**195**
Recurring contributions in excess of service cost	**237**
Past service cost	**(27)**
Curtailment gains	**26**
Net financing charge	**(72)**
Foreign exchange translation	**38**
Movement in US healthcare schemes	**11**
Total IAS 19 deficit at 31 December 2012	**(5,708)**
Allocated to equity accounted investments and other participating employers	**1,148**
Group's share of IAS 19 deficit at 31 December 2012	**(4,560)**
Assets held in Trust	**–**
Pension deficit (as defined by the Group)	**(4,560)**

The increase in the Group's share of the pre-tax pension deficit mainly reflects reductions in real discount rates in both the UK and US. A net deferred tax asset of £1.1bn (2011 £1.2bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**, and disclosed in note 18 to the Group accounts.

The Group's pension schemes are discussed in more detail overleaf.

There was a £0.9bn decrease in **working capital** mainly reflecting a net increase in advance contract funding and utilisation of provisions.

Pension schemes

The Group's principal pension schemes are funded defined benefit schemes. The two largest schemes are the BAE Systems Pension Scheme (Main Scheme) and the BAE Systems 2000 Pension Plan (2000 Plan). In aggregate, these two schemes represent 73% (2011 73%) of the total IAS 19, Employee Benefits, deficit at 31 December 2012.

Investment strategy

Some 52% (2011 51%) of the Group's pension scheme assets are held in equities due to the higher expected level of return over the long term. The investment portfolios are highly diversified in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. Some of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of risk.

An analysis of pension scheme assets split between equities, bonds, property and other investments, together with the expected returns on those investments, is shown in note 23 to the Group accounts.

Valuation

Pension plan valuations are performed by independent actuaries for both IAS 19 accounting and funding purposes.

Accounting valuations

A summary of the Group's pension scheme assets and liabilities is shown below:

Pension scheme assets and liabilities	2012 £m	2011 £m
Fair value of plan assets	19,583	17,707
Present value of obligations	(25,291)	(23,292)
Total IAS 19 deficit, net	**(5,708)**	(5,585)
Allocated to equity accounted investments and other participating employers	1,148	965
Group's share of IAS 19 deficit, net	**(4,560)**	(4,620)
Assets held in Trust	–	403
Pension deficit (as defined by the Group)	**(4,560)**	(4,217)

Assets held in Trust of £428m were paid into the Main Scheme and 2000 Plan in 2012 following £25m of additional payments into Trust.

Pension scheme assets are included in the valuation at bid value.

The key assumptions used to calculate pension scheme liabilities for the principal schemes are shown below:

Principal pension accounting valuation assumptions	UK 2012	UK 2011	US 2012	US 2011
Discount rate (%)	4.5	4.8	4.1	5.0
Inflation (%)	2.9	2.9	n/a	n/a
Rate of increase in salaries (%)	3.4	3.4	3.7	4.5
Rate of increase in pensions in payment (%)	1.8–3.5	1.9–3.4	n/a	n/a
Rate of increase in deferred pensions (%)	2.3/2.9	2.0/2.9	n/a	n/a
Life expectancy of a male currently aged 65 (years)	22–24	22–24	19	19
Life expectancy of a female currently aged 65 (years)	24–25	24–25	21	21

The discount rate assumptions are based on third party AA corporate bond indices using yields that reflect the maturity profile of the expected benefit payments. The valuation of the Group's pension liabilities is highly sensitive to movements in the **discount rate**. A ten basis point movement in the rate changes the total pre-tax liability by some £0.4bn.

In the US, **inflation** assumptions are not significant as the Group's US schemes are not indexed with inflation.

The **rate of increase in salaries** for the UK schemes is assumed to be 0.5% (2011 0.5%) above Retail Prices Index (RPI) inflation of 2.9% (2011 2.9%). From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.

The **rate of increase in pensions in payment** differs between UK schemes. Different tranches of the schemes increase at rates based on either RPI or Consumer Prices Index (CPI) inflation, and some are subject to an inflation cap. With the exception of two smaller schemes, the rate of increase in pensions in payment is based on RPI inflation.

The **rate of increase in deferred pensions** for the UK schemes is based on CPI inflation of 2.3% (2011 2.0%), with the exception of the 2000 Plan, which is based on RPI inflation of 2.9% (2011 2.9%).

Life expectancy assumptions use, for the UK schemes, the Self-Administered Pension Scheme S1 tables, with assumed long-term future annual mortality improvements of 1%, and, for the US schemes, the 2013 Internal Revenue Service Static Tables.

In February 2013, with the agreement of the Company, the trustees of the 2000 Plan entered into an arrangement with Legal & General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. This will reduce the funding volatility relating to increasing life expectancy.

A revised version of IAS 19 has been issued, which is effective from 1 January 2013. The revised standard, which is not expected to have an impact on the net pension deficit, is discussed in more detail on page 121.

Funding valuations

Pension scheme assets are included in the valuation at market value, whilst the liabilities are determined based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The latest valuations of the Main Scheme and 2000 Plan were performed as at 31 March 2011 and showed a funding deficit of £3bn. Deficit recovery plans agreed with the trustees of both schemes run until 2026. The expected level of pension deficit funding across all Group schemes, in excess of service cost, is expected to be approximately £0.4bn in 2013.

The results of future triennial valuations and associated funding requirements will be impacted by the future performance of investment markets, and interest and inflation rates.

Deficit allocation

Certain of the Group's equity accounted investments participate in the Group's defined benefit pension schemes as well as Airbus SAS, the Group's share of which was sold in 2006. As these are multi-employer schemes, the Group allocates an appropriate share of the IAS 19 pension deficit to those equity accounted investments and Airbus SAS.

Capital

Objectives	Policies	Performance
Maintain the Group's investment grade credit rating and ensure operating flexibility, whilst: – **meeting its pension obligations;** – **continuing to pursue organic investment opportunities;** – **paying dividends in line with the Group's policy of long-term sustainable cover of around two times underlying earnings[4];** – **making accelerated returns of capital to shareholders when the balance sheet allows; and** – **investing in value-enhancing acquisitions, where market conditions are right and where they deliver on the Group's strategy.** For more information see note 25 to the Group accounts	The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings. The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required.	At 31 December 2012, the Group's capital was £3,782m (2011 £4,291m), which comprises total equity of £3,774m (2011 £4,299m), excluding amounts accumulated in equity relating to cash flow hedges of £8m debit (2011 £8m credit). Net cash (as defined by the Group)[6] was £387m (2011 net debt £1,439m). During the year, the Group returned £620m to shareholders in dividends.

Tax

Objectives	Policies	Performance
The Group's tax strategy aims to: – **ensure compliance with all relevant statutory obligations; and** – **manage the Group's tax burden in a way that is consistent with its Values and its legal obligations in all relevant jurisdictions.** For more information see notes 6 and 18 to the Group accounts	The Group seeks to build constructive, open working relationships with tax authorities through full disclosure, and actively considers the implications of tax planning for the Group's wider corporate reputation. Whilst the Group aims to maximise the tax efficiency of its business transactions, it does not use structures in its tax planning that are against the spirit of the law, nor does it engage in tax evasion. Arm's length principles are applied in the pricing of all intra-group transactions of goods and services in accordance with OECD guidelines. Where appropriate, the Group consults with tax authorities to help shape proposed legislation and tax policy. BAE Systems operates internationally and is subject to tax in many different jurisdictions. The Group employs professional tax managers and takes appropriate advice from reputable professional firms. The Group is routinely subject to tax audits and reviews which can take a considerable period of time to conclude. Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiations or litigation.	The Group's tax affairs are broadly up to date in the jurisdictions in which it operates. During 2012, an Annual Compliance Agreement (ACA) was signed with the Australian Tax Office (ATO) covering income tax and goods and services tax. The ATO's Tax Commissioner said the arrangements offered an innovative way forward for business to work closely with the ATO, and that an ACA formalises the open and transparent relationship they seek to have with large business.

4 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 8 to the Group accounts).
6 See note 10 to the Group accounts.

Treasury

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 tax expertise.

The Group operates a centralised treasury department that is accountable to the TRMC for managing treasury activities in accordance with the treasury policies 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.

Compliance with treasury policies is monitored and any exceptions found are reported to the TRMC. Treasury policies remain under close review given continuing volatility in financial markets.

Objectives	Policies	Performance
Net cash/(debt)		For more information see note 10 to the Group accounts
Maintain a balance between the continuity, flexibility and cost of debt funding through the use of borrowings from a range of markets with a range of maturities, currencies and interest rates, reflecting the Group's risk profile.	Material borrowings are arranged by the central treasury department. Funds raised are lent onward to operating subsidiaries as required and any surplus funds are lent back where appropriate. The Group intends to continue to fund the business conservatively through proactive use of bank and capital markets.	In June 2012, the Group issued a £400m, ten-year bond with an annual coupon of 4.125% intended for general corporate purposes, including the repayment of debt securities at maturity in 2014. Excluding acquisition or disposal financing and share buybacks, net cash/(debt) is driven by the Group's operational performance and receipts on major contracts. The net cash/(debt) position of the Group is generally best at the end of the year.
Interest rates		For more information see note 27 to the Group accounts
Manage the Group's exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, mainly interest rate swaps.	A minimum of 50% and a maximum of 90% of gross debt is maintained at fixed interest rates. The Group's interest rate policy has been amended by the TRMC during the year to allow the fixed interest rate component of gross debt to increase from a maximum of 75% to 90% reflecting the current exceptionally low interest rate environment.	At 31 December 2012, the Group had 79% (2011 63%) of fixed rate debt and 21% (2011 37%) of floating rate debt based on a gross debt of £3.0bn, including debt-related derivative financial assets (2011 £3.1bn).
Liquidity		For more information see note 27 to the Group accounts
Maintain adequate undrawn committed borrowing facilities.	The Group's committed Revolving Credit Facility (RCF) is £2bn (2011 £2bn). The RCF, which is contracted until 2015, is syndicated amongst the Group's core relationship banks and is available to meet expected general corporate funding requirements. The RCF also acts as a back stop to Commercial Paper issued by the Group. Cash flow forecasting is performed by the businesses on a monthly basis. The Group monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet operational needs and maintain adequate headroom.	The RCF was undrawn throughout the year. The Group had no Commercial Paper in issue at 31 December 2012 (2011 £513m).
Monitor and control counterparty credit risk and credit limit utilisation.	The Group adopts a conservative approach to the investment of its surplus cash. It is deposited with financial institutions with the strongest credit ratings for short periods. A credit limit is allocated to each institution taking account of its market capitalisation, credit rating and credit default swap price.	The Group had cash and cash equivalents at 31 December 2012 of £3,355m (2011 £2,141m), which was invested with 29 financial institutions (2011 24). The maximum amount deposited with any individual bank as at 31 December 2012 was less than £300m (2011 £200m). The Group has no exposure to Greek, Irish, Italian, Portuguese or Spanish banks. Additionally, the Group monitors its exposure to banks which have exposure to these countries.

Objectives	Policies	Performance
Currency		For more information see note 27 to the Group accounts
Reduce the Group's exposure to volatility in earnings and cash flows from movements in foreign currency exchange rates, mainly the US dollar, Euro and Saudi Riyal.	The Group is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. All material firm transactional exposures are hedged, unless otherwise approved as exceptions by the TRMC, and the Group aims, where possible, to apply hedge accounting to these transactions. The Group is exposed to movements in foreign currency exchange rates in respect of the translation of the net assets and income statements of foreign subsidiaries and equity accounted investments. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of foreign subsidiaries and equity accounted investments it regards as long-term investments.	There was a net charge of £5m in the income statement for the year (2011 net credit £85m) in respect of market value and foreign exchange adjustments on financial instruments and investments.
Credit quality		
Maintain an investment grade rating in order to ensure access to the widest possible sources of finance, minimise the cost of debt funding and to support the efficient operation of the Group's activities.	The Group aims to deliver its planned operating cash flows and manage its relationships with debt capital market investors, banks and rating agencies.	Three credit rating agencies publish credit ratings for the Group: – Moody's Investors Service – Baa2; – Standard & Poor's Ratings Services – BBB+; and – Fitch's Investors Service – BBB+. During the year, all three maintained their categories and outlooks for the Group as investment grade and stable, respectively.

Insurance

Objectives	Policies	Performance
Maintain an understanding of the current and future risk profile of the Group, offer tailored risk mitigation solutions, and ensure the Group insurance protection reflects current exposures.	The Group operates a policy of partial self-insurance, with the majority of cover placed in the external market. The Group insures its export contracts and associated on-demand bank guarantees against political and corporate risks. All of the Group's insurers must have a minimum credit rating of A-.	The Group continues to monitor its insurance arrangements to ensure the quality and adequacy of cover. During 2012, the Group again sought external validation of the credit rating of those insurers who have a significant proportion of the insurance portfolio. The views of a number of rating agencies and insurance intermediaries were considered to assess the long-term stability of the Group's insurers. Following the flood at the Electronic Systems site in Johnson City, New York, in 2011, the Group successfully recovered $186m (£115m) under various insurance policies.

Critical accounting policies

Certain of the Group's accounting policies are considered by the directors to be critical because of the level of complexity, judgement or estimation involved in their application and their impact on the consolidated financial statements. The directors believe that the consolidated financial statements reflect appropriate judgements and estimates, and provide a true and fair view of the Group's financial performance and position. The critical accounting policies are listed below and explained in more detail in note 32 to the Group accounts. References to the relevant individual notes to the Group accounts are also provided.

Recognition of profit on long-term contracts (IAS 11, Construction Contracts)

Revenue on long-term contracts is recognised in the Group's income statement when performance milestones have been completed.

The ultimate profitability of the contract is estimated based on estimates of revenue and costs, including allowances for technical and other risks, which are reliant on the knowledge and experience of the Group's project managers, engineers, and finance and commercial professionals. Material changes in these estimates could affect the profitability of individual contracts.

Revenue and cost estimates are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances.

Profit is recognised progressively as risks have been mitigated or retired.

A significant proportion of the Group's £16.6bn of revenue in 2012 was accounted for under IAS 11.

For more information see note 1 to the Group accounts

Valuation of retirement benefit obligations for defined benefit pension schemes (IAS 19, Employee Benefits)

The retirement benefit obligation recognised in the Group's balance sheet represents 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.

For each of the assumptions used to measure the Group's pension scheme liabilities (summarised on page 34), there is a range of possible values and management exercises judgement in deciding 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. Pension scheme accounting valuations are prepared by independent actuaries as at 30 June and 31 December each year.

The Group has allocated a share of the pension deficit to its equity accounted investments and other participating employers using a consistent method of allocation, which represents the directors' best estimate of the deficit anticipated to be funded by these entities.

At 31 December 2012, the Group's share of the IAS 19 pension deficit was £4.6bn, excluding amounts allocated to equity accounted investments and other participating employers.

For more information see note 23 to the Group accounts

Valuation of acquired intangible assets (IFRS 3, Business Combinations) and ongoing impairment testing (IAS 36, Impairment of Assets)

Acquired intangible assets, excluding goodwill, are valued in line with internationally used models, which require the use of estimates that may differ from actual outcomes. These intangible assets are amortised over their estimated useful lives. Future results are impacted by the amortisation periods adopted 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 businesses.

At 31 December 2012, total intangible assets were £10.9bn, including £10.4bn of goodwill.

For more information see note 11 to the Group accounts

CORPORATE RESPONSIBILITY REVIEW

1 2 3 4

Our business model
See page 17

Our approach to Corporate Responsibility

The Group's approach to Corporate Responsibility (CR) is an integral part of its strategy, with the Responsible Behaviour element of Total Performance (see page 16). CR is focused on embedding responsible business behaviours by placing emphasis not just on what the Group does, but how it is done.

CR supports the long-term sustainability of the Group by managing the current impacts of its operations and products, and anticipating the future global business environment to ensure that it has in place:

- responsible business practices to underpin business activities and support employees in making the right decisions to drive business performance;
- a safe work environment for employees;
- a diverse range of talented employees with a broad range of skills and capabilities to deliver against global customer requirements; and
- programmes to manage the environmental impacts of the Group's operations and products, reducing the Group's carbon footprint and that of the Group's customers.

In September 2012, BAE Systems was confirmed as a member of the Dow Jones Sustainability European Index.

Dow Jones Sustainability Indexes
Member 2012/13

Clear governance structures and visible leadership play a vital role in embedding CR.

The Chief Executive has overall responsibility for the Group's ongoing commitment to CR. He is supported by the Board and Corporate Responsibility Committee in ensuring that appropriate policies, systems, reporting structures and metrics are in place to achieve the Group's ethical, social and environmental performance objectives.

The Group's CR team reports directly to the Chief Executive, and supports the Executive Committee in embedding and driving CR processes and performance. Performance is measured and risk monitored throughout the year via the Group's six-monthly Operational Assurance Statement (OAS) (see page 86) and Quarterly Business Review (QBR) (see page 84) processes.

The Group's Internal Audit team also assesses the effectiveness of policies and processes relating to key areas of ethical and reputational risk.

Stakeholders and materiality

The Group's principal stakeholders include investors, customers, employees, business partners, suppliers, non-government organisations and the communities in which it operates.

Stakeholder feedback informs the Group's strategy and approach to managing CR. BAE Systems aims to communicate openly with stakeholders about its business. Two-way dialogue helps the Group to understand their views and concerns, and explain the Group's approach.

CR covers the areas identified by internal and external stakeholders as having the most potential to affect the long-term sustainability of the Group, by directly impacting the Group's reputation or ability to operate (outlined below). The areas identified shape the Group's CR objectives and programmes, and are given priority.

The key CR areas and emphasis are:

- Ethics and governance
- Employee and product safety
- Diversity and inclusion
- Operational and product environmental impacts

Details of these areas are covered in this section of the report.

CR objectives

During 2012, the Group focused on four key areas:

- Ethics – continuing to strengthen the Group's governance processes and policies to ensure that employees have clear guidance to enable them to make ethical decisions.
- Employee safety – embedding a safety first approach to the Group's operations so that all employees understand the importance of a safe workplace.
- Diversity and inclusion – continuing to develop a diverse and inclusive workplace which encourages innovation and enhances productivity.
- Operational environmental impacts – minimising the Group's operational impacts.

Progress against the ethics objective is supported by Group-wide programmes and is discussed overleaf.

Progress against objectives in employee safety, diversity and inclusion, and operational environmental impacts is driven by programmes at reporting segment level. These objectives are bonus-related for senior executives globally (see page 99 of the Remuneration report). An overview of progress against these objectives is discussed on the following pages and within the reporting segment reviews (see pages 59 to 75).

In 2012, the Group and individual reporting segments made good progress across all CR objectives.

See page 114 for more information on the Group's Community Investment programme

Ethics and governance

2012 objective
– Continue to improve and evolve the Group's business conduct programme.

BAE Systems continues to embed its ethics programme globally. It continues to focus on driving the right behaviours by supporting employees in making good ethical decisions and embedding responsible business practices.

Supporting employees in making ethical decisions is core to the Group's ethics programme and governance framework. The Group's Code of Conduct sets out the principles and standards of business conduct expected of all employees wherever they operate and in whatever role. It provides them with practical guidance on how to deal with situations that may arise in their day-to-day activities. It also includes guidance on where to go for advice, where to report concerns and information on the Group's Ethics Helpline.

The Code of Conduct and related policies are supported by regular mandatory training for all employees. During 2012, the Group rolled out its latest employee ethics training programme which focused on making responsible decisions. The training was based around a number of scenarios, each representing different working environments and subject areas.

Detailed mandatory policies and procedures, including the Group's policies on Fraud, Facilitation Payments, Product Trading and Export Control, are also available online for employees.

Additional compliance-based e-learning training is also targeted at employees throughout the year. For example, senior executives and business leaders undertake the Group's Integrity in Business Dealings training covering our policies on Gifts and Hospitality, Facilitation Payments, Company Giving and Conflicts of Interest. All employees using the Group's IT system have been required to complete a number of training modules in IT Security and Export Control.

Employees have the opportunity to get independent advice and support or report concerns via Ethics Officers, now in place across the businesses, or via the Ethics Helpline, which is also available to third parties. During 2012, 1,024 enquiries were reported to Ethics Officers and via the Helpline. The Group has seen a steady increase in reports and requests for guidance to Ethics Officers as they become more established within their businesses.

If employees are found to be in breach of the Group's Code of Conduct or related policies, they will potentially be subject to disciplinary action. In 2012, 292 employees were dismissed for reasons relating to breaches of the Group's standards and policies, primarily for personnel and workplace issues.

The Group's governance framework covers the products it makes and exports. The Group's Responsible Trading Principles, Product Trading Policy and Pursuit of Export Opportunities Policy help employees make informed decisions about the business opportunities the Group pursues and to address any responsible trading risks, including risks associated with the product and its intended end use, the country of origin and delivery, and the customer.

The Group is committed to respecting human rights in its operations, within its sphere of influence, including supporting conventions on child labour and minimum wages.

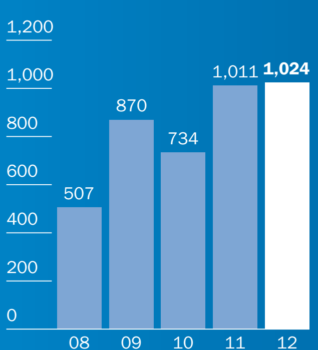
The Group continues to support and help improve ethical standards across the defence industry. During 2012, the Group chaired the International Forum on Business Ethical Conduct (IFBEC) for the Aerospace and Defence Industry and remained a Task Force member. IFBEC is committed to promoting high ethical standards through the adoption of Global Principles of Business Ethics for the Aerospace and Defence Industry.

Supplier management is important to the Group as it depends on its suppliers to help to deliver the products and systems its customers need, on time and to the quality they expect. Poor performance or unethical conduct by a supplier could affect the Group's reputation or its ability to operate effectively.

The Group expects its suppliers to comply with local legislation and to meet equivalent standards on issues such as ethical conduct, health and safety, product safety, the environment, civil liberties and human rights. The Group also expects them to apply these standards in their own supply chains and assesses compliance during the supplier selection process.

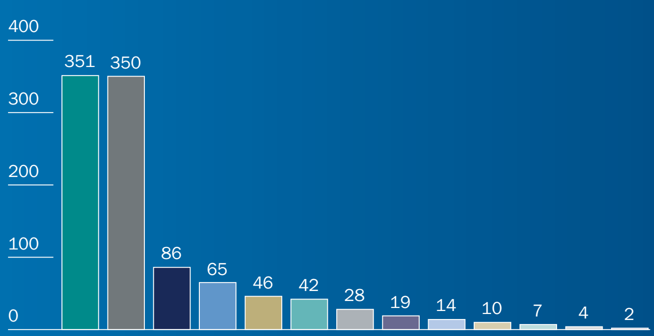
2013 objective
– Continue to improve and evolve the Group's business conduct programme.

Enquiries to Ethics Helpline^



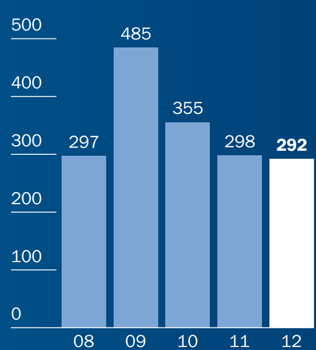
All enquiries reported to Ethics Officers and via the Ethics Helpline were reviewed and reported either to the Ethics Review Committee or, in BAE Systems, Inc., to the Ethics Review Oversight Committee.

2012 enquiries to Ethics Helpline^



- Employee relations and conduct
- Guidance and advice
- Labour/expenses practices
- Management practices
- Open enquiries[1]
- Security and misuse of assets
- Conflicts of interest
- Company ethical practices
- Environmental, Health and Safety
- Procurement, trade and marketing
- Quality or manufacturing issues
- Contract compliance
- International business issues

Dismissals for reasons relating to unethical behaviour*



If an employee is found to be in breach of the Group's Code of Conduct or any other relevant policies, appropriate disciplinary action, which may include dismissal, is taken.

^* See assurance statement on www.baesystems.com/deloitteassurancestatement
1 US category only.

Employee and product safety

2012 objectives

- Businesses to demonstrate improvement against 2011 performance on recordable accidents.
- Continue to progress against the Safety Maturity Matrix.

Employee safety

The safety of the Group's employees, and anybody who works on its sites, is a key priority. The Group wants everyone to return home safely at the end of each day. The Group's goal is to continue to embed a safety first approach by providing training and tools that help employees understand the importance of a safe workplace, and encouraging employees to take responsibility for their own safety and the safety of those around them.

During 2012, the Group's global Safety, Health and Environment (SHE) Steering Group focused on reviewing high risk manufacturing activities which could lead to major accidents. A working group was set up to establish minimum safety standards and processes, which will be launched during 2013. The SHE Steering Group also monitored safety performance, including progress against the Safety Maturity Matrix (SMM) which was introduced in 2008. The SMM has helped drive consistent standards of safety across the Group.

Collaboration across the Group's safety teams was recognised during 2012 with a Gold award in the BAE Systems' Chairman's Awards category of Transferring Best Practice. Safety teams worked together to support the launch of an employee safety programme that can be easily transferred across businesses (see page 71 for more information).

The Group uses a number of global metrics throughout the year to manage and monitor safety.

At the start of 2012, the Group changed the metric used to monitor work place injuries from the Lost Work Day Case Rate to the Recordable Accident Rate. The change in metric enables inclusion of a wider scope of accidents within its reviews, which is expected to lead to improvements in accident prevention. The Recordable Accident Rate is the metric that has been linked to executive bonuses.

During 2012, the Recordable Accident Rate decreased by 30%. This was ahead of improvement targets set. This progress represents a fifth consecutive year of improvement. Individual reporting segment performance against this metric can be found on pages 59 to 75.

Regrettably, there was one work-related employee fatality in 2012. Each accident is thoroughly investigated and lessons learnt are applied across the Group.

2013 objective

- Demonstrate improvements against key safety indicators, including a 10% improvement in the Recordable Accident Rate.

Product safety

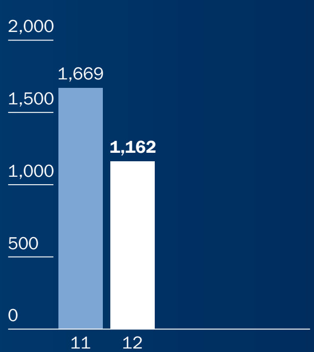
It is critical that the Group's products do what they are designed for without unacceptable harm to any third parties or the people using them. No complex and innovative product, whether used in defence or civilian markets or both, is without risk. It is essential that the Group achieves an appropriate balance between the benefits they provide to customers and the risks associated with their use.

The Group's Product Safety Policy and practices are built on a set of product safety principles that apply throughout a product's life from concept and manufacturing through to use and disposal. The safety of the Group's products relies on the application of its safety policies and processes, and on the behaviours and attitudes of the employees working on them.

Across the Group's businesses, there are a number of working groups that ensure a consistent approach to product safety by sharing ideas and best practice.

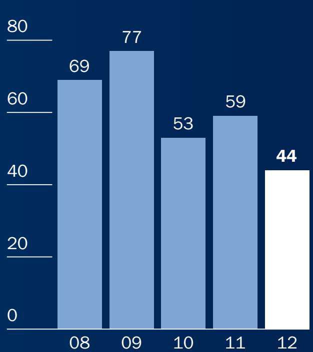
During 2012, the Group continued to work with its customers to agree the level of safety required that is both ethical and lawful, the risks that are acceptable, and to deliver products that met that level.

Recordable Accident Rate (per 100,000 employees)*



The Recordable Accident Rate decreased by 30% during 2012, exceeding the 15% stretch objective set by the Group (see page 15).

Major injuries recorded*



Major injuries recorded decreased during 2012 in line with the Group's overall focus on accident reduction.

2012 causes of major injuries recorded*

* See assurance statement on www.baesystems.com/deloitteassurancestatement

Diversity and inclusion

2012 objective
– Demonstrate continued progress against the Diversity & Inclusion Maturity Matrix and establish milestones/targets to underpin delivery of the stated 2015 position.

The Group is committed to creating an inclusive work environment in which a diverse range of talented people work together to improve business performance and productivity by helping the Group to remain competitive and innovative. A more diverse workforce has a greater range of skills and capabilities which helps to better understand customers and their requirements.

To support this commitment, the Group's long-term goal is to build a high-performing workforce that more closely reflects the diversity of the local communities in which its businesses operate.

Across the Group, businesses have put in place plans to 2015 to support and progress this aim. Highlights from these programmes can be seen within the reporting segment reviews on pages 59 to 75. Activities include the development of frameworks and steering groups, mentoring programmes, and training designed to support the improvement in the diversity of its employees and create a more inclusive work environment over the long term.

In 2012, the Executive Committee progressed actions to grow the female talent pipeline at senior executive levels, with an aspiration of continuing to achieve 25% female membership of the Executive Committee by 2015:

Fostering a culture of inclusion – unconscious bias training for executives globally has been scoped and will be rolled out during 2013. The objective of the training is to enhance talent management decisions by raising awareness of unconscious and conscious bias that influence those decisions.

Accelerating the development of high-potential women – an Executive Committee mentoring programme was launched during 2012 to leverage the readiness of high-potential women across the organisation and 24 high-potential women were mentored during the year. This programme was supported by increased participation by high-potential women in training and development programmes.

Increasing leadership diversity – to ensure diverse candidate lists for leadership roles, where possible, executive search firms were employed with a track record of open and inclusive recruitment processes, and drawing from an appropriately diverse pool of candidates, with the overall aim of appointing the best person for the role.

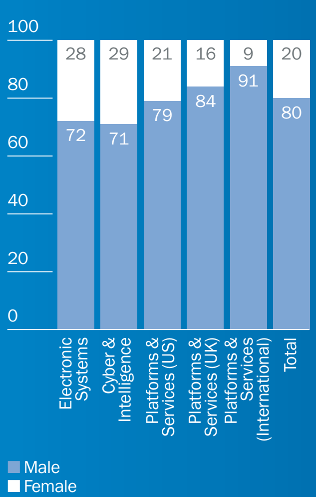
Measuring performance – on a national basis, defined aspirational objectives and actions have been put in place to increase gender diversity. Gender diversity in leadership positions and succession plans is monitored.

At the end of 2012, 27% and 25% of the Board and Executive Committee members, respectively, were women. Globally, 20% of the Group's workforce are women.

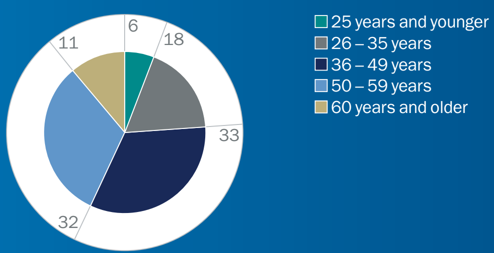
2013 objective
– Increase diversity and inclusion within the organisation in accordance with business goals.

See page 26 for more information on our people

2012 gender diversity (%)*



2012 age diversity (%)*



Diversity data for both gender and age remained consistent with 2011. During 2012, the Group continued to embed a diversity and inclusion strategy to support the recruitment, engagement and retention of talented employees from all backgrounds.

* See assurance statement on www.baesystems.com/deloitteassurancestatement

Operational and product environmental impacts

2012 objective
- Continued progression against the Environmental Sustainability Maturity Matrix – businesses to meet 2012 targets for energy, waste and water.

Operational environment
Businesses across the Group have environmental management systems in place that monitor and manage impacts from greenhouse gas emissions, material and solvent use, waste products, and emissions to the atmosphere.

The Group's goal is to reduce the environmental impact of its operations and products by using energy, waste and water more efficiently.

During 2012, businesses set targets to reduce the amount of energy and water used, and the amount of waste generated. In total during the year, energy use was reduced by 12%[1], water consumption was reduced by 7%[1,2] and waste generated was reduced by 25%[1].

The Group monitors and reports greenhouse gas emissions, primarily from energy use, on a Group-wide basis to understand its global contribution to climate change. This helps the Group to meet the requirements of legislation, such as the UK government's Carbon Reduction Commitment and the Australian National Greenhouse Energy Reporting Act.

The Group's 2012 carbon footprint decreased by 12% against 2011 to approximately one million tonnes[3] of CO_2 equivalent primarily due to the energy reduction targets achieved across the businesses during 2012.

The majority of the Group's greenhouse gas emissions come from the energy it uses in manufacturing and business travel.

Product environment
The Group ensures that environmental considerations are taken into account throughout a product's lifecycle from concept, design and manufacture through to use and disposal via the Group's Lifecycle Management (LCM) process (see page 84). LCM supports the Group in identifying and managing environmental risks, including reducing the environmental impacts of the Group's products during research and development, minimising waste materials during manufacturing, and helping to reduce product impacts when being used, upgraded and disposed.

Engineers are given training and guidance via the Group-wide Environmental Policy and Product Environmental Management handbook to promote understanding of environmental product design.

The Group's Product Environmental Working Group develops guidance documents and identifies good practices to share with businesses to promote consistently high standards.

The Group works with customers to help them to understand the environmental impacts of its products and supports them on their environmental programmes. For example, the Group works with the UK Ministry of Defence on their Sustainable Procurement Strategy.

The Group also works with suppliers to reduce the environmental impact of the products and services they supply, reducing costs and the Group's environmental footprint. To support this, the Group introduced a Sustainable Procurement handbook to help purchasing teams understand and embed environmental standards into the supplier management process.

Working in partnership with a variety of organisations, the Group helps improve the environmental impacts of its business and the wider defence industry. In the UK, the Group is a member of ADS Group, the Aerospace, Defence, Security and Space industries association, to help the industry prepare for, and respond to, legislation on hazardous materials and environmental design. Also in the UK, the Group works with the Institute of Environmental Management and Assessments to develop environmental competencies for environmentalists and non-environmentalists.

2013 objectives
- Set environmental improvement targets in line with the Integrated Business Plan to include energy, water and waste.
- Establish a monitoring and recording system for air travel.

1 Data is derived from internal recording systems and is not subject to external verification or audit.
2 Data excludes Ordnance Solutions Inc. and Saudi Arabia.
3 The Group's 2012 carbon footprint was externally compiled by the Coefficient Company.

Deloitte LLP assurance statement

This year, Deloitte LLP assured the following performance indicators at Group level:

Ethics and governance – employee and third-party enquiries to Ethics Helpline^ (total number and number by category) and dismissals for reasons relating to unethical behaviour*;

Safety – Recordable Accident Rate*, the number of major injuries recorded* and causes of major injuries recorded*;

Diversity and inclusion – employees split by gender* and age*; and

Community – total Community Investment programme donations* (see page 114).

Deloitte LLP has provided limited assurance on performance indicators marked with a * and reasonable assurance on performance indicators marked with a ^.

To see Deloitte LLP's assurance statement go to: www.baesystems.com/deloitteassurancestatement

More information

More information on the Group's CR performance is available online at: www.baesystems.com/corporateresponsibility

- Stakeholder engagement
- Support for local communities
- Internal governance controls
- Deloitte assurance statement

RISK MANAGEMENT

Effective management of risks and opportunities is essential to the delivery of the Group's strategic objectives, achievement of sustainable shareholder value, protection of its reputation and meeting the requirements of good corporate governance.

How BAE Systems manages risk

Board

The Board has overall responsibility for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives, and ensuring that risks are managed effectively across the Group.

Risk is a regular agenda item at Board meetings and the Board reviews risk as part of its regular strategy review process. This is aimed at providing the Board with an appreciation of the key risks within the business and oversight of how they are being managed.

The Board delegates certain risk management activities to the Audit and Corporate Responsibility committees as follows.

Audit Committee

The Audit Committee monitors the Group's key risks identified by the risk assessment processes and reports its findings to the Board on a regular basis. It is also responsible for reviewing in detail the effectiveness of the Group's system of internal control policies, and procedures for the identification, assessment and reporting of risk.

Corporate Responsibility Committee

The Corporate Responsibility Committee monitors the Group's performance in managing the Group's significant non-financial risks, including those arising in respect of business conduct, health and safety, and the environment, and reports its findings to the Board on a regular basis.

Approach

The Group's approach to risk management is aimed at the early identification of key risks, to remove or reduce the likelihood and effect of those risks before they occur, and deal 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.

Reporting within the Group is structured so that key issues are escalated through the management team and ultimately to the Board where appropriate. The underlying principles of the Group's risk management policy are that risks are monitored continuously, associated action plans reviewed, appropriate contingencies provisioned and this information reported through established management control procedures.

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 misstatement or loss.

Financial and non-financial risks

Financial risks expose the Group to potential costs which are quantifiable on the basis that their probability and impact can be adequately understood and related to the financial statements.

Non-financial risks cannot readily be assessed in financial terms and, therefore, cannot be reflected reliably in the financial statements.

See page 78 for more information on the activities of the Board and its committees

Process

Businesses

The responsibility for risk identification, analysis, evaluation and mitigation rests with the line management of the businesses. They are also responsible for reporting and monitoring key risks in accordance with established processes under the Group's Operational Framework.

The Group's risk management process is set out in the Risk Management Policy, a mandated policy under the Operational Framework, and, in respect of projects, in the Lifecycle Management Framework, a core business process under the Operational Framework. Further guidance is provided by a Risk Management Maturity self-assessment tool.

Identified risks are documented in controlled risk registers showing: the risks that have been identified; characteristics of the risk; the basis for determining mitigation strategy; and what reviews and monitoring are necessary. Each risk is allocated an owner who has authority and responsibility for assessing and managing it.

Project risks are reported and monitored in Group-mandated format Contract Review Packs, which are reviewed by management at monthly Contract Reviews. The financial performance of projects is reported and monitored using Contract Status Reports, which form part of the Contract Review Pack. These include programme margin variation metrics, which are reviewed regularly by the Executive Committee and Board (see KPI on page 15). Project margin is recognised after making suitable allowances for technical and other risks related to performance milestones yet to be achieved.

In addition, every six months, the businesses complete an Operational Assurance Statement (OAS), which is a mandated policy under the Operational Framework. The OAS is in two parts: a self-assessment of compliance with the Operational Framework; and a report showing the key financial and non-financial 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.

Executive Committee

The key financial and non-financial risks identified by the businesses from the risk assessment processes are collated and reviewed by the Executive Committee to identify those issues where the cumulative risk, or possible reputational impacts, could be significant.

Management responsibility for the management of the Group's most significant non-financial risks is allocated at the Executive Committee's risk workshops. The OAS and Non-financial Risk registers are reviewed regularly by the Executive Committee to monitor the status and progression of mitigation plans, and these key risks are reported to the Board on a regular basis.

Principal risks

Risks are identified as principal based on the likelihood of occurrence and potential impact on the Group.

The principal risks identified by the Group using the policies and processes explained above during the year are shown on pages 46 to 51.

See page 83 for more information on the Group's business processes and mandated policies

BOARD
– Overall responsibility for risk management

Monitoring

AUDIT COMMITTEE
– Operational Assurance Statement Risk Register
– Non-financial Risk Register

CORPORATE RESPONSIBILITY COMMITTEE
– Non-financial Risk Register

Monitoring and reporting

Monitoring and reporting

Monitoring and reporting

EXECUTIVE COMMITTEE
– Operational Assurance Statement Risk Register
– Non-financial Risk Register

Monitoring and reporting

BUSINESSES

Integrated Business Plan – Core Business Process*
Annual long-term strategy and five-year plan for each business

Operational Assurance Statement – Mandated Policy*
Six-monthly management self-assessment of compliance with the Operational Framework and summary of key risks

Chief Executive's Business Review – Core Business Process*
Quarterly top-level review of the key operational, financial and non-financial performance issues within the business, and significant forthcoming bids and events

Quarterly Business Review – Core Business Process*
Quarterly management review of the performance of each of the Group's businesses against their objectives, measures and milestones

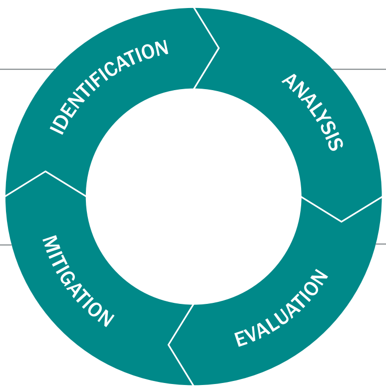
Lifecycle Management Contract Review – Core Business Process*
Monthly management review of project performance and issues to ensure that appropriate decisions and actions are taken

Monitoring and reporting

BUSINESS RISK

Risk Management Policy – Mandated Policy*

1. IDENTIFICATION
– Financial and non-financial risks recorded in controlled risk registers



2. ANALYSIS
– Risks analysed for impact and probability to determine gross exposure

3. EVALUATION
– Risk exposure reviewed and risks prioritised

4. MITIGATION
– Risk owners identified and action plans implemented
– Robust mitigation strategy subject to regular and rigorous review

* As defined in the Group's Operational Framework

See page 84 for more information on the Group's Operational Framework

PRINCIPAL RISKS

Summary of principal risks

The Group's principal risks are identified below, together with a description of how the Group mitigates those risks.

Link to Total Performance	Financial Performance			
	Customer Focus	Programme Execution	Responsible Behaviour	Other
High impact	Defence spending **p46** Government customers **p47** Global market **p47**	Large contracts **p48** Fixed-price contracts **p48**	Laws and regulations **p49**	Competition **p49** Pension funding **p50** Export controls and other restrictions **p50** Acquisitions **p50**
Medium impact	Contract award timing **p47**	Component availability, subcontractor performance and key suppliers **p48**		Consortia and joint ventures **p51** Exchange rates **p51** Cybersecurity **p51**

Defence spending

The Group is dependent on defence spending.

Description
The Group's core businesses are primarily defence-related, selling products and services directly and indirectly, mainly to the US, UK, Saudi Arabian and other national governments. 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, and, as such, may be subject to significant fluctuations from year to year. With constraints on government expenditure in a number of the Group's markets and countries in the Eurozone area experiencing serious financial difficulties, affordability continues to be a key focus for customers.

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

Mitigation
The Group's business is geographically spread across five home markets and its products are marketed across a range of defence markets. The Group has a highly sustainable services business, which is an area for growth as customers' operations and maintenance budgets come under pressure. Significant cost reductions continue to be made to address increased budgetary pressures in the US and UK. The Group continues to use conservative assumptions to underpin its financial and operational planning.

Overhanging the US defence sector into 2013 is the potential impact of a sequestration or other budget reductions that could result in indiscriminate funding cuts. The Group bases its plans on conservative assumptions and continues to address its cost base accordingly.

Defence budgets in the UK are expected to remain flat, but the recent stabilising of equipment and services requirements and the budget outlook has established a more predictable planning environment.

In Saudi Arabia, regional tensions continue to dictate that defence remains a high priority.

See page 22 for more information on the Group's five home markets

Government customers

The Group's largest customers are governments.

Description
Companies engaged in the supply of defence and security-related equipment and services to government agencies are subject to certain business risks particular to the defence and security industries. These governments could modify contracts or terminate them at short notice and at their convenience. For example, long-term US government contracts are normally funded annually and are subject to cancellation or delay if funding appropriations for subsequent performance periods are not made. 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, the failure of the relevant agencies to obtain expected funding appropriations for the Group's programmes, or a deterioration in the Group's relationship with any of its key government customers and corresponding reduction in contract awards, could have a material adverse effect on the Group's future results and financial condition.

Mitigation
The Group regularly reviews performance in its markets and the Executive Committee continues to work closely with the government customers in these markets to ensure the Group's strategy is aligned with theirs.

In the event of a customer termination for convenience, the Group would typically be paid for work done and commitments made at the time of termination. Having sovereign governments as major customers offers the benefits of dealing with mature procurement organisations with which the Group can have long-standing business relationships, and well-established and understood terms of trade.

See page 16 for more information on the Group's strategy

Global market

The Group operates 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: political changes could lead to changes in the business environment in which the Group operates; economic downturns, political instability and civil disturbances could disrupt the Group's business activities; 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; and burdensome taxes or tariffs could be introduced.

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

Mitigation
The Group has a balanced portfolio of businesses across its markets.

See page 22 for more information on the Group's five home markets

Contract award timing

The Group is dependent on the timing of award of defence contracts.

Description
The Group's profits and cash flows are dependent, to a significant extent, on the timing of award of defence contracts.

Impact
Amounts receivable under the Group's defence contracts can be substantial and, therefore, the timing of awards, or failure to receive anticipated awards, could materially affect the Group's profits and cash flows for the periods affected.

In 2012, the Group's financial performance was impacted by a delay in the award of a contract amendment from the Kingdom of Saudi Arabia relating to price escalation on the Salam Typhoon programme. Negotiations on the contract continue in 2013.

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.

See page 55 for more information on the Group's major programmes

Large contracts

Certain of the Group's businesses 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. Each of these contracts, which are primarily in the Platforms & Services (UK) and Platforms & Services (International) reporting segments, is typically worth or potentially worth over £1bn.

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

Mitigation
To mitigate risk on UK Ministry of Defence contracts, development programmes are normally contracted with appropriate levels of risk being initially held by the customer. Subsequent production programmes are priced when a platform's development has reached sufficient maturity. A variety of contract structures are used to mitigate risk on production programmes, such as incentive arrangements, whereby the customer and contractor share cost savings and overruns against target prices.

The Group has a well-balanced spread of programmes and significant order backlog, which provides long-term visibility. The Board regularly reviews the Group's performance on these large contracts and the Executive Committee continues to work closely with these customers to ensure the Group's strategy is aligned with theirs.

See page 55 for more information on the Group's order backlog by major programme and reporting segment

Fixed-price contracts

The Group has fixed-price contracts.

Description
A significant portion of the Group's revenue is derived from fixed-price contracts. 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. These contracts can extend over many years and it can be difficult to predict the ultimate outturn costs associated with the terms on which they are based.

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

Mitigation
The Group has reduced its exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity. To manage contract-related risks and uncertainties, contracts are managed under the Group's mandated Lifecycle Management (LCM) process at the operational level.

Robust bid preparation and approvals processes are well established throughout the Group, with decisions required to be taken at the appropriate level in line with clear delegations of authority. The consistent application of metrics is used to support the review of individual contract performance.

See page 84 for more information on LCM which mandates project management processes

Component availability, subcontractor performance and key suppliers

The Group is dependent upon component availability, subcontractor performance and key suppliers.

Description
The Group is dependent upon the delivery of materials by suppliers, and the assembly of components and subsystems by subcontractors used in its products in a timely and satisfactory manner, and in full compliance with applicable terms and conditions.

Impact
Some of the Group's suppliers or subcontractors may be impacted by the economic environment and constraints on available financing, which could impair their ability to meet their obligations to the Group. In addition, some products require relatively scarce raw materials. The Group is generally subject to specific procurement requirements which may, in effect, limit the suppliers and subcontractors it may utilise. In some instances, the Group is dependent on one or a limited number of suppliers. If any of these suppliers or subcontractors fails to meet the Group's needs, the Group may not, in the short term, have readily available alternatives, thereby impacting its ability to complete its customer obligations satisfactorily and in a timely manner, which could have a negative impact on the Group's future results and financial condition.

Mitigation
The Group's procurement function, which is led by a member of the Executive Committee, is responsible for establishing and managing end-to-end integrated supplier arrangements. The Executive Committee continues to monitor this risk and the Group has experienced no material negative impact to date. The Group reviews the financial health of strategically important suppliers globally on an ongoing basis.

See page 21 for more information on suppliers

Laws and regulations

The Group is subject to risk from a failure to comply with laws and regulations.

Description
The Group has contracts and operations in many parts of the world, operates in a highly regulated environment, and is subject to applicable laws and regulations of many jurisdictions. These include, without limitation, regulations relating to import-export controls, money laundering, false accounting, anti-bribery and anti-boycott provisions. Non-compliance could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group. From time to time, the Group is subject to government investigations relating to its operations.

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 resources dedicated to legal and regulatory compliance in order to enhance further 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 and training processes.

A uniform global policy and process for the appointment of advisers engaged in business development is in effect.

Pursuant to its commitments concerning ongoing regulatory compliance made in the course of the 2010 settlement with the US Department of Justice and the consequent 2011 settlement with the US Department of State, the Group appointed, respectively, an independent monitor in 2010 and a Special Compliance Official in 2011, in each case for a period of three years, to monitor the Group's compliance with its respective commitments under those settlements and its compliance obligations going forward.

See page 40 for more information on the Group's approach to business conduct

Competition

The Group's business is subject to significant competition.

Description
The Group's businesses are subject to competition from national and multi-national firms with substantial resources and capital, and many contracts are obtained through a competitive bidding process, including contracts where the Group is the current incumbent.

The Group's ability to compete for contracts depends in particular on: the strength of its intellectual property rights and technical knowhow; 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.

In some instances, governments direct to a single supplier all work for a particular programme, commonly known as sole-source programmes. 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 and security-related products and services can, in certain countries, be awarded on the basis of home country preference.

Impact
The Group's business and future results may be adversely impacted if it is unable to compete adequately in the markets in which it operates.

Mitigation
The Group's global, multi-market presence, balanced portfolio of businesses, leading capabilities and performance continue to address this risk. In particular, the Group invests in research and development, and innovation, and continues to reduce its cost base and improve efficiencies.

See page 22 for more information on the Group's five home markets

Pension funding

The Group has an aggregate funding deficit in its defined benefit pension schemes.

Description
The Group operates certain defined benefit pension schemes. At present, in aggregate, there is an actuarial deficit between the value of the projected liabilities of these schemes and the assets they hold.

Impact
The amount of the deficits may be adversely affected by changes in a number of factors, including investment returns, long-term interest rate and price inflation expectations, and anticipated members' longevity. Further increases in pension scheme deficits 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 operating, investing and financing requirements.

Mitigation
Following triennial funding valuations of the Group's two largest UK pension schemes in 2011, revised deficit recovery plans were agreed during the year. 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 appropriate. The results of these reviews are discussed with the Board and appropriate action taken.

In future, the growth of the defined benefit liabilities is expected to be curtailed as follows:

– With effect from April 2012, new employees in the UK are offered membership of a defined contribution scheme rather than the previous defined benefit/defined contribution hybrid scheme. Existing members of the Group's legacy UK plans are unaffected by this change;

– With effect from January 2013, all employees in the US are offered membership of a defined contribution scheme (401(k)) and no longer accrue salary-related benefits in defined benefit schemes; and

– In February 2013, with the agreement of the Company, the trustees of the BAE Systems 2000 Pension Plan entered into an arrangement with Legal & General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. This will reduce the funding volatility relating to increasing life expectancy.

See page 34 for more information on the Group's pension accounting and funding valuations, and deficit recovery plans

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. The export of defence and security products outside the jurisdictions in which they are produced is 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 and financial condition. Failure to comply with export controls and wider regulations could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group.

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

See page 23 for more information on exports

Acquisitions

The anticipated benefits of acquisitions may not be achieved.

Description
The Group considers investment in value-enhancing acquisitions where market conditions are right and where they deliver on its strategy. Whether the Group realises the anticipated benefits from these transactions depends upon the successful integration of the acquired businesses, as well as their post-acquisition performance in the markets in which they operate.

Impact
The diversion of management attention to integration efforts and the performance of the acquired businesses below expectations could adversely affect the Group's business, and create the risk of impairments arising on goodwill and other intangible assets.

Mitigation
The Group has established policies in place to manage the acquisition process, monitor the integration and performance of acquired businesses, and identify potential impairments.

See page 10 for more information on the Group's recent M&A activity

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 degrees of control. The risk of failure or the risk of disagreement, particularly in those that require the unanimous consent of all members with regard to major decisions, is inherent in any jointly controlled entity.

Impact
In the event of failure or 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 future results may be adversely affected.

Mitigation
The Group seeks to participate only in ventures in which its interests are complementary to those of its partners, and has formal systems and procedures in place to monitor the performance of such business arrangements.

See page 145 for more information on the Group's principal joint ventures

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, Euro and Saudi Riyal.

Impact
Significant fluctuations in exchange rates to which the Group is exposed could have a material adverse effect on the Group's future results and financial condition.

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 exceptions by the Treasury Review Management Committee. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of foreign subsidiaries and equity accounted investments it regards as long-term investments.

See page 36 for more information on the Group's treasury policies

Cybersecurity

The Group could be negatively impacted by information technology security threats.

Description
As a defence, aerospace and security company, the security threats faced by the Group include threats to its information technology infrastructure, unlawful attempts to gain access to its proprietary or classified information and the potential for business disruptions associated with information technology failures.

Impact
Failure to combat these risks effectively could negatively impact the Group's reputation among its customers and the public, cause disruption to its business operations, and could result in a negative impact on the Group's future results and financial condition.

Mitigation
The Group has a broad range of measures in place, including appropriate tools and techniques, to monitor and mitigate this risk.

See page 24 for an overview of the Cyber & Intelligence reporting segment

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

Supplying and supporting Hawk trainer aircraft for the Royal Saudi Air Force

Following agreement between the governments of the Kingdom of Saudi Arabia and the UK, under the Saudi British Defence Co-operation Programme, BAE Systems has a contract to support the future aircrew training requirements of the Royal Saudi Air Force.

The contract, aimed at meeting the growing demands of a world-class air force, covers the provision of equipment and training devices, such as aircraft simulators, training aids and aircraft on which to train aircrew. Included within this requirement is the supply of 55 Pilatus PC-21 aircraft to fulfil the basic training role and 22 BAE Systems Hawk Advanced Jet Trainer aircraft, which will be used to fulfil the fast jet training part of the syllabus.

REPORTING SEGMENTS PERFORMANCE REVIEW

In this section:

This section provides summaries of the operational, financial and non-financial performance of the Group's five principal reporting segments.

REPORTING SEGMENTS OVERVIEW

The Group has five principal reporting segments which align with the Group's strategic direction.

Reporting segments financial performance summary

2012		Funded order intake[1] £m	Order backlog[1,2] £bn	Sales[1] £m	Underlying EBITA[3] £m	Return on sales %	Cash flow[4] £m
Electronic Systems	p56	**2,540**	**3.6**	**2,507**	**356**	**14.2**	**256**
Cyber & Intelligence	p60	**1,454**	**1.0**	**1,402**	**124**	**8.8**	**113**
Platforms & Services (US)	p64	**5,010**	**8.4**	**4,539**	**394**	**8.7**	**314**
Platforms & Services (UK)	p68	**8,077**	**21.2**	**5,646**	**689**	**12.2**	**1,719**
Platforms & Services (International)	p72	**5,266**	**9.3**	**4,071**	**417**	**10.2**	**506**
HQ		**268**	**–**	**267**	**(85)**		**(214)**
Discontinued operations		**–**	**–**	**–**	**–**		**(2)**
		22,615	**43.5**	**18,432**	**1,895**		**2,692**
Less: Intra-group		**(374)**	**(1.1)**	**(598)**	**–**		**–**
Total		**22,241**	**42.4**	**17,834**	**1,895**	**10.6**	**2,692**

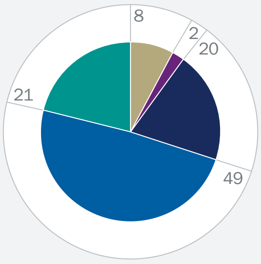
2011	Funded order intake[1] £m	Order backlog[1,2] £bn	Sales[1] £m	Underlying EBITA[3] £m	Return on sales %	Cash flow[4] £m
Electronic Systems	2,620	3.6	2,645	386	14.6	268
Cyber & Intelligence	1,443	1.1	1,399	136	9.7	
Platforms & Services (US)	5,077	8.7	5,305	478	9.0	410
Platforms & Services (UK)	4,355	18.7	6,258	658	10.5	69
Platforms & Services (International)	3,319	8.3	3,794	449	11.8	80
HQ	236	–	233	(82)		(308)
Discontinued operations	–	–	–	–		(8)
	17,050	40.4	19,634	2,025		634
Less: Intra-group	(403)	(1.3)	(480)	–		–
Total	16,647	39.1	19,154	2,025	10.6	634

The Group's US businesses are engaged in significant multi-year contracts. Performance on many contracts beyond the first year is contingent upon the receipt of funding, which the US government typically authorises on an annual basis. The order book metric presented in previous years excludes the unfunded element of these multi-year contracts. The order backlog[1,2] metric presented above provides visibility of the total value of contracts won, not just the funded value as recorded in the order book. In the US businesses, this metric gives a more meaningful measure of the sustaining business levels. An example of order backlog[1,2] is the ship repair business within Platforms & Services (US). Multi-Ship, Multi-Option contracts for five years are secured, but then only funded by the customer incrementally. Order backlog[1,2] recognises the remaining period of the contracts awarded, but yet to be funded.

1 Including share of equity accounted investments.
2 Comprises funded and unfunded unexecuted customer orders.
3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
4 Net cash inflow/(outflow) from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

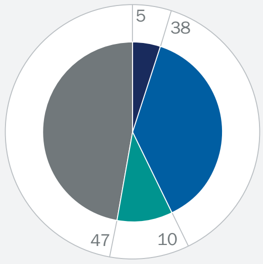
Order backlog[2,5,6] by reporting segment (%)

The Group has a £42.4bn order backlog[1,2].



Top 15 programmes in order backlog[2,5,6] (%)

53% of the order backlog[2,5,6] is represented by the Group's top 15 programmes, with the remaining 47% spread across the five principal reporting segments.



Top 15 programmes summary

Programme	Description	End user
Astute Class Submarines	Design and manufacture of seven nuclear-powered attack submarines	Royal Navy
Queen Elizabeth Class Aircraft Carriers	Design and manufacture of two 65,000 tonne aircraft carriers	Royal Navy
Oman Typhoon and Hawk Aircraft	Supply of 12 Typhoon and eight Hawk aircraft and in-service support	Royal Air Force of Oman
Typhoon Tranche 3A Aircraft	Manufacture of 88 Typhoon combat aircraft	Air forces of the UK, Germany, Italy and Spain
Typhoon Tranche 2 Aircraft	Manufacture of 236 Typhoon combat aircraft	Air forces of the UK, Germany, Italy and Spain
Availability Transformation Tornado Aircraft Contract (ATTAC)	Availability service for Tornado aircraft, including maintenance, support and training	Royal Air Force
India Hawk Aircraft	Supply of products and services to enable 57 Hawk aircraft to be built under licence in India	Indian Air Force and Navy
Successor Submarine	Design of nuclear-powered submarine to carry the UK's nuclear deterrent	Royal Navy
Saudi British Defence Co-operation Programme, including Saudi Aircraft Acquisition[7]	Provision of support to operational capability, including the provision of training aircraft, manpower, logistics and training	Royal Saudi Air Force
Saudi Typhoon Aircraft[7]	Supply of 72 Typhoon combat aircraft	Royal Saudi Air Force
Landing Helicopter Dock	Design, production and supply of two 27,000 tonne amphibious Landing Helicopter Dock ships	Royal Australian Navy
Aster Phase 3	Full-scale production of Aster 15 and 30 missiles	French, Italian and Royal navies, French Air Force and Italian Army
Munitions Acquisition Supply Solution	Capability provision and manufacture of general munitions	British Army
Radford Army Ammunition Plant	Management, operation and maintenance of the Radford Army Ammunition Plant	US Army
Norway CV90 Armoured Combat Vehicles	Supply of 144 new and 103 upgraded CV90 armoured combat vehicles	Norwegian Army

5 Excluding HQ.
6 Including share of equity accounted investments' order backlog and before the elimination of intra-group order backlog.
7 The appropriate work share of the Saudi Typhoon Aircraft and Saudi Aircraft Acquisition contracts is reported within Platforms & Services (UK).

ELECTRONIC SYSTEMS

Electronic Systems, with 13,000 employees[1], comprises the US and UK-based electronics activities, including electronic warfare systems and electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems.

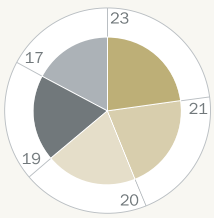
Operational key points

- Sustained a leadership position in the airborne electronic warfare market
- Strengthened position in high growth commercial aircraft electronics market
- Won key development contracts in the classified area
- Continued focus on increasing productivity and efficiency
- Business recovery complete following disruption from flood damage at the Johnson City facility
- £0.2bn of research and development expenditure[5] in 2012

Financial key points

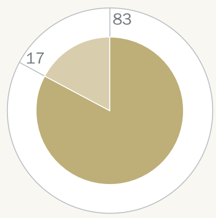
- Underlying order backlog[1,4] increased in challenging business environment
- Sales[1] reduction from operational tempo-driven activity on Thermal Weapon Sights
- Return on sales of 14.2%
- Cash flow[3] conversion of underlying EBITA[2] at 95%, before pension deficit funding

Sales analysis: activity (%)



- Electronic Combat
- Survivability & Targeting
- Communications & Control
- Intelligence, Surveillance & Reconnaissance (ISR)
- Commercial Aircraft electronics/HybriDrive® propulsion

Sales analysis: defence and commercial (%)



- Defence
- Commercial

		2012	2011	2010
Funded order intake[1]	KPI	**£2,540m**	£2,620m	£2,894m
Order backlog[1,4]		**£3.6bn**	£3.6bn	£3.5bn
Sales[1]	KPI	**£2,507m**	£2,645m	£2,969m
Underlying EBITA[2]	KPI	**£356m**	£386m	£455m
Return on sales		**14.2%**	14.6%	15.3%
Cash inflow[3]	KPI	**£256m**	£268m	£367m

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
4 Comprises funded and unfunded unexecuted customer orders.
5 Includes both Group-funded and customer-funded expenditure.

KEY CHARACTERISTICS

- Broad base of programmes, with more than 5,000 active contracts
- No programme greater than 5% of sales
- Over 67% of 2012 sales were fixed price-based
- Cutting-edge technology and capabilities, with significant levels of research and development invested in the business
- 17% of total sales are to commercial customers

Financial performance

Order backlog[1,4], excluding the impact of US dollar exchange translation, increased despite the impact of contracting delays as the US administration operated federal budgets under Continuing Resolution limitations.

On a like-for-like basis, sales[1] reduced by 7% on 2011 primarily reflecting the completion of deliveries of Thermal Weapon Sights as operational tempo-driven activity reduces. Sales in the Commercial Aircraft electronics business increased by 11%.

Underlying EBITA[2] was £356m (2011 £386m). Return on sales was 14.2% (2011 14.6%).

Cash flow[3] conversion of underlying EBITA[2] was 95%, before pension deficit funding.

Operational performance

Following severe flooding in September 2011, operations formerly conducted at the Electronic Systems facility in Johnson City, New York, have been moved to Endicott, New York. After a year of recovery efforts, operational capability has been restored and programmes are back on schedule.

Electronic Combat The business maintains its leadership position in the electronic warfare market, with continued focus on the F-35 Lightning II Systems Design and Development programme, planning for the flight test programme starting in 2013. The business progressed Low-Rate Initial Production (LRIP) Lot 5 and 6 deliveries during the year, and has responded to the LRIP Lot 7 request for proposal, which includes production aircraft for international customers.

In support of the US Navy's Next-Generation Jammer, which will replace the ageing jammer currently on certain US Navy aircraft, a $20m (£12m) modification was received to expand the scope of the existing technology maturation contract. BAE Systems is one of three bidders on the next phase technology development contract valued at approximately $300m (£185m).

The Digital Electronic Warfare System (DEWS) continues to secure new contract awards, including a six-year, $0.4bn (£0.2bn) contract to upgrade 70 F-15 aircraft for the Royal Saudi Air Force. Initial flight testing providing advanced radar warning and countermeasure capabilities is scheduled to begin in March 2013. The business continues to pursue other export opportunities for the DEWS suite.

Also in international markets, the business received three contracts totalling $86m (£53m) to provide F-16 support equipment, test systems and spares to the governments of Oman, Indonesia and Iraq for delivery by early 2014.

Survivability & Targeting In early 2012, the US Army awarded the business a two-year, $38m (£23m) contract to develop the Common Infrared Countermeasures capability. Using its Boldstroke® system, an integrated aircraft survivability system for protecting aircraft from infrared-guided missiles and other threats, the business will provide increased system capability in a smaller, more energy efficient package. Following a competitor protest, the award was upheld by the US Government Accountability Office and work restarted in June. Initial test systems are in progress, with the first units scheduled for government acceptance ahead of schedule.

The Advanced Precision Kill Weapon System programme passed tests on several airborne platforms. With deployment in theatre and positive performance feedback, the US Navy has authorised Full-Rate Production of the system and awarded a base contract valued at $28m (£17m) for 985 units and a Full-Rate Production option of $41m (£25m) for 1,476 units.

Under a $37m (£23m) subcontract, BAE Systems continues to support the engineering and manufacturing development of the Joint and Allied Threat Awareness System, a next-generation warning system to enhance aircraft survivability for the US Navy.

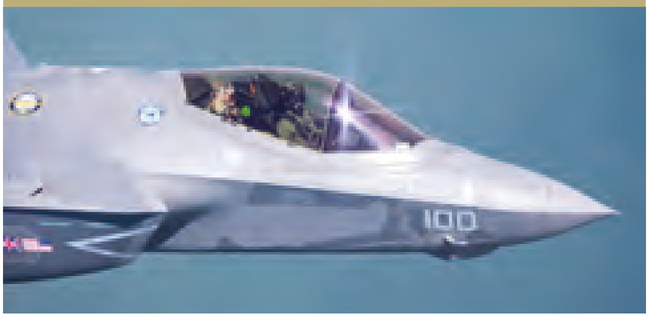
The Thermal High-Altitude Area Defence seeker programme provides a transportable, rapidly deployable, ground-based capability to intercept and destroy ballistic missiles inside or outside the atmosphere during their final phase of flight. BAE Systems has received an initial amount of $87m (£54m) in combined US government and Foreign Military Sales to the United Arab Emirates on the programme, including a base quantity of 146 seekers with an option for up to a further 147.

Deliveries of Thermal Weapon Sights to the US Army in support of military operations in Iraq and Afghanistan were completed.

BAE Systems is responsible for a number of subsystems and equipment on the F-35 Lightning II, including the electronic warfare suite. The flight test programme for the electronic warfare suite is planned to commence in 2013.

See page 69 for more information on the Group's involvement on F-35 Lightning II

Electronic Combat



Survivability & Targeting

The Advanced Precision Kill Weapon System is a laser-guided rocket that provides a low-cost surgical strike capability. In 2012, the programme passed tests on several airborne platforms and achieved initial operational capability. The system has been deployed in theatre and received positive performance feedback.

ELECTRONIC SYSTEMS

BAE Systems has responded to a US Army request for proposal for its Joint Effects Targeting System programme, which has been designed to enhance dismounted, forward-deployed soldiers' ability to accurately locate positions and target precision-guided munitions fire support. An award decision is expected in the first half of 2013 for a 26-month Engineering and Manufacturing Development phase, which will be followed by a Low-Rate Initial Production award competition.

Communications & Control The F-35 Lightning II programme continues to be a key platform for the Group's avionics products. Deliveries continue on plan for the active inceptor system out of Rochester, UK, and the vehicle management system out of Endicott, New York. The business has continued to pursue additional opportunities expanding its content on the platform.

Leveraging commercial technology to create a low size, weight and power design, the business launched the PHOENIX™ family of networking radios to integrate easily into US Army ground combat vehicles. In October, the business responded to the US Army's next-generation Mid-tier Networking Vehicular Radio request for proposal with its two-channel PHOENIX-SC radio, with an award decision expected in 2013.

Intelligence, Surveillance & Reconnaissance (ISR) The business continues to provide Wide Area Airborne Surveillance capability for the US Air Force and US Army. These key programmes are based on two wide-area, high-resolution imaging sensor systems, the Airborne Wide Area Persistent Surveillance System, which has been operational for over 12,000 hours in theatre, and the Autonomous Real-time Ground Ubiquitous Surveillance – Imaging System. These systems enable observation of very wide areas of interest with sufficient imagery resolution to meet intelligence and surveillance needs.

The business is providing state-of-the-art processing capabilities to Boeing for the US Navy's P8A Poseidon programme. The mission computer suite has robust, flexible and rugged open architecture providing high performance in the military environment. Over 30 initial systems have been delivered and a contract for Full-Rate Production Lot 1 has been awarded.

As a leader in the Identification Friend or Foe market, the business has a strong order backlog[4] driven by the Mode 5 cryptographic system upgrades, which have been incorporated into products deployed on multiple US Department of Defense platforms. Production has begun and is expected to continue to the end of the decade.

Commercial Aircraft electronics The business continues to be well positioned for growth in worldwide demand for commercial aviation through its engine and flight controls activities.

FADEC Alliance, a new joint venture between FADEC International (a joint venture between BAE Systems and Sagem) and GE Aviation, began development of the Full-Authority Digital Engine Controls for CFM International's LEAP and GE Aviation's Passport family of engines.

Ongoing development of the primary flight control electronics and active side sticks for Embraer's KC-390 military transport aircraft is raising the Group's profile in the emerging Brazilian aerospace industry. The first flight of the KC-390 is expected in 2014.

HybriDrive® propulsion BAE Systems has delivered 3,800 hybrid diesel-electric propulsion systems since 2004, which are now in service with over 60 operators.

In April 2012, European bus manufacturer, Iveco Irisbus, announced that it had been awarded Europe's largest single order for 132 diesel-electric hybrid buses for Dijon and Bordeaux in France. Prior to this award, Iveco Irisbus had delivered approximately 20 diesel-electric hybrid buses equipped with BAE Systems' propulsion systems.

The business has progressed solutions for battery reliability issues in the field from its first-generation lithium-ion battery packs. In addition, ownership of the current battery supplier has changed and the business is working with the new owner to minimise the impact on the Group and its customers.

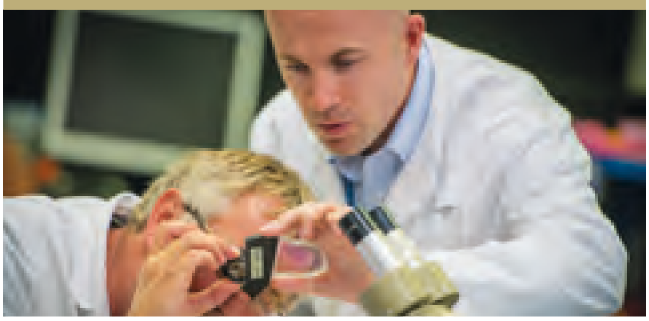
Looking forward

Efforts to reduce the US government's budget deficit are likely to impact all areas of government spend. A Continuing Resolution on the 2013 fiscal budget has been passed through to March 2013 and the risk of further reductions in US defence budgets remains, including the impact of sequestration.

4 Comprises funded and unfunded unexecuted customer orders.

BAE Systems' research and development investment and innovations in technology have resulted in two significant helmet-mounted display products: the Striker® and the Q-Sight® helmets. The Striker® helmet variant for Typhoon integrates night vision and full crew head protection. The Q-Sight® helmet uses quantum wave guide technology to directly couple the output of an LCD projector to a combining lens, eliminating the need for intermediate lenses.

Communications & Control



Intelligence, Surveillance & Reconnaissance (ISR)

BAE Systems is a leading provider of Intelligence, Surveillance and Reconnaissance capability, producing tactical identification, sensing and intelligence exploitation systems for airborne, maritime, land and space-based applications.

NASA's Curiosity rover vehicle successfully landed on Mars and began transmitting images back to Earth in August. Two BAE Systems RAD750® computers controlled the flight from Earth and the landing on Mars, and will continue to control the rover during its two-year mission.

Whilst likely funding reductions and the resultant slow down or cancellation of ongoing and new programmes could impact the business, Electronic Systems remains well positioned with a balanced portfolio that will enable it to respond to changing US Department of Defense priorities whilst maintaining its emphasis on cost reduction. The business expects to benefit from its incumbent positions on core platforms, and from positions in areas such as commercial aircraft electronics and international defence programmes.

Non-financial performance	
Employee safety	
Businesses to demonstrate improvement against 2011 performance on recordable accidents	15% stretch target achieved
Continue to progress against the Safety Maturity Matrix	Achieved
Diversity and inclusion	
Demonstrate continued progress against the Diversity & Inclusion Maturity Matrix	Achieved
Establish milestones/targets to underpin delivery of the stated 2015 position[1]	Confirmed
Environment	
Continued progression against the Environmental Sustainability Maturity Matrix	Achieved
Reduction in energy[2]	Target achieved
Reduction in water[2]	Target achieved
Reduction in waste[2]	Target achieved

Employee safety During 2012, safety remained a priority for Electronic Systems, achieving a 17% reduction in the Recordable Accident Rate. This performance was supported during the year by the introduction of a safety awareness campaign and training programme for employees.

Diversity and inclusion Electronic Systems supported US-wide diversity and inclusion activities, including inclusive leadership training, launching a multi-cultural network, and introducing diverse candidate shortlists and panels for executive roles.

Locally, Electronic Systems focused on increasing the speed and rigour of its diversity efforts. The business recruited a dedicated diversity and inclusion manager, and introduced a diversity and inclusion personal development objective for leaders.

Environment To support progress in environmental sustainability, the business launched an Environment Policy to help progress business-wide reduction targets in energy, water and waste, and launched a recording system to drive consistency in data collection.

To help employees support reduction targets, an education programme was launched to raise awareness of how each employee could personally contribute to reducing energy used and waste created.

People Electronic Systems operates a successful 'One Team Award' recognition programme. Each quarter, the programme recognises teams that have been nominated for exemplifying one or more of five imperatives demonstrated through end-user impact: community focus; technology innovation; collaboration; best practices; and overall value to the business.

1 Businesses have put in place plans to 2015 to support and progress the Group's long-term goal to build a high-performing workforce that more closely reflects the diversity of the local communities in which its businesses operate.
2 Data is derived from internal recording systems and is not subject to external verification or audit.

Many of the world's commercial aircraft employ BAE Systems' engine and flight controls. Worldwide demand for commercial aviation is expected to grow. In 2012, BAE Systems secured a commercial aircraft electronics position in Brazil.

Commercial Aircraft electronics

HybriDrive® propulsion

The Group's efficient, low emission HybriDrive® propulsion technology has been in service on buses since 2004. In 2012, European bus manufacturer, Iveco Irisbus, was awarded an order for 132 buses using BAE Systems' HybriDrive® propulsion systems.

Reporting segments performance review

CYBER & INTELLIGENCE

Cyber & Intelligence, with 8,200 employees[1], comprises the US-based Intelligence & Security business and UK-headquartered BAE Systems Detica business, and covers the Group's cyber, secure government, and commercial and financial security activities.

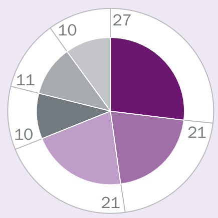
Operational key points

- The US-based business continues to perform well on existing programmes and secured strategic contract awards with existing customers
- The US-based business continues to invest in differentiating technologies, such as activity-based intelligence and cybersecurity, including a leading-edge network operations and security centre environment, to support a pipeline of submitted bids of $2.9bn (£1.8bn) at the end of 2012
- BAE Systems Detica continues to invest in products and capability, including its Security Operations Centre
- BAE Systems Detica awarded a contract by Vodafone for next-generation enterprise secure networks for mobile devices

Financial key points

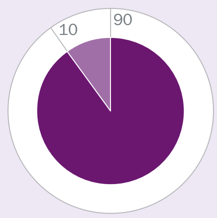
- Funded order intake[1] and sales[1] were broadly unchanged from 2011
- Return on sales impacted by investment in the BAE Systems Detica business for future growth
- Cash flow[3] conversion of underlying EBITA[2] at 91%

Sales analysis: activity (%)



- Information Technology & Cybersecurity Solutions
- GEOINT-ISR
- Global Analysis
- SpecTal
- BAE Systems Detica government
- BAE Systems Detica commercial

Sales analysis: government and commercial (%)



- Government
- Commercial

		2012	2011	2010
Funded order intake[1]	KPI	**£1,454m**	£1,443m	£1,300m
Order backlog[1,4]		**£1.0bn**	£1.1bn	£0.9bn
Sales[1]	KPI	**£1,402m**	£1,399m	£1,201m
Underlying EBITA[2]	KPI	**£124m**	£136m	£108m
Return on sales		**8.8%**	9.7%	9.0%
Cash inflow[3]	KPI	**£113m**	£123m	£89m

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
4 Comprises funded and unfunded unexecuted customer orders.

KEY CHARACTERISTICS

Intelligence & Security:

- Delivers cost-effective IT solutions that solve complex problems of collaboration and security for the US national security community
- Delivers real-time threat assessments that rapidly inform critical security actions. The business is a leading provider of specialised security and intelligence operational support and solutions in the US
- Delivers automated, efficient and reliable intelligence processing, data management systems and imagery mapping tools for the US intelligence and defence communities

BAE Systems Detica:

- Expanding in the fast-growing cybersecurity market
- Increasing focus on products and services for the financial services and telecommunications sectors
- Providing core intelligence technology and managed services for government clients

Financial performance

Funded order intake[1] and sales[1] were broadly unchanged from 2011.

Order backlog[1,4] reduced to £1.0bn (2011 £1.1bn). There is a significant number and value of competitive bids in the Intelligence & Security business awaiting award decisions.

Underlying EBITA[2] was £124m (2011 £136m). Return on sales reduced to 8.8% (2011 9.7%) reflecting increased levels of investment in the BAE Systems Detica business in support of targeted future growth in commercial and international markets.

Operating cash inflow[3] was £113m (2011 £123m), which represents a conversion of underlying EBITA[2] of 91%.

Operational performance

Intelligence & Security

The US-based Intelligence & Security business delivers a broad range of services, including secure IT solutions, cybersecurity, geospatial solutions and intelligence analysis to enable the US military and government to recognise, manage and defeat threats. The business is structured into four key business areas that provide specific domain expertise, whilst working closely together to provide enterprise-wide support to a range of customers, and key agencies in the intelligence, defence, homeland security and civilian markets.

Information Technology & Cybersecurity Solutions develops, deploys and maintains mission applications focused on information sharing, knowledge management and enhanced enterprise mission IT solutions for the US federal, civilian and defence intelligence communities. The business also provides analytics, cyber analysis and real-time network forensics.

Through 2012, work continued on the Solutions for the Information Technology Enterprise Indefinite Delivery, Indefinite Quantity (IDIQ) contract, with the business as the prime contractor, receiving task orders now worth a total of $344m (£212m). Since the project began, approximately 700 security-cleared IT experts, deployed across 84 locations in 14 countries, have assisted the US Defense Intelligence Agency in delivering IT services to 50,000 Department of Defense personnel by standardising global IT operations and reducing the time taken to deliver technician services.

Continuing work on the Next-Generation Desktop Environment (NGDE) programme for the US Defense Intelligence Agency, the business has virtualised hundreds of applications and deployed data centre infrastructure to 13 sites, now supporting over 12,000 global analyst workstations. The NGDE is an enterprise networking environment based on virtual desktop infrastructure.

The Security Operations Centre in the US protects the Group's networks by monitoring its global intranet, with more than 100,000 network interfaces serving employees across five home markets and offices in over 100 countries. Services include security engineering, risk analysis, support of IT hardware and software, IT engineering and applications, and global enterprise monitoring and security incident response.

GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) develops and supports software systems and mission applications for geospatial tasking, including data collection, processing, exploitation and dissemination, as well as mission planning, Intelligence, Surveillance and Reconnaissance (ISR), precision targeting, and command and control for the US defence and intelligence communities.

The business was awarded a five-year, $106m (£65m) contract by the National Geospatial-Intelligence Agency (NGA), under which engineers will design, develop and implement a transformational solution enabling the US government to evolve from its current image library to a standardised image storage, management and dissemination process. This is an important strategic win that will drive future GEOINT and imagery systems development.

In December 2012, BAE Systems was awarded a multi-year, $60m (£37m) contract to provide activity-based intelligence systems, tools and support for mission priorities for the NGA. This award is a task order under the NGA's Total Application Services for Enterprise Requirements programme, a five-year IDIQ contract.

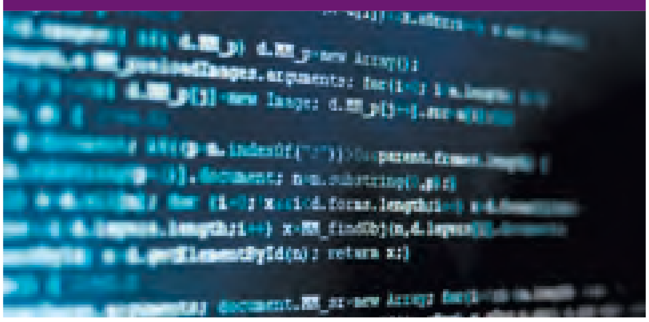
Global Analysis provides mission-enabling analytic solutions and support to operations across the US homeland security, law enforcement, defence, intelligence and counterintelligence communities.

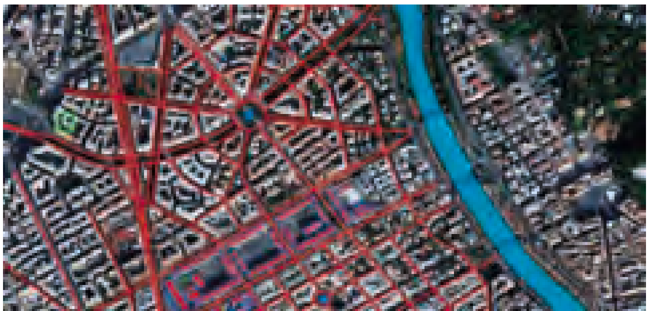
The business continues to provide approximately 450 security cleared analysts working alongside forward deployed US defence personnel as part of the Counter Improvised Explosive Device (C-IED) programme, with a total value of funded orders of approximately $450m (£277m) over the two years of the contract. The business is now working with the customer to manage staffing levels in line with reducing mission requirements.

BAE Systems provides critical cybersecurity and network defence solutions in support of the US government.

Capabilities, such as digital forensics and cyber investigations, play a role in the ongoing battle to protect computer networks from cyber threats.

Information Technology & Cybersecurity Solutions





GEOINT-ISR

The Group develops Geospatial Intelligence (GEOINT) and Intelligence, Surveillance and Reconnaissance (ISR) hardware and software platforms, and mission applications for the defence and intelligence communities.

The Group's advanced tools and applications allow defence and intelligence communities to quickly process high volumes of data to help military and law enforcement officials confront or avoid threats on the battlefield and give troops operating around the world the accurate, real-time situational awareness they need to make informed, tactical decisions.

CYBER & INTELLIGENCE

The business is executing well on the Full Motion Video and Geospatial Imagery Analysis contract awarded in 2011, with a contract value of $402m (£248m) and over 400 employees being utilised.

SpecTal provides US government customers with specialised security and intelligence mission support, including intelligence analysis, targeting operations support, training and IT deployment.

With the 2011 acquisition of L-1 Identity Solutions' Intelligence Services Group, a key contract with an intelligence community customer was gained. The contract has since been re-competed and SpecTal was part of the winning bid team serving as a major subcontractor on the five-year programme.

BAE Systems Detica

BAE Systems Detica continues to build a business that provides security and intelligence products and services to both government and commercial customers. In July, the stratsec business in Australia, acquired in 2011, and a new security entity in India were integrated into BAE Systems Detica. The business is also focused on developing opportunities in the Americas' commercial market.

Cyber Security Demand is growing across both government and commercial sectors, with contracts secured with a global law firm and a US financial institution in 2012. The Security Operations Centre became fully operational in 2012, providing services to detect and remediate advanced cyber attacks for clients.

The business was one of four companies selected by the UK's Government Communications Headquarters (GCHQ) to work in partnership on a new Cyber Incident Response pilot programme, a government quality-assured service that organisations can turn to when they have suffered a cybersecurity incident.

Detica NetReveal® As a provider of risk, fraud and compliance solutions to the global financial services industry, orders of £74m were received during the year, including contracts in new business areas of healthcare and insurance in the US.

Global Communications Solutions is a provider of specialist communications equipment, including monitoring and lawful intercept solutions, for use by government and commercial clients.

During 2012, a review of routes-to-market was carried out, resulting in necessary changes which adversely impacted the 2012 financial performance of the business.

Services The business, which provides consultancy, systems integration and managed services, was impacted by challenging market conditions in both the UK government and commercial sectors.

Orders in the year included a contract under a business change programme for a complex UK cross-government programme and a managed services contract with Vodafone for the provision of next-generation enterprise secure networks for mobile devices. The business was unsuccessful in its bid to provide services under the UK government's Disclosure and Barring Service.

The business continues to develop opportunities internationally, in both the Middle East and, with the addition of stratsec, the Asia Pacific region.

Looking forward

Efforts to reduce the US government's budget deficit are likely to impact all areas of government spend. A Continuing Resolution on the 2013 fiscal budget has been passed through to March 2013 and the risk of further reductions in US defence budgets remains, including the impact of sequestration.

Growth opportunities remain, particularly in critical, mission-focused areas, such as next-generation ISR, Multi-INT fusion (the seamless synthesis of the individual intelligence disciplines to enable more complete situational awareness), counter intelligence and enterprise solutions for big data problems.

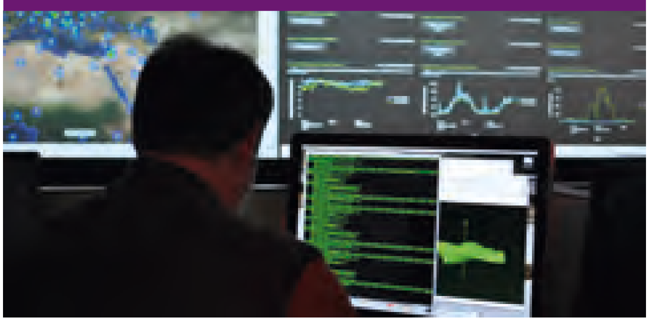
The US market is experiencing delays in procurement awards and descoping of existing contracts as US government agencies look to reduce IT budgets. Sales in 2013 are expected to be impacted by the completion of the C-IED contract as the US withdraws from Afghanistan. However, the business expects an enduring need to provide data management solutions, including the rapid collection, processing and dissemination of data to intelligence community customers and the US military. The business is well prepared to compete in this price-sensitive market through its customer intimacy, innovation and continued cost management.

BAE Systems Detica expects growth in cyber and intelligence, both in the UK and overseas government markets, with increasing demand for products and services in commercial markets to manage cyber threats, counter financial fraud and improve compliance, including next-generation security for mobile devices.

The US-based Intelligence & Security business provides mission-enabling analytic solutions supporting a number of US government departments.

BAE Systems' tactical analysts work alongside warfighters around the world to provide them with the insight they need to successfully complete their missions through a number of specialised analytic and support capabilities.

Global Analysis



SpecTal

The US business provides specialised security and intelligence consulting services to the US government.

Non-financial performance	
Employee safety	
Businesses to demonstrate improvement against 2011 performance on recordable accidents	15% stretch target achieved
Continue to progress against the Safety Maturity Matrix	Achieved
Diversity and inclusion	
Demonstrate continued progress against the Diversity & Inclusion Maturity Matrix	Achieved
Establish milestones/targets to underpin delivery of the stated 2015 position[1]	Confirmed
Environment	
Continued progression against the Environmental Sustainability Maturity Matrix	Achieved
Reduction in energy[2]	Target achieved
Reduction in water[2]	Target achieved
Reduction in waste[2]	Target achieved

Employee safety During 2012, the business achieved a 46% reduction in the Recordable Accident Rate.

The Intelligence & Security business has continued to mature its safety culture by engaging its offsite employee population to identify workplace hazards and increase overall accountability.

BAE Systems Detica continued to progress its performance in safety. To help increase awareness and understanding of safety, a leadership toolkit and safety tours were introduced for directors, and an online safety training course was launched for employees.

Diversity and inclusion Intelligence & Security supported US-wide diversity and inclusion activities, including inclusive leadership training, launching a multi-cultural network, and introducing diverse candidate shortlists and panels for executive roles. At a local level, a communications programme targeted at employees was launched.

At the start of 2012, BAE Systems Detica launched its diversity and inclusion plan and steering group to drive progress throughout the year. Activities within the plan included reviewing the business's recruitment and succession planning processes. During the year, a dedicated communications campaign was aimed at engaging employees.

Environment Intelligence & Security focused on reducing waste during 2012, including the launch of an employee awareness programme to reduce and recycle waste within the work environment.

During 2012, BAE Systems Detica broadened its environmental impact analysis to cover two new site locations and the Australian stratsec business. This analysis enables BAE Systems Detica to understand and monitor the effect of its operations on various environmental factors, including energy consumption, waste disposal and recycling.

People The Intelligence & Security business employs over 5,700 people, many of whom are deployed alongside customers in the US and overseas, with the latter including active service deployments. Where people are deployed overseas, the Group makes available support services to ensure families can stay in touch.

BAE Systems Detica instigated its first apprenticeships with a new programme launched at its Leeds, UK, facility. Elsewhere, the business continues to recruit to support its growing customer base.

1 Businesses have put in place plans to 2015 to support and progress the Group's long-term goal to build a high-performing workforce that more closely reflects the diversity of the local communities in which its businesses operate.
2 Data is derived from internal recording systems and is not subject to external verification or audit.

BAE Systems Detica – smart metering

The UK-headquartered BAE Systems Detica business has been working with energy company E.ON on its Smart Metering Customer Programme, which will see the installation of smart meters in homes across the UK. Smart metering will provide up to 35,000 gas and electricity consumption readings per household per year. Drawing on its experience, knowledge and previous central involvement in UK Smart Metering, BAE Systems Detica conducted a programme-level data security review to help ensure its security and the privacy of customers' data.

BAE Systems Detica – analytics platform

BAE Systems Detica has a bespoke analytics platform which integrates a range of applications to identify behaviours, activities and connections in data for fraud, cyber and communications monitoring activities.

PLATFORMS & SERVICES (US)

Platforms & Services (US), with 21,300 employees[1], comprises the US-headquartered Land & Armaments business, with operations in the US, UK, Sweden and South Africa, together with US-based services and sustainment activities, including ship repair and munitions services.

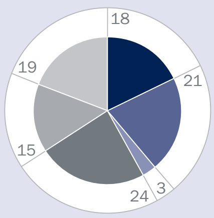
Operational key points

- Growth in US ship repair activities
- Executing munitions infrastructure and facility operations management contracts
- Strategic international win with Korean F-16 upgrade down-select
- Continued to protect Bradley franchise with $376m (£231m) in related awards
- Awarded a $750m (£462m) contract for CV90 armoured combat vehicles to Norway
- Letter of Request received from Indian government for 145 M777 howitzers
- Continued consolidation in the Land & Armaments business
- Business disposals of Safety Products, Safariland and Tensylon completed

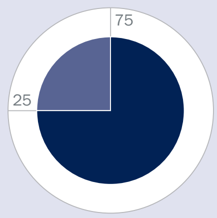
Financial key points

- Sales[1] reduced by 2% in Support Solutions business and by 23% in Land & Armaments business
- Return on sales increased to 8.8% in Support Solutions business and reduced to 8.6% in Land & Armaments business
- Support business delivered an increase in order backlog[1,4] and strong operating cash flow[3]

Sales analysis: activity (%)



Sales analysis: platforms and services (%)



		2012	2011	2010
Funded order intake[1]	KPI	**£5,010m**	£5,077m	£5,605m
Order backlog[1,4]		**£8.4bn**	£8.7bn	£9.1bn
Sales[1]	KPI	**£4,539m**	£5,305m	£7,671m
Underlying EBITA[2]	KPI	**£394m**	£478m	£728m
Return on sales		**8.7%**	9.0%	9.5%
Cash inflow[3]	KPI	**£314m**	£410m	£967m

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
4 Comprises funded and unfunded unexecuted customer orders.

KEY CHARACTERISTICS ▶▶

Support Solutions:
- US naval ship repair and modernisation
- Complex infrastructure services and operations support
- Aircraft sustainment and modernisation
- Soldier survivability products

Land & Armaments:
- Tracked combat vehicles
- Tactical wheeled vehicles
- Artillery, ammunition and naval armaments

Financial performance

Sales[1] were £4.5bn (2011 £5.3bn), representing a like-for-like reduction of 13%. Sales[1] at Support Solutions were just 2% below 2011. Like-for-like sales[1] at Land & Armaments reduced by 20% primarily reflecting the completed Family of Medium Tactical Vehicles programme, and lower volumes on Bradley, Caiman and Mine Resistant Ambush Protected vehicles.

Underlying EBITA[2] was £394m (2011 £478m). Return on sales reduced to 8.7% (2011 9.0%). Return on sales at Support Solutions increased from 7.5% to 8.8% benefiting from certain legal settlements. Return on sales at Land & Armaments reduced from 9.9% to 8.6% reflecting accelerated rationalisation charges in respect of the Newcastle vehicle manufacturing site in the UK and certain legal claims.

Operating cash inflow[3] reduced to £314m (2011 £410m) reflecting continued investment in the UK munitions facilities in the Land & Armaments business. Excluding pension deficit funding, cash flow[3] conversion of underlying EBITA[2] at Support Solutions and Land & Armaments was 100% and 83%, respectively.

Operational performance

Support Solutions

The US-based ship repair business achieved 2012 commitments under its Multi-Ship, Multi-Option contract vehicles with the US Navy, receiving superior scores on award fee assessments. The business was awarded new commercial maritime construction contracts totalling $190m (£117m), including four platform supply vessels and two barges.

In the complex infrastructure services market, the business secured the Holston Army Ammunition Plant award of a follow-on five-year, $145m (£89m) contract for facility operations. In addition, the business completed the planned transition to begin operating the Radford Army Ammunition Plant on 1 July 2012 under a contract worth approximately $850m (£523m) over ten years. In October 2012, the business was notified that it had not been awarded the Lake City Army Ammunition Plant management contract.

The business won a five-year, $44m (£27m) Navy Munitions Command – Hawaii contract to handle and store munitions, which continues more than 27 years of distinguished service recognised by the US Navy.

The US Naval Air Warfare Center Aircraft Division awarded a follow-on five-year, $193m (£119m) contract to provide Command, Control, Communications, Computers and Intelligence (C4I), lifecycle support, integration and test engineering, and technical services, supporting a broad range of air, land and sea platforms.

The business was awarded a $60m (£37m) task order under the US Department of Defense's Joint Improvised Explosive Device Defeat Organization contract to develop and implement a five-year training programme.

Support Solutions continues to pursue international aircraft upgrade and modification opportunities. In August, the Republic of Korea selected BAE Systems to upgrade avionics and electronic systems on its fleet of more than 130 F-16 aircraft. The programme is expected to be contracted in 2013 and is forecast to be worth over $500m (£308m) over ten years.

In November, the business was awarded a contract by the US Navy for depot level maintenance and logistics support for more than 360 T-34/T-44/T-6 training aircraft. If all options are exercised, the contract would be valued at more than $400m (£246m) over five years.

BAE Systems is pursuing a potential bid as prime contractor for the US Air Force's T-X programme to replace the T-38 jet training system with its Hawk trainer aircraft. The programme is valued at between $11bn (£7bn) and $17bn (£10bn). The US Air Force is expected to announce the timing of its request for proposals in 2013.

In the Protection Systems business, contracts have been secured totalling over $200m (£123m) for the supply of Enhanced Small Arms Protective Inserts, Tactical Vests and Modular Lightweight Load Carrying Equipment.

In November, the Group announced a definitive agreement to acquire Marine Hydraulics International, Inc., a marine repair, overhaul and conversion company with shipyard, pier and waterfront facilities in Norfolk, Virginia. The proposed acquisition, which is expected to complete during the first quarter of 2013, complements the existing ship repair business.

Land & Armaments

During 2012, Land & Armaments completed the disposals of its Safety Products, Safariland and Tensylon businesses. The disposal of the Commercial Armored Vehicles business is expected to complete in the first quarter of 2013. In September, the business announced that production of military equipment at its Fairfield, Ohio, facility

BAE Systems is a leading provider of ship repair and modernisation services to the US Navy. In addition, building on the successful completion of the construction of the commercial tanker, American Phoenix, the business has been awarded multiple new commercial maritime construction contracts, which continue to diversify the portfolio and position the business for additional build-to-print opportunities.

Ship repair

Complex infrastructure services

In the complex infrastructure services market, the business continues to expand its portfolio, with the award of a follow-on contract for facility operations at the Holston Army Ammunition Plant. BAE Systems began operating the Radford Army Ammunition Plant in July 2012 under a ten-year contract.

PLATFORMS & SERVICES (US)

would be moved to Sealy, Texas, in early 2013. The Protection Systems business, formerly reported in Land & Armaments, was transferred to Support Solutions at the start of the year. Management of the Combat Vehicles (UK) business was transferred to Platforms & Services (UK) from 1 October 2012.

Vehicle Systems This division comprises the franchises in tracked and wheeled vehicles.

The business received a $306m (£188m) contract modification in August to upgrade 353 Bradley fighting vehicles, extending Bradley activity into 2014. This production contract is in addition to $70m (£43m) to purchase upgrade materials for the Bradley programme.

The business has received the Paladin Integrated Management (PIM) Low-Rate Initial Production request for proposal scheduled for submission in early 2013. Testing continues on the contracted prototypes activity. An award decision is expected in 2013.

On the Ground Combat Vehicle (GCV) programme, the business continues test work under the $450m (£277m) technology development phase. Continuing development testing demonstrates that the technology provides more power, efficiency and vehicle performance than comparable conventional drive systems.

In January 2012, the business was awarded a £65m contract to supply 48 BvS10 armoured all-terrain vehicles and associated support to Sweden. The business was also awarded a £38m contract to regenerate the British Royal Marines' fleet of BvS10 vehicles. The last of 53 BvS10s ordered by France was delivered by year end.

In June, the business was awarded a $750m (£462m) contract to upgrade Norway's existing 103-vehicle CV90 fleet and build new vehicle chassis to deliver 144 CV90s in five different configurations, including a variant equipped with a sensor suite for improved surveillance capability.

All deliveries of the Caiman Multi-Terrain Vehicle were delivered to contract schedule, with re-fit and integration of 592 vehicles completed at the Mine Resistant Ambush Protected (MRAP) sustainment facility in November.

In August, the business was selected as part of the industry team led by Lockheed Martin for the engineering and manufacturing development phase of the US government's potentially large Joint Light Tactical Vehicle programme.

The South African business continues to execute on a £39m contract for 73 RG31 Mobile Mortar Platforms for the United Arab Emirates and a £43m order for 110 RG32 patrol vehicles for the Swedish Defence Force that were secured in December 2011.

The business secured places on all the amphibious trade studies, demonstrators and hull survivability demonstrations, allowing the US Marine Corps customer to evaluate design concepts based on a new design or an upgrade to current vehicles.

In November, Denmark announced that eight bids had been received in response to its requirement for up to 450 armoured vehicles. BAE Systems bid a version of the CV90, which Denmark already operates. The award decision is expected in late 2013.

In Canada, following a one-year delay, a new request for proposal was released for up to 138 Close Combat Vehicles. BAE Systems submitted a proposal based on its CV90 armoured combat vehicle.

The business was unsuccessful in its bid for the Tactical Armoured Patrol Vehicle programme for the Canadian armed forces.

Weapons Systems & Support This division comprises munitions and artillery activities.

In naval armaments, orders for six Mk110 57mm naval guns were received for the US Coast Guard and to equip the US Navy's Littoral Combat Ships.

During the year, Australia announced its intention to buy 19 M777 howitzers to augment the 35 it already operates. In addition, the Indian government has issued a Letter of Request to the US government under the US Foreign Military Sales process for the supply of 145 M777 howitzers for the Indian Army.

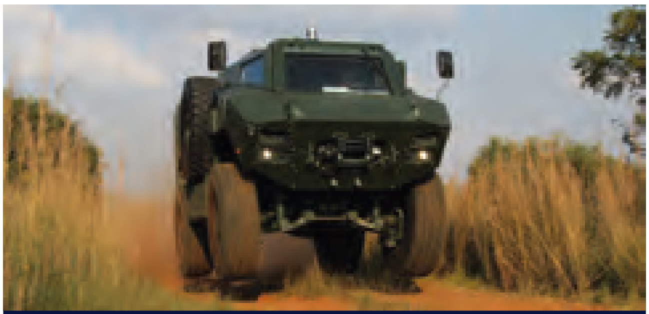
Under the 15-year Munitions Acquisition Supply Solution contract, the UK Ministry of Defence placed an order to meet its 2015 munitions requirement reflecting lower demand and quantities deferred from previous years. This anticipated lower volume results from armed force cuts and the draw-down of Afghanistan operations. Efficiencies achieved through a £123m transformation of UK munitions manufacturing facilities and support from the UK Ministry of Defence position the business to offset this reduction with exports.

Joint ventures FNSS, BAE Systems' Turkish joint venture, continues to produce and upgrade tracked and wheeled military vehicles for international customers. Design work and successful mine testing were completed on a $559m (£344m) programme to produce 259 8x8 wheeled armoured vehicles in 12 different variants for the Malaysian Army. Production has commenced and the first Infantry Fighting Vehicles are scheduled to be delivered in 2013.

The CV90 family of vehicles, manufactured in Sweden, is in service with six nations – Denmark, Finland, Norway, Sweden, Switzerland and the Netherlands.

In 2012, the business won an order from Norway to upgrade its existing CV90s and supply new vehicles in multiple configurations. Incorporating lessons learned from Norwegian operations in Afghanistan, the new vehicle fleet will have enhanced protection, survivability, situational awareness, intelligence and interoperability.

Tracked vehicles



Wheeled vehicles

The RG35, manufactured in South Africa, is one variant in BAE Systems' family of wheeled vehicles.

The RG35 family of vehicles can be deployed in many different roles and offers a choice of variants and configurations while maintaining 80% vehicle commonality. RG35 combines the high levels of survivability of the RG31 Mine Protected Vehicle with the tactical capability of an infantry fighting vehicle.

Looking forward

Efforts to reduce the US government's budget deficit are likely to impact all areas of government spend. A Continuing Resolution on the 2013 fiscal budget has been passed through to March 2013 and the risk of further reductions in US defence budgets remains, including the impact of sequestration.

In February 2013, the Group was notified that the US Navy was considering the potential to cancel, defer or descope 13 ship availability contracts, resulting in the decision to issue conditional Worker Adjustment and Retraining Notification (WARN) Act notices to nearly 3,600 employees in the ship repair business.

Whilst downward pressure will be seen across the services market as a whole, potential cancellations and delays in new programmes may present opportunities to sustain and modernise existing platforms.

In the near term, Land & Armaments continues to operate in a challenging market environment. To offset these pressures and remain viable in the future, the business is investing to protect current programme positions like Bradley modernisation and UK munitions, establish new US domestic programmes such as PIM and GCV, and to win export programmes. The business continues to drive rationalisation efforts, efficiencies and cost reduction in order to remain competitive.

Non-financial performance

Employee safety During 2012, the business achieved a 16% reduction in the Recordable Accident Rate. Support Solutions' ship repair business built on the success of its employee 'Anchored in Safety' campaign by introducing an interactive 'Safety Boot Camp' to keep employees focused on safety. During 2012, Land & Armaments continued to increase employee awareness and understanding of safety by maintaining its 'Start Safe, Talk Safe, Home Safe' campaign, focusing on potential safety issues and safe work habits.

Diversity and inclusion Platforms & Services (US) supported US-wide diversity and inclusion activities, including inclusive leadership training, launching a multi-cultural network, and introducing diverse candidate shortlists and panels for executive roles. In Support Solutions, a campaign was targeted at managers to improve their awareness of diversity and inclusion. Land & Armaments introduced a mentoring programme to support successor candidates for leadership roles and introduced a Talent Committee to facilitate senior leader commitment.

Employee safety	
Businesses to demonstrate improvement against 2011 performance on recordable accidents	15% stretch target achieved
Continue to progress against the Safety Maturity Matrix	Achieved
Diversity and inclusion	
Demonstrate continued progress against the Diversity & Inclusion Maturity Matrix	Achieved
Establish milestones/targets to underpin delivery of the stated 2015 position[1]	Confirmed
Environment	
Continued progression against the Environmental Sustainability Maturity Matrix	Achieved
Reduction in energy[2]	Target achieved
Reduction in water[2,3]	Target achieved
Reduction in waste[2]	Target achieved

Environment A new environmentally-friendly facility was opened in Sterling Heights, Michigan, during 2012. The new facility consolidated existing buildings into one new purpose-built campus. The building uses 15% less energy and 40% less water than a conventionally designed building, and waste generated is managed through a recycling programme.

People Support Solutions has a diverse and highly skilled workforce, which is a key discriminator and plays an important role in the performance of the business in an increasingly competitive market. The business remains committed to building a culture that recognises performance, creates new opportunities for employees, and focuses on long-term goals that promote a healthy and viable business.

Through the Land & Armaments Talent Committee, high-potential employees are being engaged to address key strategic opportunities. By being part of the programme, which has also been designed to support the Group's commitment to diversity and inclusion, future leaders are receiving fast track development.

1 Businesses have put in place plans to 2015 to support and progress the Group's long-term goal to build a high-performing workforce that more closely reflects the diversity of the local communities in which its businesses operate.
2 Data is derived from internal recording systems and is not subject to external verification or audit.
3 Data excludes Ordnance Solutions Inc.

Protection Systems is a leading provider of soldier protective and load carrying equipment in the US, producing a significant portion of the nation's body armour, tactical vests, combat helmets and load carrying systems. The business is focused on the design, development and production of leading-edge survivability products.

Protection Systems

Artillery

The M777 howitzer is in service with US, Canadian and Australian armed forces. Production continues and further orders are anticipated, including to India following the issue of a Letter of Request to the US government under the US Foreign Military Sales process.

PLATFORMS & SERVICES (UK)

Platforms & Services (UK), with 27,900 employees[1], comprises the Group's UK-based air, maritime and combat vehicle activities, and certain shared services activities.

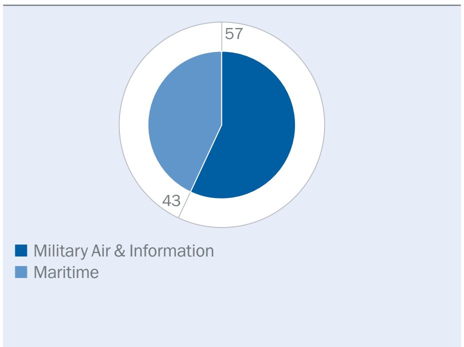
Operational key points

- 46 Typhoon Tranche 2 aircraft delivered to the partner nations
- £2.5bn Typhoon and Hawk contract for Oman secured
- £446m contract awarded for European support on Typhoon
- First F-35 Lightning II aircraft accepted by the UK Ministry of Defence (MoD)
- Fifth Type 45 destroyer accepted off-contract and support provided for all Royal Navy Type 45 deployments
- Settlement reached with the Government of the Republic of Trinidad and Tobago in respect of the cancelled Offshore Patrol Vessels (OPV) programme
- Two OPVs delivered to the Brazilian Navy
- £0.8bn of customer funding received for ongoing design and development of the Successor submarine, and continuing production of the fourth Astute Class submarine
- £0.7bn of research and development expenditure[4] in 2012

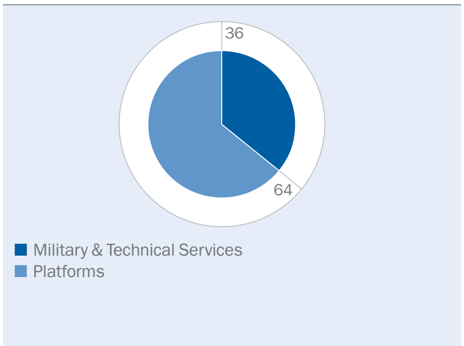
Financial key points

- Order backlog[1] increased by £2.5bn on significant awards for Oman Typhoon and Hawk and Saudi training aircraft
- 10% decrease in sales[1] pending recommencement of Salam Typhoon deliveries in 2013
- Return on sales improved to 12.2%
- Strong cash flow[3] performance on significant contract advances

Sales analysis: activity (%)



Sales analysis: platforms and services (%)



		2012	2011	2010
Funded order intake[1]	KPI	**£8,077m**	£4,355m	£3,968m
Order backlog[1]		**£21.2bn**	£18.7bn	£21.0bn
Sales[1]	KPI	**£5,646m**	£6,258m	£6,529m
Underlying EBITA[2]	KPI	**£689m**	£658m	£522m
Return on sales		**12.2%**	10.5%	8.0%
Cash inflow[3]	KPI	**£1,719m**	£69m	£191m

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
4 Includes both Group-funded and customer-funded expenditure.

KEY CHARACTERISTICS ▶▶

- Multi-year through-life programmes

Military Air & Information:
- Full spectrum of military aircraft capabilities, including design, development, manufacture, in-service support and training for combat and trainer aircraft, and design and development of Unmanned Air Systems
- Defence information systems, such as the Falcon secure deployable communication system

Maritime:
- Full spectrum of maritime systems capabilities, including design, build, integration and commissioning, in-service support and training for naval ships, submarines, radar and combat management systems, and underwater systems

Combat Vehicles (UK):
- Design, build and through-life support of armoured vehicles

Financial performance

Funded order intake[1] in the year increased to £8.1bn following the award of significant contracts for the supply of 12 Typhoon and eight Hawk aircraft to Oman (£2.5bn), and for training aircraft for the Royal Saudi Air Force (£1.6bn).

Sales[1] in 2012 were £5.6bn, 10% lower than 2011, reflecting no contractual aircraft deliveries on the Salam Typhoon programme in 2012 and the completion of South African Gripen aircraft deliveries in 2011.

Underlying EBITA[2] was £689m (2011 £658m). Return on sales increased to 12.2% benefiting from strong programme execution, particularly on the European Typhoon and Type 45 programmes.

There was an operating cash inflow[3] of £1,719m (2011 £69m) reflecting advances received on the Omani and Saudi contract awards. These were partially offset by the utilisation of advances on the European Typhoon programme and costs against the provision on the Omani Offshore Patrol Vessel (OPV) programme.

Operational performance

Military Air & Information

Deliveries of Typhoon Tranche 2 aircraft to the four European partner nations totalled 46 in the year. At the end of 2012, cumulative aircraft deliveries to the four nations were 169 of the contracted 236. The first ten Tranche 3 front fuselage sub-assemblies were manufactured during the year. Manufacture of sub-assemblies continues in advance of recommencement of deliveries of Typhoon aircraft to Saudi Arabia in 2013.

In December 2012, a £2.5bn contract was awarded for the supply of 12 Typhoon and eight Hawk aircraft, associated training, and support to the Royal Air Force of Oman.

The business continues to support its UK and European customers' Typhoon and Tornado aircraft, and their operational commitments through availability-based service contracts and support operations. Orders of £668m were received in the year, including a contract worth £446m for Typhoon support operations across Germany, Italy, Spain and the UK. Support volumes on Tornado are expected to decline as the number of aircraft and flying hours reduce in advance of the out-of-service date of April 2019.

Delivery of the first F-35 Lightning II aircraft was accepted by the UK MoD. The business has delivered a further 42 production aircraft fuselage assemblies to Lockheed Martin. Interim funding of £234m for the fifth and sixth Low-Rate Initial Production contracts was secured in the year and negotiations continue in respect of final funding.

Support continues to be provided to operators of Hawk trainer aircraft around the world. In partnership with Hindustan Aeronautics Limited, production of 66 Batch 1 Hawk aircraft has been completed in India. Deliveries of materials and equipment in support of licence production of the 57 Batch 2 aircraft continue and aircraft assembly in India is ongoing. The business has provided an initial response to a request for proposal for an additional 20 aircraft to India.

Following the 2011 government-to-government Memorandum of Understanding, BAE Systems and Dassault Aviation have jointly secured an order from the UK and French governments for a Future Combat Air System demonstration programme preparation phase to plan how to mature and demonstrate critical technology and operational aspects for an Unmanned Combat Air System.

In the defence information domain, the Falcon secure deployable communication system is now in service with the British Army and RAF.

Under a continuing focus on cost reduction and efficiency, there has been a net headcount[1] reduction of approximately 1,400 in the year.

Maritime

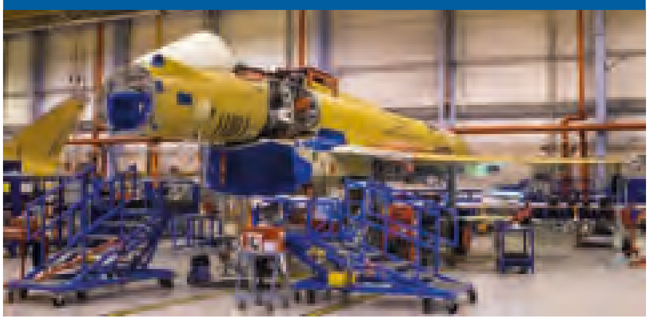
Cumulative savings of £342m have been reported to the MoD against commitments made under the 15-year Terms of Business Agreement (ToBA), significantly ahead of target. In line with the ToBA, the Group is progressing discussions with the MoD regarding future shipbuilding strategy after completion of block build for the Royal Navy's new aircraft carriers, and as the business transitions to the design and manufacture phase of the Type 26 Global Combat Ship.

The largest hull section of the first of the Royal Navy's new aircraft carriers, the Queen Elizabeth, has been delivered to Rosyth for assembly with the other completed hull sections. Block manufacture for the second ship, Prince of Wales, is well underway. BAE Systems and its Aircraft Carrier Alliance partners are working to finalise the detailed design changes required for operation of the short take-off and vertical landing variant of F-35 Lightning II on the carriers.

Typhoon is now in service with six air forces. In total, 571 Typhoon aircraft have been ordered by the four European partner nations, Saudi Arabia, Austria and Oman.

As well as Typhoon manufacture, BAE Systems also provides availability and in-service support services. In 2012, the Group was awarded a £446m contract for Typhoon support operations across Germany, Italy, Spain and the UK.

Typhoon



F-35 Lightning II

BAE Systems is a major subcontractor on the F-35 Lightning II combat aircraft. The Group has the lead in manufacture of the aft fuselage, vertical and horizontal tails and wing tips, and is responsible for a number of subsystems and equipment, including the electronic warfare suite.

Almost 2,000 people in the US, UK and Australia are employed on the F-35 Lightning II programme.

See page 57 for more information on the Group's involvement on F-35 Lightning II

PLATFORMS & SERVICES (UK)

Defender, the fifth Type 45 destroyer, was accepted by the Royal Navy in July. The final ship, Duncan, has undertaken her sea trials and is on schedule for delivery in 2013. The Type 45 support contract met all ship deployment dates during the year.

Settlement with the Government of the Republic of Trinidad and Tobago, in respect of the cancelled OPV programme, was reached in November at an amount consistent with provisions held. In January 2013, £101m of the £131m cash settlement was paid, with the remainder due in May 2013. Following the agreement in December 2011 for the sale of the OPVs to the Brazilian Navy, the first two vessels were delivered in the year, with the third ship due for delivery in 2013.

Following an incident at sea during gunnery trials on the first Khareef Class corvette for Oman, detailed engineering, schedule and contract reviews have resulted in revised delivery dates for the ships. This has resulted in an increase in costs to complete the contract. The ships are expected to be delivered in 2013 and 2014.

The Type 26 Global Combat Ship assessment phase contract continues and is intended to be completed by the end of 2014. The Type 26 is planned to replace the Royal Navy's Type 23 frigates.

The warship support modernisation initiative contract, for delivery of services at Portsmouth Naval Base, continues to exceed contract performance. A new maritime support delivery framework will replace the existing contract in 2013.

The Advanced Radar Target Indication Situational Awareness Navigation (ARTISAN) 3-D radar successfully passed its factory acceptance test and the first of class has been fitted to HMS Iron Duke, a Type 23 frigate. The programme continues on track towards full production.

The Maritime Composite Training System, a shore-based warfare operator training solution, was declared ready for training by the Royal Navy in August having completed a year of initial training. Over 3,000 Royal Navy personnel have now been trained through the facility.

The Sting Ray lightweight torpedo delivery contract for the Norwegian government was completed in December.

Ambush, the second of class Astute submarine for the Royal Navy, departed for sea trials in the second half of the year. The operational handovers of both HMS Astute, the first of class, and Ambush are planned for 2013. Pricing for the fourth boat has been agreed with the customer and long lead procurement has commenced on the sixth and seventh boats.

BAE Systems secured a further £383m of funding from the UK MoD for the design and development phase of the Successor submarine programme, to replace the Vanguard Class fleet, and now has approximately 1,000 people engaged on the programme.

Combat Vehicles (UK)

The Terrier combat engineer vehicle contract concluded its reliability growth confirmation trials, which identified a number of required engineering changes. This has resulted in an increase in costs to complete the contract. Final trials are complete and deliveries of the 60 vehicles will commence in 2013.

Following delivery of the Terrier vehicles, the Newcastle facility will close, and support to Terrier and existing vehicles used by the British Army customer will be provided from the remaining facility at Telford and satellite offices.

Looking forward

Platforms & Services (UK) has a strong order backlog of long-term committed programmes and an enduring support business.

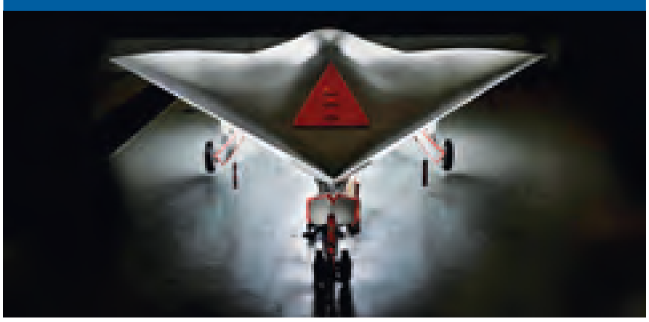
In Military Air & Information, sales are underpinned by military aircraft production on Typhoon, Hawk and F-35 Lightning II, and in-service support for existing and legacy combat and trainer aircraft. There are significant opportunities to secure future Typhoon export contracts to Malaysia, the United Arab Emirates and Saudi Arabia.

In Maritime, sales are underpinned by the Queen Elizabeth Class carrier and Astute Class submarine manufacturing programmes, the 15-year ToBA, the maritime support delivery framework, and the design of the Successor submarine and Type 26. The through-life support of these platforms and Type 45, together with their associated command and combat systems, provides sustainable business in technical services and mid-life upgrades.

In Combat Vehicles (UK), sales beyond the Terrier programme depend upon through-life support of legacy platforms.

In 2012, Taranis, the UK's Unmanned Combat Air System technology demonstrator, successfully completed a series of key tests on the way to commencing flight trials in 2013. BAE Systems, as prime contractor, provides many elements of Taranis, including systems integration, control infrastructure, full autonomy elements, and the creation and integration of the low observable technologies.

Unmanned Air Systems



Queen Elizabeth Class carriers

The largest hull section of the first of the Royal Navy's Queen Elizabeth Class aircraft carriers has been delivered to Rosyth for assembly with the other completed hull sections. Block manufacture for the second ship, Prince of Wales, is well underway.

Non-financial performance	
Employee safety	
Businesses to demonstrate improvement against 2011 performance on recordable accidents	15% stretch target achieved
Continue to progress against the Safety Maturity Matrix	Achieved
Diversity and inclusion	
Demonstrate continued progress against the Diversity & Inclusion Maturity Matrix	Achieved
Establish milestones/targets to underpin delivery of the stated 2015 position[1]	Confirmed
Environment	
Continued progression against the Environmental Sustainability Maturity Matrix	Achieved
Reduction in energy[2]	Target achieved
Reduction in water[2]	Target achieved
Reduction in waste[2]	Target achieved

Employee safety During 2012, the business achieved a 44% reduction in the Recordable Accident Rate.

Businesses across Platforms & Services (UK) helped achieve safety targets by putting in place employee engagement programmes focused on the importance of workplace safety. Campaigns included the 'Good to Go' process in the Submarines business looking at the safety responsibilities of individuals (both office-based and operational), supervisors and managers, with specific safety information targeted at each group.

During 2012, the business's 'Safety First' programme achieved a Gold award in the Chairman's Award category of Transferring Best Practice. Safety teams worked together to develop an employee programme that improves levels of safety and can be easily transferred across sites. The programme also received external recognition, including the British Safety Council International Safety Awards, the Royal Society for the Prevention of Accidents, Gold Awards for Occupational Health and Safety, and the Safety and Health Practitioner Institution of Occupational Safety and Health Awards. The programme has been endorsed by Lloyd's Register Quality Assurance and the UK Health and Safety Executive.

Diversity and inclusion Platforms & Services (UK) launched its diversity and inclusion framework during the year, the aim being to set the goals and actions for diversity and inclusion over the next five years.

To support the framework, a working group was established to help progress the following actions: develop more gender-balanced supply of appropriately qualified employees for leadership positions; hire and select a diverse mix of top-performing people; build inclusive leadership competence and capabilities; establish greater workplace flexibility; foster a more inclusive culture; and engage with employees. During the year, progress included female executives being mentored through an Executive Committee mentoring programme and unconscious bias training being scoped for senior managers.

Environment During 2012, Platforms & Services (UK)'s environmental sustainability working group developed consistent environmental standards across the businesses by aligning approaches to programmes and target setting.

To further increase energy savings and actively promote awareness amongst fellow employees across the businesses, the Energy Matters campaign 'Switch on to switching off' continued to be supported. The campaign involved training energy champions across the business to actively promote the benefits of energy conservation amongst fellow employees.

People In 2012, there were successes for young people engaged in the Group's early careers graduate and apprenticeship programmes, including a team of apprentices winning the government-sponsored 'Make it in Great Britain' competition for the design and manufacture of an innovative rehabilitation aid for amputees. In addition, an apprentice won the inaugural Apprentice Champion of the Year Award which recognises inspirational role models and outstanding advocates for apprenticeships in the UK.

The Leading for Total Performance development programme aims to ensure that the leadership engages fully with the Group's strategy.

As part of a suite of measures designed to foster employee engagement, a new Employee Assistance Programme was launched.

1 Businesses have put in place plans to 2015 to support and progress the Group's long-term goal to build a high-performing workforce that more closely reflects the diversity of the local communities in which its businesses operate.
2 Data is derived from internal recording systems and is not subject to external verification or audit.

Production of the Royal Navy's Astute Class nuclear-powered submarines continues, with Ambush, the second of class, undergoing sea trials in late 2012.

The 97 metre-long Astute Class submarines are powered by a sophisticated nuclear propulsion system, which never needs refuelling. The sonar system has the processing power of 2,000 laptops and can track ships 3,000 miles away. Armed with both Tomahawk land attack missiles and Spearfish torpedoes, its missiles have a target range of 1,200 miles with accuracy measured in metres.

Astute Class submarines

UK Sport technology partnership

During 2012, BAE Systems' £1.5m, five-year technology partnership with UK Sport contributed to a significant number of medals for Team GB at the London Olympics. The Group's technology partnership enabled its employees to share its unique engineering capabilities with the sporting community and thousands of young people through its education programmes.

BAE Systems is finalising a new four-year technology partnership with UK Sport to provide £800,000 of engineering time, equipment and materials to support British athletes. The partnership will run from 2013 to 2016.

Reporting segments performance review

PLATFORMS & SERVICES (INTERNATIONAL)

Platforms & Services (International), with 15,500 employees[1], comprises the Group's businesses in Saudi Arabia, Australia, India and Oman, together with its 37.5% interest in the pan-European MBDA joint venture.

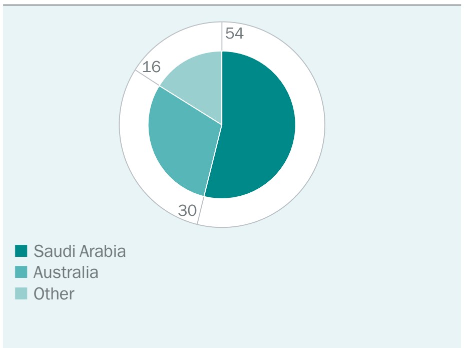
Operational key points

- Salam price escalation negotiations ongoing
- £5.0bn of orders received under the Saudi British Defence Co-operation Programme (SBDCP) for training aircraft and support to the end of 2016
- First Landing Helicopter Dock hull arrived in Australia for completion and second hull launched in Spain
- MBDA export order for MICA air-to-air missiles to India

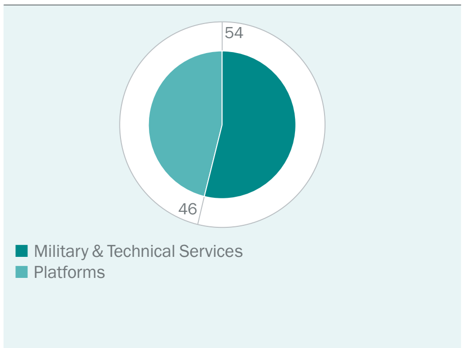
Financial key points

- Order backlog[1] increased reflecting multi-year support and training awards under the SBDCP
- Like-for-like increase in sales[1] of 9% on increased support activity on the Salam Typhoon programme and weapons deliveries under the Tornado Sustainment Programme (TSP)
- Strong operating cash flow[3] reflecting acceleration of advances on TSP

Sales analysis (%)



Sales analysis: platforms and services (%)



		2012	2011	2010
Funded order intake[1]	KPI	**£5,266m**	£3,319m	£2,694m
Order backlog[1]		**£9.3bn**	£8.3bn	£9.1bn
Sales[1]	KPI	**£4,071m**	£3,794m	£4,325m
Underlying EBITA[2]	KPI	**£417m**	£449m	£449m
Return on sales		**10.2%**	11.8%	10.4%
Cash inflow[3]	KPI	**£506m**	£80m	£190m

1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 31).
3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

KEY CHARACTERISTICS

Saudi Arabia:
- Long-term contracts from the Royal Saudi Air Force for equipment, training and support, including Salam Typhoon aircraft
- Support to Royal Saudi Navy minehunter programme

Australia:
- Strategic capability and sustainment provider to the Australian Defence Force
- Delivering defence contracts across the air, land, maritime and electronics domains

India:
- Long-standing military aircraft relationships

MBDA:
- Pan-European guided weapons joint venture

Oman:
- In-service base across air, land and maritime products

Financial performance

Order intake[1] increased to £5.3bn (2011 £3.3bn) reflecting the award of orders for continuing support of the operational capability and training of the Saudi armed forces under the Saudi British Defence Co-operation Programme (SBDCP) to the end of 2016. Contracts were previously let on an annual basis.

Sales[1] in 2012 were £4.1bn, 9% higher than 2011 on a like-for-like basis, reflecting increased support activity on the Salam Typhoon programme and weapons deliveries under the Tornado Sustainment Programme (TSP).

Underlying EBITA[2] was £417m (2011 £449m). Return on sales reduced to 10.2% (2011 11.8%) as 2011 benefited from strong performance and risk reduction on the Tornado upgrade and core support programmes in Saudi Arabia.

Operating cash inflow[3] of £506m (2011 £80m) reflected acceleration of advances on TSP.

Operational performance

Saudi Arabia

Through the entry into service of Typhoon and the continued development of the in-country industrial base, the Group remains committed to developing a greater indigenous capability in Saudi Arabia.

On the Salam programme, UK final assembly of the remaining 48 of the 72 Typhoon aircraft has commenced and deliveries are expected to resume in 2013. Work to expand the multi-role capabilities of the Royal Saudi Air Force (RSAF) Typhoon is progressing to schedule.

The initial three-year Typhoon support contract finished at the end of June and two subsequent six-month extensions have been secured. Discussions continue with the customer on the next five years of support.

Discussions on Typhoon price escalation with the Saudi Arabian government remain ongoing. Negotiations are also ongoing for the provision of maintenance and upgrade facilities in-Kingdom, and further capability enhancement of the aircraft.

The business continues to support the operational capability of both the RSAF and Royal Saudi Naval Forces (RSNF). A £1.6bn contract was awarded in May to upgrade the RSAF's aircrew training aircraft, involving the supply of, and initial support for, Hawk Advanced Jet Trainer and Pilatus PC-21 training aircraft. The business was also awarded orders totalling £3.4bn for support to the end of 2016, including the provision of manpower, logistics and training to the RSAF.

Under the Tornado Sustainment Programme (TSP), the upgrade of the RSAF Tornado fleet is complete, with all of the contracted aircraft having been delivered back into the RSAF fleet. Delivery of Storm Shadow missiles to the RSAF under the TSP is progressing in line with the agreed programme schedule.

Work continues on the first ship re-fit on the minehunter mid-life update programme. The ship is due to be handed back to the RSNF customer during the second half of 2013.

On the C4I (Command, Control, Communications, Computers & Intelligence) programme, the business continues to seek an acceptable closure of the contract with the customer.

Australia

Integration of the first of two Landing Helicopter Docks commenced at the Williamstown shipyard following the arrival of the hull from subcontractor Navantia in Spain. The second hull was launched at Navantia's Ferrol shipyard.

A total of nine hull blocks have been constructed and delivered under the A$209m (£134m) Air Warfare Destroyer contract, completing the Group's involvement in the first two ships of the three being built.

In 2012, the business completed the multi-year project to modernise 431 M113 armoured personnel carriers for the Australian Army.

The first of seven Royal Australian Navy ANZAC Class frigates is being upgraded with anti-ship missile defence capability at the Henderson shipyard under a A$267m (£171m) contract signed in January 2012.

The business has been selected as the preferred tenderer to provide ongoing in-service support for the Royal Australian Air Force's Hawk Lead-In Fighter fleet and contract negotiations are ongoing.

The business was awarded an in-service electronic warfare support contract for the Wedgetail airborne early warning and control aircraft fleet to 2015 with a value up to A$68m (£43m).

Final assembly of the remaining 48 of the 72 Typhoon aircraft for the Royal Saudi Air Force (RSAF) has commenced and deliveries are expected to resume in 2013.

The Saudi Typhoon support contract is an availability contract supporting the aircraft's entry into service with the first of the RSAF's Typhoon squadrons.

See page 19 for more information

Saudi Arabia – Typhoon manufacture and support

Saudi Arabia – Tornado Sustainment Programme

As part of the Saudi British Defence Co-operation Programme, BAE Systems has substantial training and support activities in Saudi Arabia.

In partnership with the Royal Saudi Air Force (RSAF), the Tornado Sustainment Programme has successfully upgraded all of the RSAF Tornado fleet.

See page 21 for more information

PLATFORMS & SERVICES (INTERNATIONAL)

Whilst the business submitted a bid for the next-generation Battlespace Communications System, the decision was taken to withdraw from this competition after a breach of tender protocols had occurred during its participation in the initial tender process.

India

Following a strategic review of the Defence Land Systems India (DLSI) joint venture, it has been jointly agreed that Mahindra & Mahindra will acquire BAE Systems' 26% shareholding in DLSI. This decision is a reflection of the shareholders' belief that they can best meet customer requirements and address market opportunities on a case-by-case basis, including continuing to explore opportunities for co-operating on specific defence projects.

BAE Systems is participating as a subcontractor to Bharat Electronics Limited (BEL) on the Tactical Communications Systems programme for the Indian military, for which BEL has been selected as one of two design authorities.

The Indian government has issued a Letter of Request to the US government under the US Foreign Military Sales process for the supply of 145 M777 howitzers for the Indian Army.

Together with its Eurofighter industry partners, the Group continues to monitor the Medium Multi-Role Combat Aircraft competition and stands ready to support the Indian government's procurement process.

The Group has received a request for proposal for a third batch of Hawk Advanced Jet Trainer aircraft for the Indian Air Force.

Oman

The contract for the supply of Typhoon and Hawk aircraft awarded in December 2012 builds on the close partnership with the Omani armed forces and provides the platform to ensure this relationship is further developed. The Group has a long history of working closely with the Omani armed forces, and currently supports their existing air, land and maritime platforms, such as air defence radars, Challenger tanks, and Jaguar and Hawk aircraft.

MBDA

In the export market, a significant order was received from India in early 2012 for MICA air-to-air missiles as part of the Indian Air Force's Mirage 2000 upgrade.

In the domestic market, the business secured an important support contract for the Principal Anti-Air Missile System and a development contract for the Future Local Anti-Air Defence System. The business continues to pursue the Anglo-French joint development and production opportunity for the Future Anti-Ship Guided Weapon – Anti-Navire Léger.

Development programmes continue to progress well. The Meteor beyond visual range air-to-air missile successfully concluded its guided firing programme.

Looking forward

In the Kingdom of Saudi Arabia, the Group seeks to build upon its long-term presence through delivering current programmes and industrialisation, and developing new business in support of the Saudi military and security forces.

Following agreement of the training aircraft and support orders under the SBDCP in 2012, the focus turns towards mobilising activities on the next phases of these programmes.

In Australia, BAE Systems will continue to support the Department of Defence by working with the customer to deliver cost and service improvements. The business continues to explore and secure opportunities in adjacent markets, including commercial maritime repair and support, and commercial fabrication for the natural resources industry.

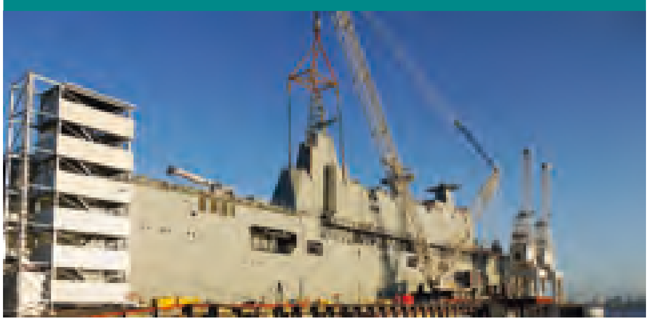
In India, significant aircraft and artillery opportunities continue to be pursued.

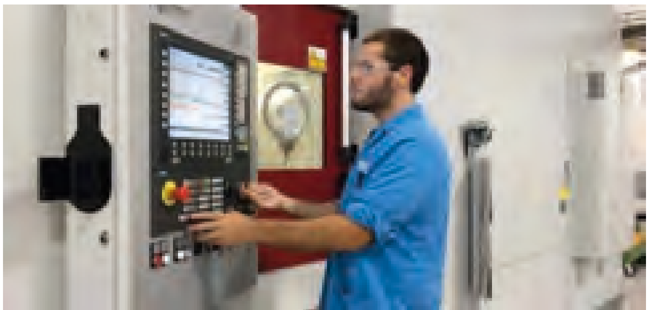
In MBDA, whilst domestic budgetary pressures continue, export markets are anticipated to grow, potentially benefiting from significant military aircraft procurements.

BAE Systems is the prime contractor for two 27,000 tonne Landing Helicopter Docks, the largest ships ever to be built for the Royal Australian Navy.

The completed hull of the first Landing Helicopter Dock arrived at the Williamstown shipyard in October from the subcontractor Navantia in Spain and integration activity has commenced.

Australia – Landing Helicopter Docks





Australia – air platforms

BAE Systems provides systems integration and sustainment solutions to Australia's current and future military air platforms. The Group has an F-35 Lightning II manufacturing plant in South Australia.

Non-financial performance	
Employee safety	
Businesses to demonstrate improvement against 2011 performance on recordable accidents	15% stretch target achieved
Continue to progress against the Safety Maturity Matrix	Achieved
Diversity and inclusion	
Demonstrate continued progress against the Diversity & Inclusion Maturity Matrix	Achieved
Establish milestones/targets to underpin delivery of the stated 2015 position[1]	Confirmed
Environment	
Continued progression against the Environmental Sustainability Maturity Matrix	Achieved
Reduction in energy[2]	Target achieved
Reduction in water[2,3]	Target achieved
Reduction in waste[2]	Target achieved

Employee safety During 2012, the business achieved a 17% reduction in the Recordable Accident Rate.

Regrettably, during 2012, an employee died in a road traffic accident whilst at work in Saudi Arabia.

All businesses launched safety training and communications campaigns targeted at employees to increase safety awareness and to reinforce the message that safety is everyone's responsibility.

Each business addressed specific safety priorities. In Saudi Arabia, a working group was established to progress safety performance, with key activities including safety on customer bases and road safety awareness weeks. In Australia, safety objectives for senior leaders were rolled out across the business. In India, the focus has been on embedding safety processes across its offices and a Safety, Health & Environment framework was launched.

Diversity and inclusion The businesses have launched a number of initiatives to progress diversity and inclusion.

In Saudi Arabia, BAE Systems has developed a female employment strategy and five-year plan to support the establishment last year of its female office in Riyadh. In total, 117 women are now employed by the business, including 43 in Saudi Arabia.

In Australia, a Flexible Working handbook was launched to support a flexible work culture and aspirations for female representation were set for executives.

In India, a 'Diversity & Inclusion Essentials' course was rolled out to all line managers, which aims to increase awareness and understanding of how diversity and inclusion can create value for the business. A women's forum was introduced to provide personal development and networking opportunities for women in the workplace.

Environment In Saudi Arabia, environmental sustainability has been built into the procurement team's processes and major subcontractor reviews. This is also being done in Australia.

During the year, both Saudi Arabia and India launched environmental conservation programmes. In Saudi Arabia, water conservation and re-use is now a priority, and employee training was launched in India.

The Australian business implemented and sustained compliance processes to meet environmental regulatory reporting requirements, such as the National Greenhouse Energy Reporting Act.

People In Saudi Arabia, the Saudisation programme is crucial to the long-term sustainability of the business. BAE Systems remains committed to recruiting and training local nationals, with local employees currently filling 60% of positions in-Kingdom. In 2012, the Saudi business selected 24 high-potential people to participate in its Mustakbal Management Development Programme, which leads to Chartered Management Institute internationally recognised qualifications.

In Australia, the 'Bright Stars' programme has been launched to develop the next generation of leaders, actively engaging 13 high-performing people to provide opportunities, leadership and mentoring to fast track their career prospects.

In India, the Group has entered into a long-term partnership agreement with Smile Foundation, a national level development organisation with an outreach of over 200,000 underprivileged children, women and youth across 25 states.

1 Businesses have put in place plans to 2015 to support and progress the Group's long-term goal to build a high-performing workforce that more closely reflects the diversity of the local communities in which its businesses operate.
2 Data is derived from internal recording systems and is not subject to external verification or audit.
3 Data excludes Saudi Arabia.

India – Hawk Advanced Jet Trainer

BAE Systems has received a request for proposal for a third batch of Hawk Advanced Jet Trainer aircraft for the Indian Air Force.

The potential addition to the Indian fleet, one of the largest fleets of Hawk in the world, would take the number of Hawk aircraft ordered worldwide to over 1,000. Customers for Hawk include Australia, Canada, South Africa, Bahrain, India, the Royal Saudi Air Force and the Royal Air Force. The Royal Air Force aerobatics team, the Red Arrows, has used the BAE Systems Hawk since 1979.

MBDA

BAE Systems is a 37.5% shareholder in MBDA, a leading global guided weapons manufacturer.

MBDA is the prime contractor for a series of multi-national programmes, including Storm Shadow, an Anglo-French air-launched cruise missile that can be carried by Tornado aircraft.

Reporting segments performance review

GOVERNANCE

In this section:

BAE Systems places great importance on the way it conducts its business. This section explains the Group's approach to governance.

Photo credit:
US Army

Operating the Radford Army Ammunition Plant

BAE Systems is the operating contractor of the Radford Army Ammunition Plant in Virginia, managing, operating and maintaining the plant under an initial ten-year contract from the US Army. The Radford plant, established in 1941, is a government-owned, contractor-operated facility that manufactures propellants for military munitions.

BOARD OF DIRECTORS

Chairman

Dick Olver Chairman

Appointed to the Board: 2004 *Nationality:* British

Skills and experience: A chartered civil engineer with extensive experience of managing complex international engineering projects, he held a variety of senior management positions in the oil industry culminating in his appointment to the board of BP p.l.c. as CEO of Exploration and Production in 1998. Subsequently appointed Deputy Group Chief Executive of BP in 2003, stepping down from that role when he assumed the chairmanship of BAE Systems.

Other appointments: Member of the Prime Minister's Business Advisory Group, Business Ambassador for UK Trade & Investment, and member of the Prime Minister's India/UK CEO Forum. Also a member of the Multinational Chairman's Group and the Trilateral Commission, a Fellow of the Royal Academy of Engineering, Chairman of the Education for Engineering (E4E) Policy Group, and adviser to HSBC and Clayton, Dubilier & Rice.

Other past appointments: Non-executive director of Thomson Reuters plc.

Committee membership: Chairman of the Nominations Committee and the Non-Executive Directors' Fees Committee

Executive directors

Ian King Chief Executive

Appointed to the Board: 2007 *Nationality:* British

Skills and experience: Appointed as Chief Executive in 2008 having been originally appointed to the Board as Chief Operating Officer, UK and Rest of the World. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Prior to the BAe/MES merger he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems.

Other appointments: Non-executive director and Senior Independent Director of Rotork p.l.c.

Committee membership: Non-Executive Directors' Fees Committee

Linda Hudson President and Chief Executive Officer of BAE Systems, Inc.

Appointed to the Board: 2009 *Nationality:* US

Skills and experience: Appointed to the Board as President and Chief Executive Officer of BAE Systems, Inc., Linda Hudson was previously President of the Company's US-based Land & Armaments business. She joined the Company in 2006 from General Dynamics where she had worked since 1992 in a variety of roles culminating in her appointment as Corporate Vice President and President, Armament and Technical Products.

Other appointments: Member of the Bank of America Board of Directors, the Smithsonian National Air and Space Museum Board of Directors, the Executive Committee of the Aerospace Industries Association, and the University of Florida Foundation Board. She also serves on advisory boards for the University of Florida's College of Engineering.

Committee membership: Non-Executive Directors' Fees Committee

Peter Lynas Group Finance Director

Appointed to the Board: 2011 *Nationality:* British

Skills and experience: Peter Lynas, a qualified accountant, was appointed to the Board as Group Finance Director in April 2011. He previously served for a number of years as Director, Financial Control, Reporting & Treasury. He joined GEC-Marconi in 1985 having previously worked for other companies in the UK and Europe. After progressing through a number of positions he was appointed Finance Director of GEC's Marconi Electronic Systems business, which was subsequently acquired by British Aerospace in 1999 to become BAE Systems.

Non-executive directors

Paul Anderson Non-executive director

Appointed to the Board: 2009 *Nationality:* US

Skills and experience: Paul Anderson has extensive global business experience in the energy and mining sectors. He spent more than 20 years in two spells at Duke Energy Corporation and its predecessor companies, culminating in his appointment as Chairman, President and Chief Executive Officer. He was subsequently Chairman of Spectra Energy Corporation until 2009 and in the intervening period he served as Managing Director and Chief Executive Officer of BHP and, subsequently, of the newly merged BHP Billiton.

Other appointments: Non-executive director of BP p.l.c.

Other past appointments: Non-executive director of BHP Billiton Plc, Qantas Airways Limited and Spectra Energy Corporation.

Committee membership: Chairman of the Corporate Responsibility Committee and member of the Nominations Committee

Harriet Green OBE Non-executive director

Appointed to the Board: 2010 *Nationality:* British

Skills and experience: Appointed Chief Executive Officer and executive director of Thomas Cook Group plc in July 2012. She was previously Chief Executive Officer and executive director of Premier Farnell plc, a leading, high service, multi-channel technology distribution group. Harriet Green has significant global business experience having run volume distribution businesses in four continents for Premier Farnell and volume distributor, Arrow Electronics, Inc.

Other appointments: Non-executive director of Emerson Electric Co.

Committee membership: Corporate Responsibility Committee

Lee McIntire Non-executive director

Appointed to the Board: 2011 *Nationality:* US

Skills and experience: Lee McIntire is Chairman and Chief Executive of CH2M HILL, a leader in consulting, design, design-build, operations, risk management and programme management for public and private clients. Prior to joining CH2M HILL, he was an executive at Bechtel Group Inc., where he served on the board of directors and was Executive Vice President for the parent company.

Committee membership: Remuneration Committee

Sir Peter Mason KBE Non-executive director

Appointed to the Board: 2003 *Nationality:* British

Skills and experience: Chairman of Thames Water and Senior Independent Director of Subsea 7 S.A., an international offshore engineering, construction and services contractor. Non-executive member of the board of Spie S.A. Formerly Chairman and Chief Executive of Balfour Beatty Limited, and Chief Executive of AMEC plc, Sir Peter has extensive experience in engineering, construction and long-term contracting.

Other past appointments: Executive director of BICC plc and Chief Executive of Norwest Holst Group PLC.

Committee membership: Audit Committee, Corporate Responsibility Committee and Nominations Committee. He served as the Company's Senior Independent Director for a number of years before stepping down from that role in January 2013.

Paula Rosput Reynolds Non-executive director

Appointed to the Board: 2011 *Nationality:* US

Skills and experience: Paula Rosput Reynolds is Chief Executive Officer and President of the business advisory group, PreferWest, LLC. She had previously spent over 20 years in the energy sector in a variety of operational roles, culminating in her appointment as President and Chief Executive Officer of AGL Resources in 2002. She subsequently served as President and Chief Executive Officer of Safeco Corporation, an insurance company located in Seattle, Washington, until its acquisition by Liberty Mutual Group in 2008. She was then appointed as Vice Chairman and Chief Restructuring Officer of American International Group, Inc. (AIG) from October 2008 to September 2009, overseeing AIG's divestiture of assets and serving as chief liaison with the Federal Reserve Bank of New York.

Other appointments: Non-executive director of Delta Air Lines, Inc., Anadarko Petroleum Corporation and TransCanada Corporation.

Other past appointments: Non-executive director of Coca-Cola Enterprises, Inc. and Air Products and Chemicals, Inc.

Committee membership: Audit Committee

Nick Rose Non-executive director and Senior Independent Director

Appointed to the Board: 2010 *Nationality:* British

Skills and experience: Nick Rose held the position of Chief Financial Officer of Diageo plc for over ten years until October 2010 where, in addition to his finance responsibilities, he was also responsible for supply, procurement, strategy and IT on a global basis. His financial experience has encompassed a number of roles since joining Diageo's predecessor company, Grand Metropolitan, in 1992, including group treasurer and group controller, having spent his earlier career with Ford Finance. He assumed the chairmanship of the Company's Audit Committee in August 2011 and was appointed the Company's Senior Independent Director on 21 January 2013.

Other appointments: Chairman of Williams Grand Prix Holdings PLC and Edwards Group Limited. Non-executive director of BT Group plc.

Other past appointments: Non-executive director of Moët Hennessy SNC and Scottish Power plc.

Committee membership: Chairman of the Audit Committee, and member of the Nominations Committee and Remuneration Committee

Carl Symon Non-executive director

Appointed to the Board: 2008 *Nationality:* British/US

Skills and experience: Carl Symon has an extensive background in global business operations and management, retiring in 2001 after a long career at IBM during which he held senior executive positions in the US, Canada, Latin America, Asia and Europe, including that of Chairman and Chief Executive Officer of IBM UK.

Other past appointments: Non-executive director of BT Group plc, Rexam PLC and Rolls-Royce Group plc, and Chairman of HMV Group plc.

Committee membership: Chairman of the Remuneration Committee

Company Secretary

David Parkes

Back row from left to right: Sir Peter Mason KBE, Carl Symon, Harriet Green OBE, Paul Anderson, Ian King, Lee McIntire, Linda Hudson, Nick Rose, Paula Rospud Reynolds

Seated from left to right: Peter Lynas, Dick Olver

Governance

CHAIRMAN'S CORPORATE GOVERNANCE LETTER

Dick Olver
Chairman

"Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board have been applied."…"Above all, the personal reporting on governance by chairmen as the leaders of boards might be a turning point in attacking the fungus of "boiler-plate" which is so often the preferred and easy option in sensitive areas but which is dead communication."

Preface to The UK Corporate Governance Code (September 2012)

Dear Shareholders,

Those of you that have read this section of our report and accounts in past years will know that I like to reflect on certain corporate governance matters that are topical or of particular interest to you as BAE Systems shareholders. This year, I want to highlight how we use board visits to develop directors' understanding of the business and provide an update on board diversity. However, I will start with a matter that generated much interest during 2012, the Board's decision that the Company should hold discussions with EADS to look at a possible combination of the two businesses. These discussions, and the subsequent decision to terminate them, were the subject of much interest last year and I think it is worthwhile looking at this matter from a governance perspective.

Strategy and decision making

The UK Corporate Governance Code states that a board's role is to provide entrepreneurial leadership for a company in setting its strategic aims. BAE Systems has a well-developed strategy and planning process that involves the Board throughout the year. Consequently, the Company's strategy is the subject of a good deal of review that involves both the senior executive management team and Board members in analysis and discussion. As a result of this, prior to the discussions with EADS last year, we knew we had a robust standalone strategy and business plan but if a board is to provide strategic leadership it also needs to look at wider opportunities to deliver shareholder value.

The UK's Corporate Governance Code also aims to promote effective board decision-making. The essential elements of good governance in this area being a well-constituted board with a clear division of responsibilities between chairman and chief executive, that is able to make well-informed decisions on the basis of collective debate and deliberation, and, once a decision has been made, ongoing board oversight and supervision.

On the basis of the work that had been undertaken prior to 2012, the Board was well informed on strategic matters and, therefore, well placed to decide whether or not the Chief Executive should be given authority to engage with EADS to explore that strategic opportunity. The Board discussed this matter at length. The discussions were well informed with effective engagement between executive and non-executive members of the Board, following which there was clear agreement on how to take this forward. Thereafter, we took steps to ensure that directors were kept up-to-date with developments and given the opportunity to raise any matters or concerns they had. Regular conference calls and Board meetings provided this engagement, and in the period from the initial Board discussions to the termination of the talks, a total of six Board meetings and five informal telephone conference calls were held. In addition, as Chairman, I remained in close contact with all Board members (both executive and non-executive) to ensure that everyone remained close to developments and all had the opportunity to provide guidance or raise concerns.

Engagement with shareholders is a fundamental part of the UK's corporate governance model and BAE Systems has a well-developed investor relations programme that has helped us to develop important relationships with major shareholders. Once the discussions with EADS became public, we recognised the need to engage with various stakeholders, such as shareholders and employees, without delay. This was a key priority for the Board and had been the subject of much debate and planning. However, it should be recognised that, as for all transactions governed by the UK's code on takeovers and mergers, the strict requirement to treat all shareholders equally in terms of access to information and not selectively disclose information meant that we were inevitably restricted as to what we could disclose to shareholders and other stakeholders in meetings. Accepting the limitations, many stakeholder meetings were held and all directors received regular feedback on them.

Major strategic actions test the true effectiveness of boards. As a starting point, a good board needs to stay on top of market conditions and understand a company's strengths and the challenges it faces so that it is able to make important strategic decisions when opportunities present themselves. Decisions should be made collectively and on a well-informed basis – where necessary, with assistance from subject experts and professional advisers. Prior to making major decisions, all directors should have the time and the opportunity, both formally and informally, to discuss matters and raise any concerns they may have. The chairman, chief executive and senior independent director have important roles to play in this process. Having made a decision, a board needs to maintain oversight of matters as they develop and be given every opportunity to get involved if there are issues that need to be addressed.

When putting a board and an executive team together you look for people with the knowledge, experience and basic sound judgement that will enable them to guide a company through all eventualities – knowing that there will be times when the quality of your governance arrangements and people will be tested. As part of our annual performance evaluation process, we have reviewed our performance in 2012 and how we stood up to that test, and whilst as a Board and as a Company we will always look at ways to improve our performance, we believe our board governance was, and remains, robust and effective.

Understanding the business

To be effective, directors need to develop an understanding of a company's business. For me, that means getting out of the boardroom and meeting employees and experiencing business operations at first-hand. Therefore, one of the highlights of 2012 from a board perspective was the visit we made to the Kingdom of Saudi Arabia. Over the course of the three-day visit, directors met with the customer, received direct feedback on the Company's performance and gained a valuable insight into our long-standing relationship with the Kingdom. We also spent time with the local management team reviewing the strategic and operational priorities for the business.

Visiting different locations in Saudi Arabia, Board members met with our employees and learnt how they work within the performance framework and values agreed by the Board. Our Chief Executive, Ian King, has consistently said that it is not just about what we do, but how we do it, building a culture that delivers shareholder value by meeting the needs of our customers and acting responsibly at all times. Whilst in Saudi Arabia, we were encouraged by the progress being made to build a sustainable long-term business shaped by our values and performance expectations.

In addition to the visit to Saudi Arabia, the Board also undertook similar visits to the US during the year, visiting the Company's operations at Greenlawn, New York, and holding meetings in Washington, DC, with management and members of our US board. The Board's committees are also encouraged to engage with the business at first-hand, and last year the Corporate Responsibility Committee visited part of our UK ammunitions business at Glascoed and the Audit Committee held one of its meetings at our Naval Ships business in Glasgow.

Diversity

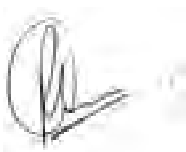
Last year, the Board agreed a policy statement on board diversity. As part of that statement, we undertook to report in future annual reports on progress against actions taken. In respect of the last 12 months I can report the following:

- There are currently three women on the BAE Systems Board (2012 three), 27% of the total membership (2012 25%). Below the Board, there are three women on the Executive Committee (2012 two), 25% of its total membership (2012 17%), and 20% of the Group's global workforce are women (2012 19%).
- Four of the 11 members of the Board are non-UK citizens.
- The Board and the Nominations Committee reviewed the Group's management resources during 2012 and noted the actions being taken to grow the female talent pipeline at senior executive levels. These actions included the following:
  - Initiating work aimed at developing a flexible work culture. In particular, establishing the principles, behaviours and education requirements to underpin this.
  - Planning the roll-out of unconscious bias training in 2013.
  - Establishing a senior executive mentoring programme managed by the Executive Committee.
  - Using executive search firms with a track record of open and inclusive recruitment processes.
- Certain of the Company's directors are involved in providing mentoring services to potential, and recently appointed, listed company directors. The Company is a founder member of the FTSE 100 Cross-Company Mentoring programme and I am a member of the 30% Club, a group committed to greater board diversity. Also, we provide mentoring services through the Chartered Management Institute.

Further details of our diversity and inclusion activities can be found on page 42.

Board evaluation

In the following Corporate governance report, you will find details of how the Board evaluates its own performance. We have undertaken such evaluations every year since my appointment as Chairman, and they have all been facilitated externally. You will also see over the page details of achievement against the Board evaluation objectives we set last year and the ones we have agreed for this year. Every year since 2006, we have provided a similar summary of the objectives agreed by the Board following its performance evaluation. We introduced this innovation in governance reporting to provide the readers of these reports with greater insight into the working of the Board, and I believe it also shows our commitment to transparency and the development of best practice in board governance.



Dick Olver
Chairman

Board performance – 2012 objectives and achievements	
Strategy Continue to keep strategy under review and support moves to adjust the portfolio of businesses where it is in the interests of shareholders to do so.	As detailed on page 80, the Company held discussions with EADS looking at a possible combination of the two businesses. Minor adjustments to the portfolio of businesses have been made, with three business disposals completed in 2012.
Succession planning Increase focus on matching succession and development to the strategic challenges of internationalisation, and the next decade of change in the business environment.	The Board and the Nominations Committee reviewed management resources during the year, and noted the work being undertaken to understand the key attributes and behaviours required for present and future senior management roles in the Company, and the application of focused development work aimed at achieving this.
Performance monitoring Extract insight from the new segmentation of business results.	The revised reporting segments have improved visibility of the business, in particular, in Cyber & Intelligence, and have enabled management to bring additional strategic insight to the business and include this as part of the Board's review of strategy.
Culture and behaviour Implement improvements and observations identified in the Ethical Leadership Group (ELG) report and the US monitors' reports, and oversee progress against these at Board meetings.	The Board and the Corporate Responsibility Committee have maintained oversight of the implementation of the actions in the ELG report and the reports produced by the US monitors. The monitor appointed by the Department of Justice attended Audit and Corporate Responsibility committee meetings during the year.
Risk and risk management Continue to review the corporate risk register, including major programme risks and crisis management plans.	During the year, the Board reviewed the different elements of risk management and how it discharged its responsibility – using the Financial Reporting Council's Boards and Risks report to inform and structure the discussion.
Board development Use deep dives to improve understanding of principal markets and other major business issues.	As reported above, the Board visited the Kingdom of Saudi Arabia and the US during the year, and used these visits to develop directors' understanding of these businesses and the particular markets they serve.

Board performance – 2013 objectives	
Strategy	Continue the strategic review of the business portfolio, with focus this year on the services businesses. Work with the executive team in the development of a comprehensive narrative of the Company's strategy.
Succession planning	The Nominations Committee to complete the recruitment of two additional non-executive directors and identify a world-class candidate to succeed Dick Olver as Chairman.
Culture and behaviour	Ensure that the Company remains at the forefront of developing and embedding best practice in responsible business behaviour.
Risk and risk management	The Board to continue to review cybersecurity protection, the management of risk in major programmes and crisis management.
Board development	Enhance the Board's strategic understanding of geo-political and economic risks in international markets. Use Board visits to promote understanding of markets and the business development opportunities they offer.

CORPORATE GOVERNANCE REPORT

Our business model
See page 17

"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

Cadbury Committee Report – December 1992

Compliance with the provisions of the UK Corporate Governance Code

The Company was compliant with the provisions of the UK Corporate Governance Code (the Code) throughout 2012.

In September 2012, a number of changes were made to the UK Corporate Governance Code. Whilst compliance with this revised code is not required until next year, the Board accepts that it represents an authoritative statement of best practice and, as such, it has reviewed its practices relative to it and this is reflected in additional information included within this report.

The Board

In 2012, the Board was scheduled to meet seven times and, in addition, two days were spent reviewing strategy. Additional Board meetings are called as required and in total the Board met nine times during the year. The attendance by individual directors at meetings of the Board and its committees in 2012 is shown in the table below.

Attendance by individual directors at meetings of the Board and its committees in 2012

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee	Non-Executive Directors' Fees Committee
Mr P M Anderson	9 (9)	–	4 (4)	4 (4)	–	–
Ms H Green	9 (9)	–	4 (4)	–	–	–
Mr M J Hartnall	1 (2)	–	–	–	–	–
Ms L P Hudson	8 (9)	–	–	–	–	1 (1)
Mr I G King	9 (9)	–	–	–	–	1 (1)
Mr P J Lynas	9 (9)	–	–	–	–	–
Sir Peter Mason	9 (9)	6 (6)	3 (4)	3 (4)	–	–
Mr L A McIntire	8 (9)	–	–	–	6 (7)	–
Mr R L Olver	9 (9)	–	–	4 (4)	–	1 (1)
Ms P Rosput Reynolds	9 (9)	6 (6)	–	–	–	–
Mr N C Rose	8 (9)	6 (6)	–	–	7 (7)	–
Mr C G Symon	9 (9)	–	–	–	7 (7)	–

Figures in brackets denote the maximum number of meetings that could have been attended.

The Board considers all of the non-executive directors, with the exception of the Chairman, to be independent for the purposes of the Code. Each of these directors has been identified on pages 78 and 79 of this report.

The Board appointed Nick Rose as its Senior Independent Director with effect from 21 January 2013. Amongst the duties undertaken by Mr Rose since that date was to meet with the non-executive directors without the Chairman present to discuss the Chairman's performance.

In 2012, having served as a director for nine years, Sir Peter Mason's term of office was extended for a period of 12 months to 21 January 2013. The Board has asked Sir Peter to continue as a director until the Company's Annual General Meeting (AGM) on 8 May 2013. Consequently, the Board has considered whether in respect of the period 22 January to 8 May 2013 he continues to be independent notwithstanding his length of service. The Board used its externally facilitated annual evaluation process to provide Board members with the opportunity to consider individually whether they believed that Sir Peter remained independent. The directors concluded that he remains independent and, in reaching this decision, the Board noted that his period of office had not coincided to any significant degree with that of any of the current executive directors.

The Company's Articles of Association require that all new directors seek re-election to the Board at the following AGM. In addition, the Board has agreed that in compliance with the UK Corporate Governance Code, all directors shall seek re-election on an annual basis. The Board has set out in the Notice of Annual General Meeting its reasons for supporting those directors seeking re-election at the forthcoming AGM.

Risk management and internal control

BAE Systems has developed a system of internal control that was in place throughout 2012 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;
- enable 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.

On pages 44 and 45 of this report, you will find details of the processes the Company has put in place to manage risk. For the Board, the key requirements are that the Company has robust processes to identity, evaluate and manage risk, and that the directors have visibility of the major risks.

Risks are identified on a 'bottom-up' basis as part of the Company's Operational Assurance Statement (OAS) process. This process is mandated across the Group, and requires that the heads of all businesses and functions identify their key risks. As part of this process, an assessment is made of the probability of the risk arising and its potential impact on the Group's business plan. All risks have an owner who is responsible for preparation and implementation of plans aimed at mitigating the risk.

The key financial and non-financial risks identified by the businesses from the risk assessment processes are collated and reviewed by the Executive Committee to identify those issues where the cumulative risk, or possible reputational impacts, could be significant.

Management responsibility for the management of the Group's most significant non-financial risks is allocated at the Executive Committee's risk workshops. The OAS and Non-financial Risk registers are reviewed regularly by the Executive Committee to monitor the status and progression of mitigation plans, and these key risks are reported to the Board on a regular basis.

The Audit Committee is responsible for reviewing the ongoing effectiveness of the Company's risk management processes as part of its review of the effectiveness of internal controls. Also, twice a year, the Audit Committee receives reports on the output from the OAS process, details of the changes in the risks identified by it and the status of mitigation plans. The Corporate Responsibility Committee undertakes a similar role in respect of the Non-financial Risk Register. The Board receives reports from the chairmen of these two committees, providing details of the work they have undertaken.

Each year, the Board specifically reviews the risks identified in the risk management processes. This is aimed at providing the Board with an appreciation of the key risks within the business and oversight of how they are being managed.

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 Total Performance Leadership (TPL). The IBP, approved annually by the Board, results in a five-year business plan for each business, together with detailed near-term budgets. The QBRs evaluate progress against the IBP, and business performance against objectives, measures and milestones. TPL 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 OAS process. This has been subject to regular review over several years, which has resulted in a number of refinements being made.

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 misstatement 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. BAE Systems' employees on the boards of such entities are required to exert such influence as the Company may have to encourage the adoption of a governance structure that is substantially equivalent to the Operational Framework.

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 Reporting segment reviews on pages 56 to 75. The financial position of the Group, including information on cash flow, treasury policy and liquidity, can be found in the Financial Performance section on pages 30 to 38. Principal risks are detailed on pages 46 to 51. In addition, the financial statements include, amongst other things, notes on finance costs (page 129), loans and overdrafts (page 153), and financial risk management (page 164).

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.

BOARD INSIGHTS

Performance evaluation

The Board undertakes an annual review of its own performance. In the last few years it has employed the services of an external facilitator, Sheena Crane. She is an independent consultant, with experience of working at the most senior levels in major companies. Within BAE Systems, her only work is with the Board and with the Executive Committee, where she has undertaken similar performance evaluation work. She was appointed to perform her Board evaluation work in consultation with the Nominations Committee.

Her evaluation process is based on one-to-one interviews with each of the directors and recording their views on how the Board and its committees work, and on the performance of individual directors.

"The principles on which the Code is based are those of openness, integrity and accountability. They go together. Openness on the part of companies, within the limits set by their competitive position, is the basis for the confidence which needs to exist between business and all those who have a stake in its success. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinise companies more thoroughly."

Cadbury Committee Report – December 1992

Applying the principles of the UK's Corporate Governance Code

The following report details how the Board has applied the main principles in the Financial Reporting Council's UK Corporate Governance Code (the Code), as required by the UK Listing Rules.

Leadership

Principles – An effective board collectively responsible for the long-term success of the company • A clear division of responsibilities at the head of the company between the running of the board and the executive. No one individual should have unfettered powers of decision • The chairman is responsible for the leadership of the board and ensuring its effectiveness on all aspects of its role • Non-executive directors should constructively challenge and help develop proposals on strategy.

The Company's governance structure is based on the leadership principles in the Code. The core activities of the Board and its committees are documented and planned on an annual basis, and this forms the basic structure within which the Board operates. The Board has adopted a document, the Board Charter, in which there is a statement of governance principles that reflect principles contained in the Code, and covers 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 details the separate and distinct roles of the Chairman and the Chief Executive, and also those of the Senior Independent Director and Company Secretary. It also states that the following matters are reserved specifically for the Board:

1. **Approving the Company's vision, values, principles of ethical conduct, delegated authorities and overall governance structure.**
2. **Approving all financial and commercial matters that it has reserved for its decision.**
3. **Approval of the Company's strategy and business plan.**
4. **Approval of the Company's annual report and accounts, and the preliminary and interim statements.**
5. **Approval of any distributions to shareholders including the approval of any interim dividend payments and any recommendations to shareholders concerning final dividends.**
6. **Approval of any significant changes to accounting policies or practices.**
7. **Appointment or removal of any director or the Company Secretary.**
8. **Approval of all circulars, prospectuses and other documents sent to shareholders (except for documents of a routine nature).**
9. **Approving the issuing and allotment of shares, changes to the capital structure of the Company, its legal status as a public company, the listing of its shares and its name.**
10. **Recommending to shareholders the appointment, re-appointment or removal of the Company's auditors.**
11. **Forming committees of the Board and approving their terms of reference.**
12. **Approval of the Board Charter (including this schedule of reserved matters) and the Operational Framework (a document detailing the Company's vision, values, delegated authorities and overall governance structure).**

Whilst the Board is ultimately responsible for the success of the Company, given the size and complexity of its operations, all but the most important matters are managed on a delegated basis by the Chief Executive and the executives working for him. The Board appoints the Chief Executive and monitors his performance in leading the Company, and providing operational and performance management in delivering the agreed strategy.

The Board and its committees monitor the application of values, standards and processes. This includes a range of activities such as the formal review of the effectiveness of internal controls. To ensure that non-executive directors can constructively challenge and help develop proposals on strategy, the Board has adopted a process of reviewing the development of strategy and formally approving the agreed strategy for the Company on an annual basis. In 2012, the Board members were provided with opportunities to engage in strategy development through informal meetings and workshops as well as formal Board meetings.

Feedback on Board performance is presented to a meeting of the Board, which agrees actions and objectives for the following year based on the information the facilitator provides and the conclusions that the Board derives from this.

Individual directors are also subject to annual performance evaluation, with the Chairman providing feedback to all directors. Committee chairmen also receive feedback on committee performance.

The Chairman's performance is discussed at a meeting of non-executive directors. Following this meeting, the Senior Independent Director meets with the Chairman to provide him with feedback on his performance during the year. Subject to continued satisfactory performance, directors seek re-election on an annual basis.

Management resources review

The Nominations Committee undertakes an annual review of management resources across the Group. Facilitated by the Group Human Resources Director, the Committee focuses on the detailed succession plans for all Board and Executive Committee positions, and the strategic development of the Company's management resources. Through the use of the Talent Scorecard, the Committee has access to metrics showing the Group's performance over time in populating succession plans appropriately, the level of appointments sourced internally and externally, age profiles across levels within succession plans, diversity at different management levels and attrition rates.

Effectiveness

Principles – Board and committees having an appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively • A formal, rigorous and transparent procedure for the appointment of new directors • All directors to be able to allocate sufficient time to the company to discharge their responsibilities effectively • All directors to receive induction on joining and should regularly update and refresh skills and knowledge • The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties • The board should undertake a formal and rigorous annual evaluation of its performance, and that of its committees and individual directors • All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

Succession planning is used by the Board to deliver two key responsibilities, firstly to ensure that the Group is managed by executives with the necessary skills, experience and knowledge, and secondly to ensure that the Board itself has the right balance of individuals to be able to effectively discharge its responsibilities. The Nominations Committee has specific responsibilities in this area but the Board as a whole is also involved in overseeing the development of management resources in the Group with the aim of ensuring we have the individuals with the right skills to meet the needs of an increasingly complex and global business. The procedures for the appointment of non-executive and executive directors are detailed in the Nominations Committee report.

Following review by the Nominations and Corporate Responsibility committees, the Board adopted the statement shown below to act as a guide to future Board succession planning activity and to make a clear public statement of its support for greater diversity in the boardroom. Details of progress against the statement can be found on page 81.

This included the following statement in respect of Board diversity:

– It shall have an aspirational target of at least 25% of the Board being women by 2015.

– In seeking candidates for appointment to the Board, the Nominations Committee shall only engage the services of search consultants who have open and inclusive recruitment processes that draw from an appropriately diverse pool of candidates.

– It shall report progress against targets and actions taken in the Annual Report and Accounts.

There are currently three women on the Board (2012 three), 27% (2012 25%) of the total membership. There are three women on the Executive Committee (2012 two), 25% of its total membership (2012 17%), and 20% of the Group's employees are women (2012 19%).

On appointment, all non-executive directors are advised of the likely time commitments and are asked to seek approval from the Nominations Committee if they wish to take on additional external appointments. The ability of individual directors to allocate sufficient time to the discharge of their responsibilities is considered as part of the directors' annual evaluation process overseen by the Chairman. An induction programme is agreed for all new directors aimed at ensuring that they are able to develop an understanding and awareness of the Company's core processes, its people and businesses. In addition, 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. Ongoing training is provided for the Board and individual directors as required.

The Chairman, with the assistance of the Chief Executive and Company Secretary, is responsible for ensuring that directors are supplied with information in a timely manner that is in a form and of a quality appropriate to enable them to discharge their duties. In the normal course of business, such information is provided by the Chief Executive in a regular report to the Board that includes information on operational matters, strategic developments, reports on the performance of Group operations, financial performance relative to the business plan, business development, corporate responsibility and investor relations.

Accountability

Principles – The board to present a balanced and understandable assessment of the company's position and prospects • The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems • The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor.

Through this report and, as required, through other periodic financial statements, the Board is committed to providing shareholders with a clear assessment of the Company's position and prospects. The arrangements established by the Board for the application of risk management and internal control principles are detailed on page 83. The Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors, further details of which can be found in the Audit Committee report on page 88.

BOARD INSIGHTS

Operational Assurance Statement

The Operational Assurance Statement (OAS) process is a key element of the Company's governance that is formed of two parts: a self-assessment of compliance with mandated policies and processes; and a report showing key risks for each business and function.

Managed by the Group's Internal Audit function, an OAS return must be completed every six months by each operational and functional business head, recording their formal review against such matters as compliance with law and regulation, ethical business conduct, financial controls, risk management, compliance with business planning processes, health and safety, conflicts of interest, delegated authorities, appointment of advisers, and product safety.

Remuneration

Principles – Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance • There should be a formal and transparent procedure for developing policy on executive remuneration, and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

The Board has delegated to the Remuneration Committee responsibility for agreeing remuneration policy, and the individual remuneration of the executive directors, the Chairman, members of the Executive Committee and the Company Secretary (see Remuneration report on pages 93 to 113). The Committee is formed exclusively of independent non-executive directors.

Relations with shareholders

Principles – There should be a dialogue with shareholders based on the mutual understanding of objectives • The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place • The board should use the AGM to communicate with investors and to encourage their participation.

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 available to meet with major shareholders and is in regular contact with them so as 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 shareholder presentations. This can be accessed via the Company's website, www.baesystems.com. The Company's AGM provides all shareholders with the opportunity to vote on the resolutions put to shareholders either electronically via the Company's website or by post. All resolutions detailed in the Notice of Meeting are voted on by way of a poll so as to ensure that all votes are counted on the basis of one vote for every share held. The result of the voting on all resolutions is published on the Company's website.

Where simple yes/no answers are not appropriate, an assessment of compliance is required to be made against structured qualitative guidance.

The provisions in the OAS concerning joint ventures were revised in 2012 aimed at increasing the level of assurance for such entities. The completion of a separate OAS is mandated for joint ventures and BAE Systems employees on the boards of these companies are required to exert such influence as the Company may have to encourage the adoption of a governance structure that is substantially equivalent to that mandated for wholly owned or controlled parts of the Group.

The Audit Committee and the Corporate Responsibility Committee review the output from the OAS process with the head of Internal Audit. It is also shared in detail with the Company's Auditors.

Audit Committee report

Nick Rose, Chairman

Members
Nick Rose (Chairman), Sir Peter Mason, Paula Rosput Reynolds

Governance
The Audit Committee was in place throughout 2012 and held six meetings, plus one joint meeting with the Corporate Responsibility Committee. All its members are independent in accordance with the provisions of the Code.

Summary of 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 integrity of the Group's financial statements
- Monitoring the role and effectiveness of the Internal Audit function
- Approving an annual programme of internal audit work
- Making recommendations to the Board on the appointment of the Auditors
- Agreeing the scope of the Auditors' annual audit programme and reviewing the output
- Keeping the relationship with the Auditors under review
- Assessing the effectiveness of the audit process
- Developing and implementing policy on the engagement of the Auditors to supply non-audit services

Dear Shareholders,

An important part of the role of the Audit Committee is its responsibility for reviewing the effectiveness of the Group's financial reporting, internal control policies, and procedures for the identification, assessment and reporting of risk. The latter two areas are integral to the Group's core management processes and the Committee devotes significant time to their review. Further information on the risk management and internal control systems is provided on page 83.

One of the key governance requirements of a group's financial statements is for the report and accounts to be fair, balanced and understandable. The co-ordination and review of the Group-wide input into the Annual Report and Accounts is a sizeable exercise performed within an exacting time-frame which runs alongside the formal audit process undertaken by the external Auditors.

Arriving at a position where initially the Audit Committee, and then the Board, are satisfied with the overall fairness, balance and clarity of the document is underpinned by the following:

- comprehensive guidance issued to contributors at operational level;
- a verification process dealing with the factual content of the reports;
- comprehensive reviews undertaken at different levels in the Group that aim to ensure consistency and overall balance; and
- comprehensive review by the senior management team.

The Audit Committee has also championed efforts to 'declutter' the document by stripping out duplication and sequencing information in as logical a manner as possible without compromising compliance with UK regulatory and accounting requirements.

An essential part of the integrity of the financial statements are the key assumptions and estimates or judgements that have to be made. The Committee reviews key judgements on a twice-yearly basis prior to publication of the financial statements at the full and half year, as well as considering significant issues throughout the year. In particular, this includes reviewing any materially subjective assumptions within the Group's principal programmes to enable an appropriate determination of revenue recognition or provisioning. The Committee has also reviewed an analysis of goodwill held on the Group's balance sheet in respect of a number of past major transactions and assumptions made in respect of the relevant cash-generating units to which goodwill has been attributed: the methodology for impairment testing used by the Group is set out in note 11 to the Group accounts on page 140.

Audit – both internal and external – plays an important part in assessing the effectiveness of financial reporting and internal controls and, in turn, the effectiveness and quality of audit is of key importance.

Our Auditors, KPMG Audit Plc, and their legacy predecessors, have been in place since 1981 and, in line with the audit profession's own ethical guidance, the current audit engagement partner will rotate off the Company's account in 2013 having served for a period of five years. The Committee reviews the Auditors' independence on an annual basis and also monitors on a quarterly basis the nature and level of non-audit fees payable to them. The Committee believes that certain work of a non-audit nature is best undertaken by the external Auditors, and believes that it is not appropriate to limit the level of such work by reference to a set percentage of the audit fee, as this does not take into account important judgements that need to be made concerning the nature of work undertaken to help safeguard the Auditors' independence. The Committee has implemented a policy on the engagement of the Auditors to supply non-audit services which aims at safeguarding audit objectivity and independence. The Committee has agreed the policy opposite regarding services provided by the Auditors. Details of fees payable to the Auditors are set out on page 127.

The Committee has reviewed the recent changes to the UK Corporate Governance Code including the new provision for FTSE 350 companies to put the external audit contract out to tender at least every ten years. Having considered the FRC's guidance on aligning the timing of such re-tenders with the audit engagement partner rotation cycle, the Committee's current intentions are that it will initiate a re-tendering process in 2017. This policy will be kept under review and the Committee will use its regular reviews of auditor effectiveness to assess whether an earlier date for such a re-tender would be desirable. Such regular reviews are used to assess the effectiveness of the external audit process and the Auditors' performance, with the Committee undertaking an internal assessment of the audit effectiveness and performance which is mapped against audit appointment criteria. On an annual basis, this is undertaken through a Group-wide evaluation at management and functional level, together with input from the Audit Committee itself. In addition, the Committee undertakes a comprehensive review of the effectiveness and performance of the external Auditors every three years. The last such review was undertaken in 2011 and encompassed management performance evaluation, independent client service review, future audit strategy and fee benchmarking.

Having considered the output of this review, the Committee has recommended to the Board that it recommend that shareholders support the re-appointment of the Auditors at the 2013 AGM.

As reported last year, the Committee appointed a new head of Internal Audit with effect from April 2012. An external quality assessment of the Group's Internal Audit function has been initiated and any recommendations to strengthen the function's capabilities or enhance the service it delivers will be acted upon.

The annual internal audit programme itself is agreed jointly by the Audit and Corporate Responsibility committees to ensure that the over-arching internal audit programme includes the assessment of the effectiveness of policies and processes relating to key areas of ethical and reputational risk.

The Committee derives considerable value from discussing issues with operational management as well as seeing at first hand practical demonstrations of the Group's core control, risk identification and risk mitigation processes. To this end, in 2012, the Committee met with senior management in the Group's Support Solutions business as part of its visit to the US in June, as well as meeting with senior management in the UK Naval Ships business as part of a visit to the Scotstoun site in Glasgow in December.

Nick Rose
Chairman – Audit Committee

Policy on non-audit services provided by the Auditors

Audit-Related Services

- Reporting required by law or regulation to be provided by the Auditors;
- Reviews of interim financial information;
- Reporting on regulatory returns;
- Reporting to a regulator on client assets;
- Reporting on government grants;
- Reporting on internal financial controls when required by law or regulation; and
- Extended work undertaken at the request of those charged with governance on financial information (this does not include accounting services) and/or financial controls performed where this work is integrated with the audit work, and is performed on the same principal terms and conditions.

Permitted Non-Audit Services, subject to approval under the policy

- Tax compliance services;
- Tax advisory services;
- Due diligence services relating to acquisitions of new businesses or significant investments in businesses, joint ventures or strategic alliances;
- Public reporting on investment circulars;
- Private reporting to sponsors or similar parties in connection with investment circulars (including comfort letters and reporting on working capital statements);
- Preparing information for third parties relating to acquisitions and disposals, including the conversion of financial statements into other accounting standards;
- Liquidation services in respect of redundant subsidiaries or associate companies;
- Participation in the evaluation of Internal Audit;
- Accounting advice; and
- Validation and verification work in connection with bids.

Prohibited Non-Audit Services

- Book-keeping and work relating to the preparation of accounting records and financial statements that will ultimately be subject to external audit;
- Financial information system design and implementation;
- Appraisal or valuation services in respect of material assets;
- Actuarial services;
- Internal auditing;
- Investment adviser or broking;
- Advocacy services;
- Secondments to management positions that include decision-making; and
- Any work where a mutuality of interest is created that could compromise the independence of the Auditors.

Corporate Responsibility Committee report

Paul Anderson, Chairman

Members
Paul Anderson (Chairman), Harriet Green, Sir Peter Mason

Governance
The Corporate Responsibility Committee was in place throughout 2012, and held four meetings and participated in three site visits. All its members are independent in accordance with the provisions of the Code.

Summary of responsibilities

- Assisting the Board in overseeing the development of strategy, and policy on social, environmental and ethical matters
- Keeping under review the effectiveness of the Company's internal control policies and procedures for the identification, assessment, management and reporting of reputational and other non-financial risks
- Monitoring and reviewing the role and effectiveness of the Company's Internal Audit function in relation to corporate responsibility
- Providing oversight of the Company's compliance with corporate responsibility-related policies and procedures
- Reviewing audit and assurance reports produced by the Corporate Responsibility assurer
- Overseeing and supporting key stakeholder engagement on social, environmental and ethical issues
- Making proposals to the Remuneration Committee regarding appropriate corporate responsibility-related performance objectives for executive directors
- Reviewing the Company's arrangements for employees to obtain further advice on ethical issues in confidence
- Ensuring that the Code of Conduct is regularly reviewed and reflects best practice for such codes
- Ensuring the Company's Annual Report and Accounts includes an examination of ethical business conduct within the Company

Dear Shareholders,

The Corporate Responsibility Committee has been in place since 2005 and over that time a good deal of its work has been focused on ethics. Founded on a robust approach, we have seen good progress in this area with good evidence of business conduct being embedded in the way the Company does business. There is clear leadership from the top and an ongoing education programme that provides guidance on what is expected of employees. This assists them in applying our values and behaviour expectations to workplace situations. It also includes guidance on how to validate matters and seek assistance through mechanisms such as our Ethics Helpline and network of Ethics Officers. As with all matters that shape the culture of an organisation, the Committee is mindful that there will be an ongoing requirement for clear leadership at all levels within the Company, and for training and education that is engaging and relevant. Alongside this, there will always be a need for Board oversight, supported by internal and external assurance providers, and the insight provided by employee engagement processes.

Since its formation, the Committee has also focused on safety. Here again, we have seen progress. In particular, we have seen improvements in safety leadership and the integration of safety into the core management review and reward processes that are used to drive performance throughout the Company. For 2012, the Committee agreed that our basic measure of safety performance – and the one used as part of our executive incentives – should change from the Lost Work Day Case Rate to the Recordable Accident Rate. Whilst progress had been made using the lost day measure, it was felt that we needed a metric that was more responsive to actions that help embed safety into how we approach and manage our business, and also facilitates external benchmarking against leading performers. Details of 2012 performance as measured by the Recordable Accident Rate can be found on page 41.

Compared with ethics and safety, diversity and inclusion is a comparatively recent area of focus for the Committee. However, since 2009, it has been engaged in this area, supporting the Chief Executive and his management team in developing an approach to diversity and inclusion that is capable of delivering the desired result across a large and diverse company. We have seen good engagement from the senior management team, which recognises that evolving the culture of an organisation requires leadership and commitment to change. To measure performance in this area, the Company has adopted a maturity matrix approach that provides all businesses with a model describing five levels of organisational maturity. The Committee will continue to use this and other tools to monitor performance and report on our progress to shareholders.

I'm pleased that we have been able to increase our focus on environmental matters in 2012. Against a goal of reducing the environmental impact of our operations and products, targets have been set to reduce the amount of energy and water used, and waste generated. As with all the corporate responsibility matters mentioned in this report, environmental sustainability performance has been incorporated into the Company's core performance management processes and, therefore, has the same visibility as financial measures of performance. The Committee receives management information throughout the year that informs our 'meeting room' engagement with the Chief Executive and his senior operational executives. However, there is always a need to spend time as a committee out of the meeting room, meeting employees and seeing operations. Here the experience and knowledge of Committee members can be used to assist in developing an understanding of progress against our corporate responsibility goals. We did this three times in 2012, with site visits in the UK, Saudi Arabia and the US providing valuable insights.

BAE Systems does not produce a separate corporate responsibility report. Instead we choose to integrate these matters into this Annual Report and Accounts. If corporate responsibility considerations are managed as an integral part of how you do business that is how it should be. Within the business reporting segments (pages 56 to 75) you will find details of performance in the areas of safety, diversity and inclusion, and environment for each of our reporting segments.

Paul Anderson
Chairman – Corporate Responsibility Committee

Nominations Committee report

Dick Olver, Chairman

Members
Dick Olver (Chairman), Paul Anderson, Sir Peter Mason, Nick Rose

Governance
The Nominations Committee was in place throughout 2012 and held four meetings. It is chaired by the Chairman of the Company. Whilst he is not deemed to be independent, the other three members of the Committee are independent non-executive directors in accordance with the provisions of the Code.

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

Dear Shareholders,

Over the last few years, the Board has aimed to achieve a board membership of 12 directors, comprising a chairman, three executive directors and eight non-executive directors. It is recognised that at times we will be slightly above or below, but having such a target assists the Nominations Committee in its succession planning activity.

Following Michael Hartnall's retirement at last year's Annual General Meeting, Board membership has been reduced to 11, plus the Committee knew we had to plan for Sir Peter Mason's retirement as he was in his tenth year on the Board. Consequently, the Nominations Committee initiated a search in the first half of 2012 for suitable candidates for appointment as non-executive directors of the Company. However, the discussions that the Company held with EADS last year regarding a possible combination of the two businesses could have led to the Board being re-constituted and, consequently, the pace of the search activity had to be slowed. This activity is now well underway with external search consultants, Zygos Partners, having been appointed by the Committee to assist. I manage the relationship with Zygos and they provide no other recruitment services to the Company. We expect to be in a position to announce non-executive appointments shortly.

The following table summarises the membership of the Board at present:

Director	Nationality	Date of appointment	Time on Board	Committee membership
Chairman				
Dick Olver	UK	17 May 2004	8 years 9 months	Nominations
Executive directors				
Linda Hudson	US	26 October 2009	3 years 4 months	–
Ian King	UK	1 January 2007	6 years 2 months	–
Peter Lynas	UK	1 April 2011	1 year 11 months	–
Average time on Board – Executive directors			*3 years 10 months*	
Non-executive directors				
Paul Anderson	US	8 October 2009	3 years 4 months	Corporate Responsibility, Nominations
Harriet Green	UK	1 November 2010	2 years 4 months	Corporate Responsibility
Sir Peter Mason	UK	22 January 2003	10 years 1 month	Audit, Corporate Responsibility, Nominations
Lee McIntire	US	1 June 2011	1 year 9 months	Remuneration
Paula Rosput Reynolds	US	1 April 2011	1 year 11 months	Audit
Nick Rose	UK	8 February 2010	3 years	Audit, Nominations, Remuneration
Carl Symon	UK/US	11 June 2008	4 years 8 months	Remuneration
Average time on Board – Non-executive directors			*3 years 10 months*	
Average time on Board – All directors			*4 years 4 months*	

Governance

Succession planning activity has been constant throughout my time on the Board, and rarely has there been a time when we have not been looking for candidates for appointment as non-executive directors. As you can see from the above, we have been successful in refreshing the Board, with the average time on the Board being just over four years. In discharging its succession planning duties, the Committee considers the profile of the non-executive members of the Board on a regular basis, analysing its composition in terms of knowledge, experience and skills, diversity, and length of service. Diversity is an important part of these considerations, and we look at different aspects of this, including professional background and experience, geographic/cultural diversity and gender diversity. We also consider the Company's strategy as part of our succession planning and, as a consequence, identify areas of knowledge and experience that will assist the Board in strategic development and delivery.

Executive director succession planning is also undertaken by the Committee, with the annual tempo of the Committee's work here focused on its oversight of the Company's executive development and succession planning processes. The effectiveness of these processes, which cover the whole of the Group's executive population, is fundamental to the future success of the Company. Identifying talented individuals with the ability to develop and grow as leaders is a core requirement for successful businesses and, in BAE Systems, this is led by the Chief Executive. He and the Executive Committee regularly review the experience and skills that our future leaders will require, and use this to shape our development activities.

The Committee's role in executive succession planning is to engage with the Chief Executive and the Group Human Resources Director in discussing our management development strategy and priorities, as well as the detailed succession plans for the most senior executive positions. Through such engagement, the Company draws on the knowledge and experience of the Committee's members to help shape this activity, and ensure that the analysis, objectives and processes are sound and robust. Whilst our internal resources will always be considered for any appointment, we will also look at external recruitment and use this in a balanced approach to meeting future management needs.

Finally, Nick Rose joined the Committee recently having been appointed to succeed Sir Peter Mason as Senior Independent Director. My term of office is due to expire next year and, in line with the UK Corporate Governance Code, Nick Rose will chair the Committee in its search to identify an individual to succeed me as Chairman. It is therefore appropriate that Nick provides you with the following separate statement on this matter on behalf of the Nominations Committee.

Dick Olver
Chairman – Nominations Committee

Chairman's succession

One of the main principles in the UK Corporate Governance Code states:

"The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role."

That is a very substantial role that is critical to the performance of any board and, therefore, ultimately the performance of the company. The role of the Chairman of BAE Systems is principally as defined by the Code, but it also includes representing the Company at the highest level, and building key relationships that assist in developing our strategy and customer relationships worldwide. Given the nature of our business, the importance of this aspect of the role should not be overlooked.

The Board and the Committee are fully aware of the criticality of the chairman role and the need to plan for the appointment of Dick Olver's successor in a thorough, well-structured and timely manner. As the Senior Independent Director, I am chairing the Nominations Committee as it discharges this important role. The Committee has structured the search process in line with best practice for such matters, including:

- I will engage with important stakeholders – including our major shareholders – during the search.
- The Committee will use an external search consultancy to identify possible candidates for appointment.
- The Committee will only nominate an individual for appointment who is independent at the time of appointment in accordance with Code provision B.1.1.

We have started the search for a successor to Dick Olver as Chairman of the Board and we expect to be in a position to announce the results of this later in the year.

Nick Rose
Senior Independent Director

REMUNERATION REPORT

Remuneration Committee Report

Carl Symon, Chairman

Members
Carl Symon (Chairman), Lee McIntire, Nick Rose

Governance
The Remuneration Committee was in place throughout 2012 and held seven meetings. Details of attendance at these meetings are provided on page 83. All its members are independent in accordance with the provisions of the Code.

The Chief Executive and the Company's Chairman attend meetings by invitation only. They do not attend where their individual remuneration is discussed and no director is involved in deciding his or her own remuneration.

Summary of responsibilities

- Agreeing a policy for the remuneration of the Chairman, executive directors, members of the Executive Committee (EC), the Company Secretary and other senior executives
- Within the agreed policy, determining individual remuneration packages for the Chairman, executive directors and EC members
- Agreeing the policy on terms and conditions to be included in service agreements for the Chairman, executive directors, EC members, 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

Dear Shareholders,

Over the last year, the Committee has focused on the simplification of our long-term incentive arrangements. This has been largely achieved by replacing the Share Matching Plan (SMP) with an increase in the Performance Share Plan (PSP) grant which preserves the expected value at on-target performance and results in a better balance between Earnings per Share (EPS) and Total Shareholder Return (TSR) as drivers of long-term incentives, whilst balancing our major objectives of motivation, retention, pay for performance and long-term shareholder alignment.

BAE Systems is one of the world's largest and most geographically diverse defence, aerospace and security companies. We have a clearly defined strategy to deliver sustainable growth in value to shareholders, operating in a highly technologically complex market, and with a presence in five principal markets. The Group continues to face a more challenging trading environment as governments seek to reduce fiscal deficits and defence budgets are significantly reduced in certain of our major markets. Our strategy focuses on the growing importance of winning international business, where growth markets remain. The key elements of our strategy are to support our customers in safeguarding their vital interests, inspire and develop our people to drive our success, and drive shareholder value by improving financial performance and competitive positions across the business. The current environment is increasingly competitive and, to deliver growth in shareholder value, we are focused on generating strong cash flows and profits. Improving efficiency in our operations will also make us more competitive to win future business. Each year, the Board agrees the Executive Committee's key objectives which are critical to delivering the Group's strategy. For 2013, these are set out on page 11, and are used as the basis to set the individual objectives for the executive directors and Executive Committee members which are agreed by the Chairman, Dick Olver, and the Remuneration Committee. These then flow down to the senior leadership team to ensure that all businesses within the Group are aligned with the overall Group strategy.

Our remuneration strategy is intended to recognise this business environment, whilst fostering a Total Performance culture at all levels of the Group. Given the maturity of the Group, certain areas of corporate responsibility, such as diversity and inclusion, will not be specifically incentivised in 2013. In determining the levels of executive reward, the Remuneration Committee believes it is of utmost importance to ensure a strong link between actual remuneration received and the achievement of our strategic and business objectives. The remuneration strategy incentivises executives to deliver their contribution and rewards them for the achievement of the Group's strategy through a combination of short-term incentives targeted at Group performance, business performance, personal performance and leadership behaviours, and long-term incentives targeted at Group performance (and business performance in the case of our US senior executives). To directly align short-term and long-term reward, executive directors will be required to defer at least one-third of their net 2013 annual incentive into shares when the annual incentive is paid in 2014.

The combination of the annual incentive plan, PSP and share options provides a balance between short-term cash reward and longer-term share-based reward. The proportion of the incentive package delivered through longer-term performance is significantly higher at stretch pay-out than at on-target, demonstrating that the package supports the achievement of superior long-term performance and strongly aligns the interests of executives to those of shareholders by delivering long-term reward in shares. Achieving strong performance on the in-year measures is important but, to maximise the value of their incentive package, executives need to realise growth in long-term EPS, TSR and share price.

In 2012, our performance against targets was as follows. Our EPS of 38.6p (underlying EPS adjusted to exclude the effect of foreign exchange) was below threshold; the stretch target for both year-end and average cash was achieved. Our TSR performance reflects the sustained under-performance of our share price. The reported diluted underlying EPS of 38.8p is below the level required for any vesting of PSP and SMP long-term incentives awarded in 2010. This result of 38.8p will form the baseline EPS figure against which performance of the 2013 PSP award will be measured.

Against this performance background, the main aspects of our remuneration policy and practice for the year were as follows:

- For 2013, the salaries of the Chief Executive, Group Finance Director and the President and Chief Executive Officer of BAE Systems, Inc. were frozen. There will be no increase in base compensation and no increase in earnings opportunity flowing through the rest of the package.

Advisers to the Remuneration Committee

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 is a founding member of the Remuneration Consultants Group (RCG) and complies with the RCG's code of conduct for remuneration consultants to the FTSE 350. Kepler will not undertake any work for the Company whilst they are retained as the Committee's independent adviser.

Representatives from Kepler are generally invited to attend Committee meetings unless specifically requested otherwise by the Committee and attended all but one of the Committee's seven meetings during 2012.

During the year, the Committee also received material assistance and advice on remuneration policy from the Group's Human Resources Director (Alastair Imrie until 31 March and Lynn Minella from 11 June) and the Human Resources Director, Reward, Paul Farley. Dick Olver, Chairman, and Ian King, Chief Executive, also provided advice that was of material assistance to the Committee.

Legal advice to the Committee has been provided by Linklaters who are 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 Linklaters are 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, 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. Mercer provided data to the BAE Systems, Inc. Compensation Committee, which was also used to support the review of competitive positioning of packages.

Hewitt New Bridge Street, who are appointed by the Committee, provided advice on the TSR figures for assessing the performance condition under the PSP.

- Annual bonus pay-outs for the executive directors under the annual incentive plan ranged from 55.1% to 68.2% of maximum.
- EPS performance over the three-year performance period for the 2010 awards under the long-term incentive plans was below the minimum 5% per annum average growth requirement. Consequently:
  - the SMP award granted in 2010 earned a nil match; and
  - of the 50% of the awards of shares granted in March 2010 under the EPS portion of the PSP, none will vest.
- The Company's TSR for the 50% of awards of shares granted in March 2010 under the TSR portion of the PSP was below the median position when compared against the comparator group of 17 other defence and aerospace companies, and the related awards accordingly lapsed.

The Committee will continue to monitor the market and will consult with shareholders on any further changes for 2014 to ensure that our plans continue to demonstrate a clear line of sight for executives to the achievement of strategic goals and strong alignment with the creation of shareholder value.

The Committee received important feedback from shareholders during last year's consultation largely around the perceived complexity of our long-term incentive arrangements. Specific questions were raised about the need for the SMP and the use of EPS performance in both this plan and the PSP. The Committee is proposing the following changes to our executive remuneration framework for 2013:

- Elimination of the SMP, with redistribution of the associated value into the PSP. Despite the increased face value award under the PSP, the expected value of the overall package remains unchanged and grants remain within the current PSP plan limits of 400%.
- The holding period under the PSP whereby vested shares are released in three tranches over years three, four and five is unchanged. The redistribution of value from the SMP into the PSP means that all of this element of reward value will be subject to phased five-year vesting compared to the current three-year vesting for the prior SMP.
- The PSP will continue to be based 50% on EPS and 50% on TSR against a comparator group comprising companies with a significant defence focus in order to ensure meaningful alignment between the Group's strategy for delivering shareholder value and executive performance. Elimination of the SMP (which has a sole EPS performance condition) results in an increased emphasis on TSR as a metric within the long-term incentive structure and a better balance with EPS.
- In the case of the President and Chief Executive Officer of BAE Systems, Inc., 50% of the PSP is based on a measure relating to operating cash performance of the US businesses (with the other 50% being subject to the same EPS performance condition as applies to other executive directors). The President and Chief Executive Officer of BAE Systems, Inc. also participates in the Restricted Share Plan introduced following shareholder approval at the 2011 AGM, which applies to US-based executives and has no performance conditions attached.
- Despite the challenging economic environment and reduction in defence budgets, no adjustments are being made to the performance conditions – which remain a challenging target of 5% to 11% growth per annum – or vesting structure within the PSP.
- The Committee intends to implement a simple bonus deferral and claw back mechanism, in line with UK shareholder and regulatory guidance and without matching provisions. As currently, it is proposed that one third of the annual incentive will be compulsorily deferred into shares without performance conditions and will be held for a minimum of three years, with claw back provisions in the event that performance is subsequently found to have been misstated.
- We are retaining our requirement for executive directors to build up a significant personal shareholding and increasing the minimum shareholding requirements for the Chief Executive from 200% to 300% of salary. Reflecting US market practice, the shareholding requirement for the President and Chief Executive Officer of BAE Systems, Inc. was increased substantially last year from 200% to 350% of salary.
- We will add order intake as a third financial metric within the Annual Incentive Plan to sit alongside EPS and cash, to ensure an appropriate alignment with the Board's strategic growth objectives.

– As part of a wider effort to strengthen the US business' competitive position across current and future markets, and consistent with the treatment of all other BAE Systems, Inc. employees, the formula for calculating pension benefits applicable to the President and Chief Executive Officer of BAE Systems, Inc. earned after 31 December 2012 will change from a 10% of plan compensation annual accrual to a flat dollar amount of $1,000 plus, in the Non-Qualified Plan, an annual accrual of $500.

In line with our ongoing commitment to keep our shareholders informed of developments in executive remuneration arrangements, we shared with our largest shareholders the Remuneration Committee's views on potential changes to executive remuneration for 2013 in late November 2012. This set out the conclusions of our review at that early stage, with proposals finalised and shared more widely with our major shareholders in January 2013 as part of our usual cycle of engagement. During consultation regarding proposed changes for 2013, shareholders have expressed support for the overall direction and, in particular, the structural improvement to the long-term incentive design through elimination of the SMP.

The Committee intends to enact the proposed changes as soon as possible after the formal shareholder approval of the Remuneration report at the AGM in May 2013. Annual incentive invitations for 2013 would set out the compulsory deferral requirement that would apply to annual incentive payments made in March 2014. The increased face value of PSP awards would coincide with this, in March 2014.

Carl Symon
Chairman – Remuneration Committee

On the following pages:

POLICY REPORT

Remuneration strategy

The Company's remuneration strategy is 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 Total Performance culture aligned to the achievement of the Company's strategic objectives;
- is fair and transparent;
- can be applied consistently throughout the Group; and
- balances overall commonality of design with appropriate tailoring to ensure competitiveness in our different principal markets.

Remuneration policy

To achieve the strategy, the remuneration policy for executive directors and Executive Committee members is to:

- set base salary with reference to median of the relevant market competitive level;
- reward stretching superior performance with up to upper quartile reward;
- provide an appropriate balance between:
  - short-term and long-term reward; and
  - fixed and variable reward

  with the balance becoming more long term and more highly geared with seniority; and
- provide a competitive package of benefits.

How remuneration is reviewed

In determining the levels of executive reward, the Remuneration Committee believes it is of utmost importance to ensure a strong link between actual remuneration received and the achievement of our strategic and business objectives.

In 2012, information on the market for comparable positions was provided by PricewaterhouseCoopers so that the Committee could form a view as to where to position the various elements of the package relative to comparable companies.

Appropriate comparator groups are constructed for the individual positions, taking account of company size, scale of operations and breadth of role. The comparator group for the UK executive directors' review in 2012 comprised 27 FTSE 100 companies where BAE Systems was positioned towards the median in terms of market capitalisation and which the Committee believes is appropriate for benchmarking UK executive directors' packages. For the President and Chief Executive Officer of BAE Systems, Inc., the comparator group for 2012 was drawn from companies in the US aerospace, defence and general industry sector, adjusted, as appropriate, to produce market figures consistent with the size, scale and relative independence of the US business, and adjusting where necessary to reflect the extra responsibility for her 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) are analysed at the lower quartile, 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 reviews market trends around the individual elements of remuneration to ensure that the structure of the package is appropriately aligned 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. For 2012, the review indicated that the structure is broadly in line with the relevant market.

In setting remuneration levels, the Committee is also sensitive to the pay and conditions of other employees within the Group. Many of our employees work at the very leading edge of technology. We have a diverse workforce operating in many countries. Employee remuneration packages are therefore determined locally to meet local needs, whilst respecting our culture and values. In 2012, general salary increases for our two largest employee populations in the UK and US typically averaged 3% and 3.5%, respectively.

The Committee intends to continue to flow down executive remuneration policy as detailed in this report to Executive Committee members and to the most senior executives within the Group globally to maintain a consistent approach to global reward. The principles of the remuneration strategy are applied consistently across the Group below this level, taking account of seniority and local market practice.

Elements of package	Purpose and link to strategy
Base salary	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.
Annual incentive	Drive and reward annual performance of individuals, teams and the Company on both financial and non-financial metrics, including behaviours.
Performance Share Plan	Drive and reward delivery of sustained long-term EPS and TSR performance aligned to the interests of shareholders.
Share Option Plan	Drive and reward delivery of TSR performance and sustained improvement in the Company's share price.
Restricted Share Plan	Provide long-term reward and address retention issues, through time-vesting awards principally in the Company's US market.
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 through leveraging the Company's size and scale.

Base salary

The Committee reviewed base salaries, taking into account the current economic climate, the challenges facing the business, their respective positions against benchmark and the pay environment for employees in general. No changes have been made to annual base salary levels for executive directors in 2013, which remain as follows:

Name	2012 salary	2013 salary	Increase
Ian King	£963,050	£963,050	0%
Peter Lynas	£546,000	£546,000	0%
Linda Hudson	$1,045,350	$1,045,350	0%

Annual incentive plan

The annual incentives for 2013 continue to focus on a combination of in-year financial performance, and longer-term performance and risk management (both business risk and reputation risk). Four-fifths is driven off in-year financial performance, and one-fifth based on driving performance and improvement in the area of corporate responsibility and safety, combined with the other non-financial objectives supporting the Group's strategy.

The financial targets are derived from the IBP, and are based on earnings, cash and order intake targets. These are seen as the key indicators of both short-term and long-term financial performance and value creation. At Group level, EPS is used whereas EBITA[1] is used to measure earnings performance at a business level. To incentivise improved phasing of cash generation throughout the year, a combination of year-end and average quarterly net cash/debt has been in place since 2009 and will continue for 2013. Due to the stretching nature of the plan, the payout structure includes threshold, target and stretch levels for both EPS and cash measures. Order intake has target and stretch levels only. The payout for on-target performance is 50% of maximum. The payout for achieving a threshold performance is 20% of the maximum, with no payout for achieving less than this. Payout for performance between targets is calculated on a straight-line basis.

The table below summarises the overall structure of the annual incentives for executive directors.

	Proportion of annual incentive	
Performance measure	2012	2013
In-year financial	80.0%	80.0%
Corporate responsibility and safety	10.0%	7.5%
Other objectives	10.0%	12.5%

In setting targets for the annual incentive plan, the Committee expects that these should represent positive progression relative to the level of performance achieved in the prior year.

The Committee believes that the annual incentive targets for the executive directors are stretching but achievable. The structure of the 2013 annual incentive plan for executive directors is summarised in their individual sections on pages 101 to 103.

Long-Term Incentive Plans (LTIPs)

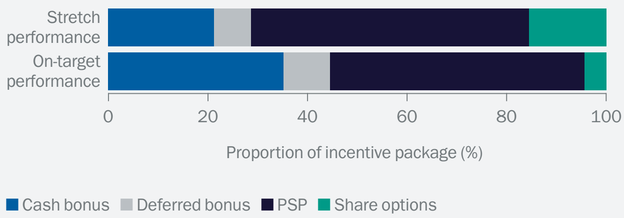
The Company currently operates four LTIPs – the Performance Share Plan (PSP), the Share Option Plan (ExSOP[2012]), the Share Matching Plan (SMP) and, for US executives only, the Restricted Share Plan (RSP) – the details of which are set out on pages 104 to 106.

The proposed simplification changes to our long-term incentive structure for 2013 are set out in the Committee Chairman's report on pages 93 to 95.

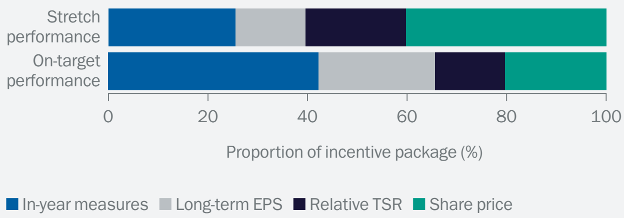
The following graphs show at on-target and stretch performance the proportion of the incentive package delivered by the various plans, and which performance metrics are driving the value of the incentive.

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

Proportion of Chief Executive's incentive package delivered by the various incentive plans (%)



Performance drivers of Chief Executive's incentive package (%)



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.

Director	Date of contract	Unexpired term	Notice period
Linda Hudson	26 October 2009 (amended 8 January 2010)	31 December 2013*	90 days either party
Ian King	27 June 2008	No fixed term	12 months either party
Peter Lynas	16 February 2011 (effective 1 April 2011)	No fixed term	12 months either party

* Subject to automatic renewal for one-year periods each year unless either party gives notice of non-renewal.

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 Ian King and Peter Lynas contain specific provisions to the effect that the Company has the right to pay a sum equivalent to 12-months' salary in lieu of notice.

Linda Hudson's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives notice of non-renewal. Separately, there is a 90-day termination provision. If the employment is (a) terminated by the Company (other than for cause as defined in the contract or in the event it is not extended following her 65th birthday) or (b) she resigns for a 'Good Reason' (as defined in her contract), she is entitled to a termination payment equal to (i) one year's base salary, (ii) a pro-rated bonus for the relevant financial year, and (iii) the continuation of 18-months' medical benefits, plus a further 18-months' subsidy of a portion of the premiums (or a cash payment in lieu of this benefit).

No executive director has provisions in his or her service contract that relate to a change of control of the Company (and neither does the Chairman nor the non-executive directors in their letters of appointment).

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 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 executive directors in 2012 were as follows: Ian King £47,000 in respect of his non-executive directorship of Rotork p.l.c.; and Linda Hudson $56,550 in respect of her non-executive directorship of Bank of America since her appointment in 2012.

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 subsequently extended in 2007 for a second term of three years to 16 May 2010. Following the approval of the Board under the chairmanship of the Senior Independent Director, it was extended again in 2009 for a third term to 16 May 2013, and subsequently in 2011 to 16 May 2014 unless terminated earlier in accordance with the Articles of Association or with either party giving the other not less than six months' prior written notice.

The Chairman's 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. Recognising that the Chairman's fees had not changed since 2007, the Remuneration Committee undertook a review of the level of his fees in 2011 taking into account, amongst other things, the scope of the duties performed by the Chairman of the Company. As a result, his fee was set at £725,000 per annum with effect from 1 June 2011. This fee will not be reviewed again during his current term of office, which ends on 16 May 2014.

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*
Paul Anderson	08.10.2009	07.10.2015
Harriet Green	01.11.2010	31.10.2013
Lee McIntire	01.06.2011	31.05.2014
Sir Peter Mason	22.01.2003	08.05.2013
Paula Rosput Reynolds	01.04.2011	31.03.2014
Nick Rose	08.02.2010	07.02.2016
Carl Symon	11.06.2008	10.06.2014

* 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. Under the Company's Articles of Association, they are subject to re-election at the AGM following their appointment and subsequently at intervals of no more than three years.

Michael Hartnall retired from the Board on 2 May 2012 having originally been appointed to the Board on 10 June 2003. Sir Peter Mason will retire from the Board at the AGM on 8 May 2013.

In compliance with the UK Corporate Governance Code, all members of the Board submit themselves for re-election on an annual basis at the AGM.

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.

Following publication of the UK Corporate Governance Code in 2010, the time commitment expectations for non-executive directors were reviewed and, with their agreement, their Letters of Appointment were amended to reflect that they need to commit approximately two days for each of the Board meetings scheduled during the year, to cover attendance and preparation for the meeting. Additional time commitments will include attending scheduled Board committee meetings, strategy review meetings and ad hoc meetings of the Board (or sub-committees of the Board) that may be called from time to time. The non-executive directors are aware that it is not possible to be specific as to exact time commitments as this will vary according to the nature of the matters that the Board is required to deal with at any point in time. Newly appointed non-executive directors also have to dedicate additional time to induction activities. 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.

The Non-Executive Directors' Fees Committee comprises Dick Olver, Philip Bramwell, Linda Hudson and Ian King. Having undertaken its review in January 2013, the Committee decided that the non-executive directors' fees should remain unchanged at the current time as follows:

	2012 and 2013 fee
Base fee	£75,000
Additional fee for chairing committees:	
Audit Committee	£25,000
Corporate Responsibility Committee	£20,000
Remuneration Committee	£20,000
Additional fee for Senior Independent Director	£20,000
Travel allowance (per meeting)*	£4,500

* The travel allowance of £4,500 per meeting is paid 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, subject to a maximum of six travel allowances per year.

The table below summarises the fee structure for 2012 and 2013:

Non-executive director	2012 and 2013 fee*
Chairman Audit Committee	£100,000
Chairman Corporate Responsibility Committee	£95,000
Chairman Remuneration Committee	£95,000
Other non-executive directors	£75,000
Additional fee for Senior Independent Director	£20,000

* Excludes the travel allowance per meeting referred to above.

IMPLEMENTATION REPORT

Financial performance 2012 was a challenging year with both constraints in our principal markets due to wider economic pressures, and the ongoing negotiations to formalise the price escalation on the Salam Typhoon programme. The Group failed to achieve its EPS target, as referred to on page 12, but stretch performance for both cash targets was achieved. At the operating group level, Programmes & Support missed its stretch profit target but achieved stretch performance on both cash targets. International achieved its threshold profit target, missed its year-end cash target and missed its stretch average cash performance. BAE Systems, Inc. achieved stretch performance for both cash targets and achieved its EBITA[1] target.

Non-financial performance Page 12 sets out the Executive Committee's key objectives for 2012 and the assessment of performance against these, whilst pages 41 to 43 provide more detailed information on performance against the specific objectives relating to safety, diversity and inclusion, and environment.

Safety – The Group has continued to drive improvement of safety management, using its Safety Maturity Matrix (SMM) as the mechanism to measure and drive performance. All businesses reported progress against the SMM. The Group achieved a 30% reduction in the Recordable Accident Rate, exceeding the stretch target of 15%.

Diversity and inclusion – The Group targeted progress against diversity and inclusion maturity matrices, which delivered to plan across all parts of the business.

Environment – The Group has continued to drive progress against environmental maturity matrices, and to meet specific targets for energy, water and waste for 2012. Businesses met the targets they set for improvement and the cumulative impact at Group level was a 12% reduction in energy, 7% reduction in water consumption and 25% reduction in waste.

Key strategic objectives – Of the remaining key strategic objectives for individual executive directors in 2012, the Committee agreed assessments taking account of overall performance and leadership behavioural performance of the individual executive. This produced an average overall assessment of 71% of maximum.

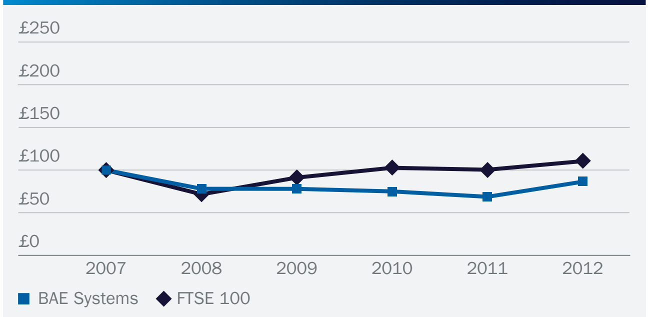
Accordingly, the Committee determined the payout under the 2012 annual incentive plan as follows:

2012 annual incentive payout	Ian King	Linda Hudson	Peter Lynas
% of target	111.3%	136.4%	110.2%
% of base salary	125.2%	153.5%	88.2%
Amount	£1,205,317	$1,604,310	£481,572

In addition:

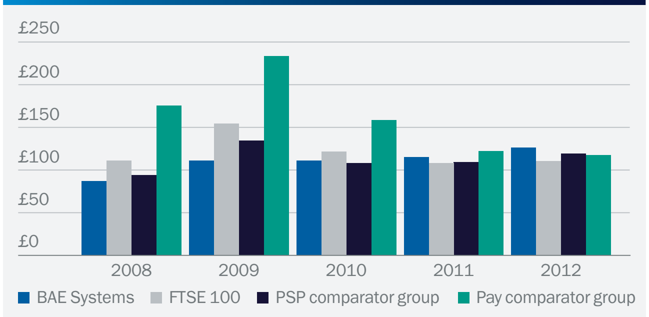
- the growth in EPS over the three years to 2012 was below the performance range of 5% to 11% per annum. Consequently:
  - the SMP award granted in 2010 earned a nil match; and
  - none of the awards granted in March 2010 under the EPS portion of the PSP vest.
- the Company's TSR for the 50% of awards of shares granted in March 2010 under the TSR portion of the PSP was below the median position when compared against the comparator group of 17 other defence and aerospace companies, and the related awards lapsed accordingly.

Value at 31 December 2012 of £100 investment at 31 December 2007 (£)



This graph, which has been produced in accordance with the requirements of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, shows the value by 31 December 2012, on a total shareholder return basis, of £100 invested in BAE Systems on 31 December 2007 compared with the value of £100 invested in the FTSE 100 index. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity 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 2012 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 2012 for the Performance Share Plan (see page 105); and (iii) the companies forming the comparator pay group for the 2012 UK executive pay review. The graph depicts the value for BAE Systems and the comparators at the end of 2012 of a single £100 investment made at the beginning of each of the last five years.

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 a fixed percentage of base salary. These limits are reviewed periodically. For 2013, the minimum shareholding requirement for the Chief Executive has been increased from 200% to 300% of base salary. The minimum requirement for the Group Finance Director remains at 200% of base salary, and at 350% in the case of the President and Chief Executive Officer of BAE Systems, Inc. As a minimum, a holding equal to 100% (175% for the President and Chief Executive Officer of BAE Systems, Inc.) 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 the levels cited above is achieved and maintained. 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 107.

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

Post-retirement benefits

UK pension benefits

UK executive directors are members of the BAE Systems Executive Pension Scheme (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 benefit 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 annual 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. Once in payment, 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' 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) were given a number of choices as previously reported. These were:

– 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.

The review carried out in 2010 concluded that the arrangements should continue to be based on the Company's registered pension schemes and that, in appropriate circumstances, the Company will continue to have the option to offer an unfunded pension promise so as to mitigate the impact of further reductions to the Lifetime Allowance (introduced in 2006) and the impact of the reduced Annual Allowance. This arrangement addresses tax-inefficiencies arising for existing employees as a consequence of the pension tax changes although members will be given the choice to remain in the current arrangement and pay the increased tax. The Committee has decided that in cases where the Company is to pay an unfunded promise, executives will be given the choice to commute some or all of the benefit for a taxable lump sum, or take it as pension.

Ian King and **Peter Lynas** already have an unfunded promise from the Company arising from the 2006 changes, which has been extended to cover the reduced Annual Allowance at no additional cost to the Company.

Ian King and Peter Lynas are both members of the BAE Systems 2000 Pension Plan (the 2000 Plan), applicable to former employees of Marconi Electronic Systems (MES), and members 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 consecutive 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 and Peter Lynas joined the ExPS in 1999 following the BAe/MES merger. Therefore their individual total pensions are the sum of their 2000 Plan benefits plus the top up from the ExPS, some of which is provided through the unfunded promise referred to above.

US pension benefits

Linda Hudson is a member of the 2006 Plan and a Non-Qualified Plan which provided a cash sum at retirement equal to a percentage of career average pay (salary plus bonus subject to a maximum bonus of 150% of salary). The cash accrual rate of the combined plans from 1 January 2010 was 14.1% of career average pay. From 1 January 2013, future accrual in the US pension arrangements changed for all employees and Linda Hudson will now receive a $1,000 annual accrual from the 2006 Plan and, from the Non-Qualified Plan, a $500 annual accrual and an annual accrual of 4.1% of salary plus bonus (subject to a maximum bonus of 150% of salary). Linda Hudson also receives a company match on her contributions to her 401(k) plan up to a maximum contribution of 6% of salary, up to regulatory limits (for 2013, $255,000). From 1 January 2013, the company match is 100%.

Details of post-retirement benefits for each of the executive directors who served during 2012 are shown in Table D on page 113 and are calculated in accordance with the requirements of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

Other benefits

Other benefits provided to executive directors are detailed under Table C on page 112.

Further to his appointment as Group Finance Director, it was agreed that Peter Lynas would be provided with Company support to establish a second home in London as the Committee believed this to be a more cost-effective option for the Company than requiring full relocation of his principal residence from outside London. This support is in accordance with Company policy, and consists of a lump sum of £22,200, together with a monthly allowance totalling £33,300 in year one declining on a uniform basis to £6,660 in year five (such monthly allowances over the five-year period totalling £99,900), and zero thereafter. Clawback provisions operate during years one and two of this arrangement whereby he would be required to repay these monies on a pro-rata basis should he leave the Company in certain circumstances, e.g. resignation or termination. No payments have yet been made under this arrangement.

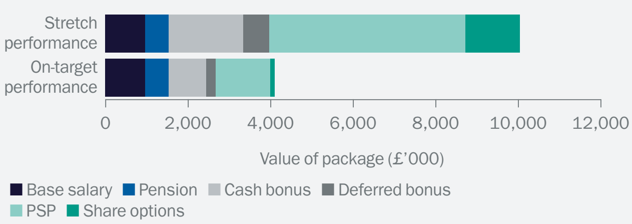
Structure of individual executive directors' packages

Ian King (Chief Executive)		**2013**		2012	
Base salary		**£963,050 pa**			
Annual incentive	On-target/maximum (% of salary)	**112.5%/225%**			
	Structure (% of salary)	**On-target**	**Stretch**	On-target	Stretch
	Group EPS	**45%**	**90%**	45%	90%
	Group cash	**28.125%**	**56.25%**	45%	90%
	Order intake	**16.875%**	**33.75%**	Not applicable	
	Safety	**5.625%**	**11.25%**	5.625%	11.25%
	Corporate responsibility	**2.8125%**	**5.625%**	5.625%	11.25%
	Personal objectives	**14.0625%**	**28.125%**	11.25%	22.5%
	Deferral	**Compulsory 1/3 of net annual incentive**		1/3 compulsory plus voluntary up to total of 50% of net annual incentive	
SMP	Gross match	**Not applicable for 2013 annual incentive**		2:1	
	Performance condition	**Not applicable for 2013 annual incentive**		EPS growth of 5% – 11% pa	
PSP	Grant (% of salary)	**125%***		125%	
	Performance condition	**1/2 on relative TSR against 12 other international defence companies; 1/2 on EPS growth of 5% – 11% pa**			
Share Option Plan	Grant (% of salary)	**300%**			
	Performance condition	**Relative TSR against 12 other international defence companies**			
Pension accrual		**1/30th of three-year final average salary from age 62 for 8% member's contributions**			

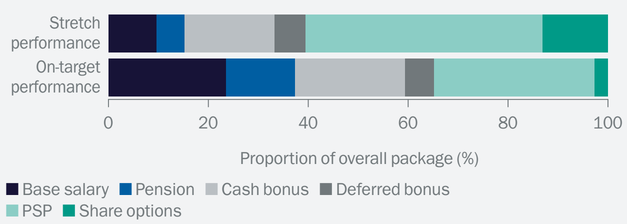
* PSP award to increase to 250% in 2014 to coincide with elimination of SMP on 2013 annual incentive.

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

Value of package (£'000)



Proportion of package value delivered through fixed and performance-related reward (%)



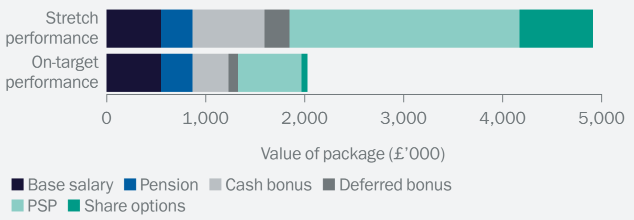
Structure of individual executive directors' packages (continued)

Peter Lynas (Group Finance Director)		**2013**		2012	
Base salary		**£546,000 pa**			
Annual incentive	On-target/maximum (% of salary)	**80%/160%**			
	Structure (% of salary)	**On-target**	**Stretch**	On-target	Stretch
	Group EPS	**32%**	**64%**	32%	64%
	Group cash	**20%**	**40%**	32%	64%
	Order intake	**12%**	**24%**	Not applicable	
	Safety	**4%**	**8%**	4%	8%
	Corporate responsibility	**2%**	**4%**	4%	8%
	Personal objectives	**10%**	**20%**	8%	16%
	Deferral	**Compulsory 1/3 of net annual incentive**		1/3 compulsory plus voluntary up to total of 50% of net annual incentive	
SMP	Gross match	**Not applicable for 2013 annual incentive**		2:1	
	Performance condition	**Not applicable for 2013 annual incentive**		EPS growth of 5% – 11% pa	
PSP	Grant (% of salary)	**125%***		125%	
	Performance condition	**1/2 on relative TSR against 12 other international defence companies; 1/2 on EPS growth of 5% – 11% pa**			
Share Option Plan	Grant (% of salary)	**300%**			
	Performance condition	**Relative TSR against 12 other international defence companies**			
Pension accrual		**1/30th of three-year final average salary from age 62 for 8% member's contributions**			

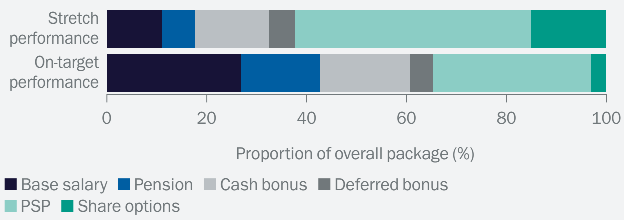
* PSP award to increase to 215% in 2014 to coincide with elimination of SMP on 2013 annual incentive.

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

Value of package (£'000)



Proportion of package value delivered through fixed and performance-related reward (%)



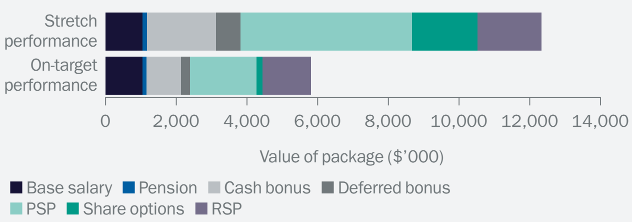
Structure of individual executive directors' packages (continued)

Linda Hudson (President and Chief Executive Officer of BAE Systems, Inc.)		**2013**		2012	
Base salary		**$1,045,350 pa**			
Annual incentive	On-target/maximum (% of salary)	**112.5%/225%**			
	Structure (% of salary)	**On-target**	**Stretch**	On-target	Stretch
	Group EPS	**15%**	**30%**	15%	30%
	Group cash	**9.375%**	**18.75%**	15%	30%
	Order intake	**5.625%**	**11.25%**	Not applicable	
	Business EBITA[1]	**30%**	**60%**	30%	60%
	Business cash	**18.75%**	**37.5%**	30%	60%
	Business order intake	**11.25%**	**22.5%**	Not applicable	
	Safety	**5.625%**	**11.25%**	5.625%	11.25%
	Corporate responsibility	**2.8125%**	**5.625%**	5.625%	11.25%
	Personal objectives	**14.0625%**	**28.125%**	11.25%	22.5%
	Deferral	**Compulsory ⅓ of net annual incentive**		Compulsory ⅓ of net annual incentive. No voluntary element	
SMP	Gross match	**Not applicable for 2013 annual incentive**		2:1	
	Performance condition	**Not applicable for 2013 annual incentive**		EPS growth of 5% – 11% pa	
PSP	Grant (% of salary)	**145%***		145%	
	Performance condition	**½ on long-term US operating cash; ½ on EPS growth of 5% – 11% pa**			
Share Option Plan	Grant (% of salary)	**390%**			
	Performance condition	**Relative TSR against 12 other international defence companies**			
RSP	% of salary	**100%**			
Pension accrual		**Cash sum at retirement of $1,500 and 4.1% of pay plus bonus (subject to a maximum of 150% of salary) for each year of service, plus a 100% company 401(k) match on contributions to a maximum of 6% of salary**		Cash sum at retirement of 14.1% of career average pay (salary plus bonus up to maximum of 150% of salary) for a contribution of 1.5% of pay, plus an 85% company 401(k) match on contributions to a maximum of 6% of salary	

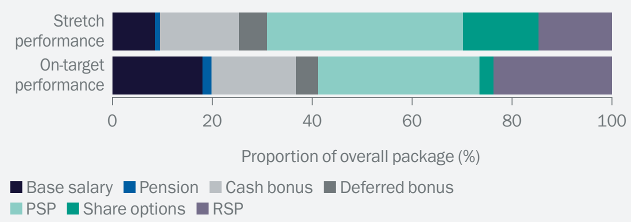
* PSP award to increase to 220% in 2014 to coincide with elimination of SMP on 2013 annual incentive.

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

Value of package ($'000)



Proportion of package value delivered through fixed and performance-related reward (%)



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

Summary of Long-Term Incentive Plans

Plan provisions

Performance conditions for grants of awards to be made under the Performance Share Plan, the Share Option Plan and investment of the 2012 annual incentive deferral into the Share Matching Plan in 2013 are detailed below. Performance conditions for grants of awards made prior to 2013 are detailed on page 111.

Clawback arrangements have operated in respect of the Performance Share Plan and Share Matching Plan from the 2010 awards onwards, and have operated for grants under the Share Option Plan since its inception. The arrangements are intended to cover situations, for example, where results are restated or otherwise turn out to be materially inaccurate or where the executive's employment can be terminated for cause.

Performance Share Plan (PSP)

Key features for PSP awards in 2013:

– awards of shares are granted based on a percentage of salary and share price at the date of grant;

– the shares are subject to satisfaction of three-year performance conditions;

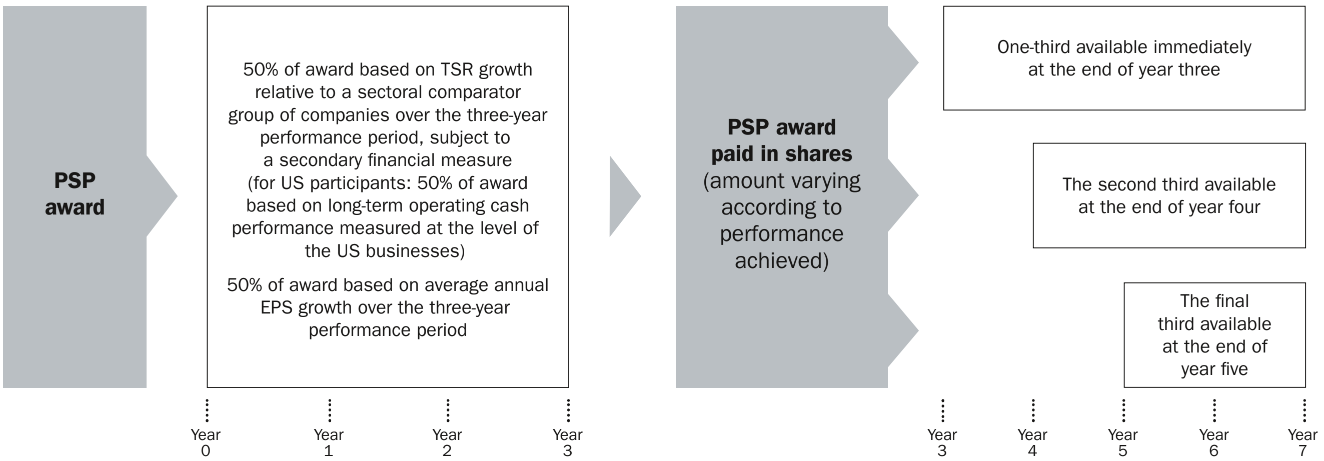
– half the PSP award will be based on a Total Shareholder Return (TSR) performance condition (PSP^{TSR}) and the other half on an Earnings per Share (PSP^{EPS}) performance condition. For US participants, the first half of the award will be based on long-term operating cash performance measured at the level of the US businesses, reflecting an increased emphasis from shareholders on cash flow generation;

– in addition, there is a further test on the PSP^{TSR} element to ensure that the TSR performance is supported by the underlying performance of the Company;

– shares under award after satisfaction of the performance condition vest at the end of year three. Awards that vest are exercisable in three tranches between the third and seventh anniversary of vesting. For US participants, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved; and

– shares under award attract dividends prior to vesting.

How the PSP operates



For the US participants, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved.

Performance condition – PSP^{EPS}

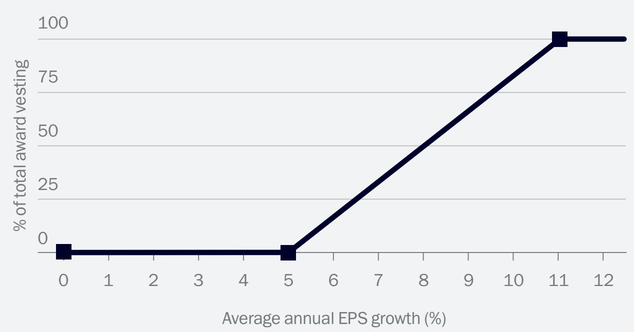
The proportion of the award capable of exercise is determined by the rate of average annual EPS growth over the three-year performance period, with nil vesting at average annual EPS growth of 5% and 100% vesting at 11% growth as set out opposite (15% to 33% growth over three years).

The rationale for the EPS performance measure is that major investors consider EPS to be a key indicator of long-term financial performance and value creation.

Summary of EPS performance to 31 December 2012

2012 EPS was 38.8p compared with the 2009 EPS baseline figure of 40.6p. This is below the performance range of 5% to 11% growth per annum. Accordingly, none of the EPS portion of the March 2010 PSP awards vest.

Performance condition – PSP^{EPS}



Performance condition – PSP[TSR]

The proportion of the award capable of exercise is determined by:

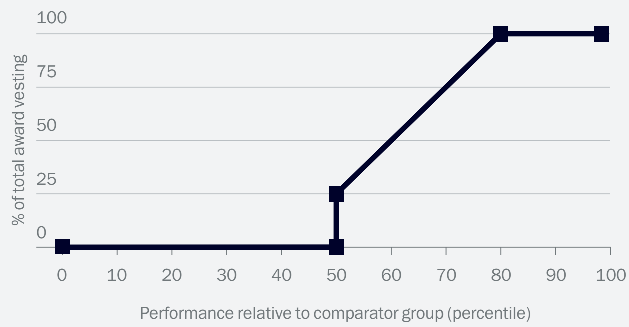
(i) the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies as shown in the table opposite*. Reflecting the Group's strategy to transition from a more diversified portfolio, the comparator group comprises those companies with a significant focus on defence and security. None of the shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group, with 25% vesting at median, and 100% vesting if it is in the top quintile (i.e. top 20%) as set out opposite; 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.

The rationale for TSR performance measures is that major investors regard TSR as an important 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.

* The previous comparator group for 2011 and prior years is also shown opposite.

Performance condition – PSP[TSR]



PSP[TSR] – sectoral peer group for 2012 and 2013

Cobham	L-3 Communications	Raytheon
Finmeccanica	Lockheed Martin	SAIC
General Dynamics	Meggitt	Thales
ITT Exelis	Northrop Grumman	United Technologies

PSP[TSR] – sectoral peer group for 2011 and prior years

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

** Goodrich is now part of United Technologies.

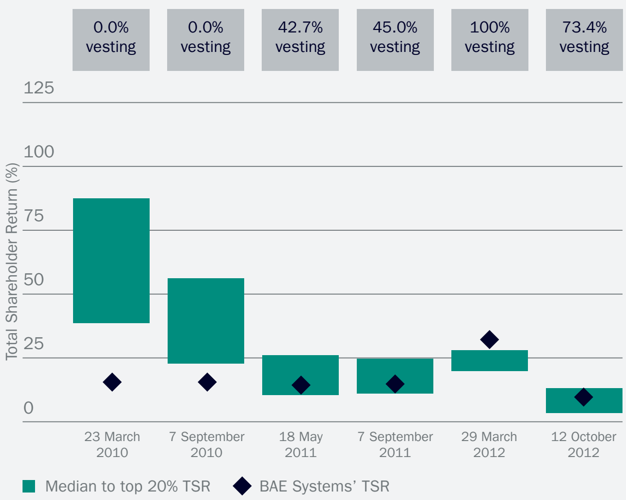
Summary of TSR performance to 31 December 2012

The chart opposite summarises the position on the TSR element for all outstanding awards under the PSP as at 31 December 2012.

The coloured box shows the range of TSR required for 25% vesting to full vesting, and the diamond shows BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.

This shows that the TSR portion of the March 2010 PSP award lapsed as the Company's TSR was below that of the comparator group.

TSR performance under the Performance Share Plan (to 31 December 2012)



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

Governance

Share Option Plan (ExSOP[2012])

Key features for option grants in 2013:

- options granted under the Share Option Plan are normally exercisable between the third and tenth anniversary of their grant; and
- for share option awards made to the executive directors only, exercise is subject to a TSR performance condition such that:
  - 25% of each option grant is exercisable if the Company's TSR (share price growth and dividends) is at the median relative to the comparator group (using the same 12 companies included in the sectoral peer group for the 2013 PSP[TSR] performance condition listed on page 105).
  - 100% of each option grant is exercisable if the Company's TSR (share price growth and dividends) is in the upper quintile relative to the comparator group. For performance between median and upper quintile, the proportion of options exercisable will be calculated on a straight-line basis.

Rationale for performance measure: major investors regard TSR as an important indication of both earnings and capital growth relative to other major companies in the same sector.

Share Matching Plan (SMP)

It has been proposed to eliminate the Share Matching Plan and as such this plan will operate for the last time in 2013 in respect of the deferral of 2012 annual incentive. Key features for grants of awards in 2013:

- 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 2012 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 average EPS growth of 5% per annum increasing uniformly to a 1:1 match at 8% per annum and a maximum 2:1 match at 11% per annum growth (i.e. 15% to 33% growth over three years).
- Rationale for performance measure: major investors consider EPS to be a key indicator of long-term financial performance and value creation.

2010 SMP award

The 2010 SMP awards were based on nil match for average EPS growth of 5% per annum increasing uniformly to a maximum 2:1 match at 11% per annum growth. 2012 EPS was 38.8p and is below the 2009 EPS of 40.6p. Accordingly, none of the EPS portion of the March 2010 PSP awards vest.

Restricted Share Plan (RSP)

Key features of awards in 2013:

- conditional awards of shares are granted based on a percentage of salary and share price at the date of grant;
- the shares are subject only to the condition that the participant remains employed by the Group at the end of the vesting date (three years after the award date); and
- shares under award attract dividends prior to vesting.

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US.

Clawback arrangements operate in respect of this Plan.

Other share schemes and share usage

Share Incentive Plan (SIP)

During 2012, the UK executive directors were eligible to participate in the all-employee free shares element of the SIP. As a result of the Company's performance in 2012, all eligible employees (including the UK executive directors) will be entitled to receive shares worth approximately £365. 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 SIP. 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, 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 SIP for UK-based employees are reinvested as Dividend Shares.

Share usage for employee share schemes

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 on this basis.

The Company currently intends to use new issue or treasury shares to satisfy future share awards under the executive long-term incentive plans and share option 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.

	Number of shares
Total issued share capital as at 31 December 2012	3,588m
All schemes:	
10% in any consecutive ten years	358.8m
Remaining headroom	200.7m
Executive schemes:	
5% in any consecutive ten years	179.4m
Remaining headroom	77.0m

Where it is appropriate to use shares purchased in the market to satisfy employee share scheme commitments, a discretionary ESOP Trust is used to acquire Company shares using funds loaned by the Group. Further detail on the ESOP Trust is provided in note 25 to the Group accounts.

On behalf of the Board

Dick Olver
Chairman

20 February 2013

Tabular information on directors' shareholdings, share-based incentives, emoluments and pensions

Table A: Directors' interests

	As at 1 January 2012					**As at 31 December 2012**				
	Ordinary shares	Executive Share Option Plans	Share Matching Plan	Performance Share Plan	Restricted Share Plan	**Ordinary shares**	**Executive Share Option Plans**	**Share Matching Plan**	**Performance Share Plan**	**Restricted Share Plan**
P M Anderson	60,000	–	–	–	–	**60,000**	**–**	**–**	**–**	**–**
H Green	–	–	–	–	–	**–**	**–**	**–**	**–**	**–**
L P Hudson	329,289	133,740	415,901	917,265	119,743	**405,020**	**988,074**	**524,025**	**1,040,457**	**338,803**
I G King	1,103,928	1,132,008	1,229,194	2,070,716	–	**1,351,886**	**2,091,858**	**1,336,626**	**1,868,559**	**–**
P J Lynas	233,937	162,795	108,578	541,563	–	**279,428**	**706,981**	**167,592**	**646,054**	**–**
Sir Peter Mason	25,283	–	–	–	–	**25,283**	**–**	**–**	**–**	**–**
L A McIntire	–	–	–	–	–	**–**	**–**	**–**	**–**	**–**
R L Olver	53,343	–	–	–	–	**53,343**	**–**	**–**	**–**	**–**
P Rosput Reynolds[1]	1,200	–	–	–	–	**1,200**	**–**	**–**	**–**	**–**
N C Rose	55,000	–	–	–	–	**55,000**	**–**	**–**	**–**	**–**
C G Symon	20,000	–	–	–	–	**20,000**	**–**	**–**	**–**	**–**

1 The ordinary shares held by Paula Rosput Reynolds are represented by 300 American Depositary Shares.

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 2012. There have been no changes in the interests of the current directors listed in the table above between 31 December 2012 and 20 February 2013 with the exception of the interests in the ordinary shares of Ian King who has acquired an additional 109 ordinary shares since 31 December 2012 under the partnership and matching shares elements of the Share Incentive Plan so that his beneficial shareholding at the date of this report stood at 1,351,995.

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 108 to 113.

Table B: Share options and Long-Term Incentive Plan (LTIP) awards – Ian King

Share options	1 January 2012	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2012	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP EPS	76,925	–	38,462	–	38,463	nil	07.05.08	26.03.12	3.06	26.03.12[1,2]	26.03.15
PSP EPS	65,219	–	–	–	65,219	nil	08.09.08	–	–	08.09.12[1]	08.09.15
PSP TSR	328,227	–	–	328,227	–	nil	24.03.09	02.03.12	–	24.03.12[3]	24.03.16
PSP EPS	328,228	–	–	188,994	–	nil	24.03.09	02.03.12	–	24.03.12[3]	24.03.16
		–	46,411	–	92,823	nil	24.03.09	26.03.12	3.06	24.03.12[1,4]	24.03.16
PSP TSR	289,351	–	–	–	289,351	nil	23.03.10	–	–	23.03.13[5]	23.03.17
PSP EPS	289,352	–	–	–	289,352	nil	23.03.10	–	–	23.03.13[5]	23.03.17
PSP TSR	346,707	–	–	–	346,707	nil	18.05.11	–	–	18.05.14[6]	18.05.18
PSP EPS	346,707	–	–	–	346,707	nil	18.05.11	–	–	18.05.14[6]	18.05.18
PSP TSR	–	199,968	–	–	199,968	nil	29.03.12	–	–	29.03.15[6]	29.03.19
PSP EPS	–	199,969	–	–	199,969	nil	29.03.12	–	–	29.03.15[6]	29.03.19
	2,070,716	**399,937**	**84,873**	**517,221**	**1,868,559**						
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[1]	30.03.17
ExSOP 2012	–	959,850	–	–	959,850	3.01	29.03.12	–	–	29.03.15[6]	29.03.22
	1,132,008	**959,850**	**–**	**–**	**2,091,858**						

LTIPs	1 January 2012	Granted during the year	Vested during the year	Lapsed during the year	31 December 2012	Market price at date of award £	Date of award	Date of lapse	Date of vesting	Market price on vesting £
SMP	371,616	–	157,658	213,958	–	3.43	24.03.09	28.02.12	26.03.12[3]	3.05
SMP	431,701	–	–	–	431,701	3.80	23.03.10	–	23.03.13[5]	–
SMP	425,877	–	–	–	425,877	3.37	18.05.11	–	18.05.14[6]	–
SMP	–	479,048	–	–	479,048	3.01	29.03.12	–	29.03.15[6]	–
	1,229,194	**479,048**	**157,658**	**213,958**	**1,336,626**					

Ian King's SMP award that vested on 26 March 2012 attracted reinvested dividends which equated on vesting to an additional 24,525 shares. The market price on vesting was £3.05.

His PSP awards exercised on 26 March 2012 also attracted reinvested dividends which equated on exercise to an additional 11,578 shares. The market price on exercise was £3.06.

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on page 111.

1 Subject to a performance condition that has been met.
2 'Date from which 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 fifth anniversary of grant.
3 The award lapsed, or partially lapsed, during the financial year under review having not met the full performance condition.
4 'Date from which 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 in two tranches on the fourth and fifth anniversary of grant.
5 The outstanding award lapsed, or partially lapsed, after the end of the financial year having not met the full performance condition.
6 Subject to a performance condition that is yet to be tested.

Table B: Share options and Long-Term Incentive Plan (LTIP) awards – Peter Lynas

Share options	1 January 2012	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2012	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP^{EPS}	25,318	–	12,658	–	12,660	nil	26.03.08	26.03.12	3.06	26.03.12[1,2]	26.03.15
PSP^{TSR}	63,822	–	–	63,822	–	nil	24.03.09	02.03.12	–	24.03.12[3]	24.03.16
PSP^{EPS}	63,822	–	–	36,749	–	nil	24.03.09	02.03.12	–	24.03.12[3]	24.03.16
		–	9,024	–	18,049	nil	24.03.09	26.03.12	3.06	24.03.12[1,4]	24.03.16
PSP^{TSR}	57,950	–	–	–	57,950	nil	23.03.10	–	–	23.03.13[5]	23.03.17
PSP^{EPS}	57,951	–	–	–	57,951	nil	23.03.10	–	–	23.03.13[5]	23.03.17
PSP^{TSR}	136,350	–	–	–	136,350	nil	18.05.11	–	–	18.05.14[6]	18.05.18
PSP^{EPS}	136,350	–	–	–	136,350	nil	18.05.11	–	–	18.05.14[6]	18.05.18
PSP^{TSR}	–	113,372	–	–	113,372	nil	29.03.12	–	–	29.03.15[6]	29.03.19
PSP^{EPS}	–	113,372	–	–	113,372	nil	29.03.12	–	–	29.03.15[6]	29.03.19
	541,563	**226,744**	**21,682**	**100,571**	**646,054**						
ExSOP	13,386	–	–	–	13,386	3.56	22.12.05	–	–	22.12.08[1]	22.12.15
ExSOP	75,887	–	–	–	75,887	4.28	12.04.06	–	–	12.04.09[1]	12.04.16
ExSOP	73,522	–	–	–	73,522	4.57	30.03.07	–	–	30.03.10[1]	30.03.17
ExSOP^{2012}	–	544,186	–	–	544,186	3.01	29.03.12	–	–	29.03.15[6]	29.03.22
	162,795	**544,186**	**–**	**–**	**706,981**						

LTIPs	1 January 2012	Granted during the year	Vested during the year	Lapsed during the year	31 December 2012	Market price at date of award £	Date of award	Date of lapse	Date of vesting	Market price on vesting £
SMP	42,142	–	17,878	24,264	–	3.43	24.03.09	28.02.12	26.03.12[3]	3.05
SMP	32,884	–	–	–	32,884	3.80	23.03.10	–	23.03.13[5]	–
SMP	33,552	–	–	–	33,552	3.37	18.05.11	–	18.05.14[6]	–
SMP	–	101,156	–	–	101,156	3.01	29.03.12	–	29.03.15[6]	–
	108,578	**101,156**	**17,878**	**24,264**	**167,592**					

Peter Lynas' SMP award that vested on 26 March 2012 attracted reinvested dividends which equated on vesting to an additional 2,777 shares. The market price on vesting was £3.05.

His PSP awards exercised on 26 March 2012 also attracted reinvested dividends which equated on exercise to an additional 3,055 shares. The market price on exercise was £3.06.

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on page 111.

1 Subject to a performance condition that has been met.
2 'Date from which 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 fifth anniversary of grant.
3 The award lapsed, or partially lapsed, during the financial year under review having not met the full performance condition.
4 'Date from which 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 in two tranches on the fourth and fifth anniversary of grant.
5 The outstanding award lapsed, or partially lapsed, after the end of the financial year having not met the full performance condition.
6 Subject to a performance condition that is yet to be tested.

Table B: Share options and Long-Term Incentive Plan (LTIP) awards – Linda Hudson

Share options	1 January 2012	Granted during the year	Released during the year	Lapsed during the year	31 December 2012	Exercise price £	Date of grant	Date of exercise, release or lapse	Market price on release £	Date from which exercisable	Expiry date
PSP^{EPS}	28,921	–	14,460	–	14,461	nil	26.03.08	26.03.12	3.05	26.03.12[1,2]	26.03.15
PSP^{TSR}	104,813	–	–	104,813	–	nil	24.03.09	02.03.12	–	24.03.12[3]	24.03.16
PSP^{EPS}	104,813	–	–	60,352	–	nil	24.03.09	02.03.12	–	24.03.12[3]	24.03.16
		–	14,820	–	29,641	nil	24.03.09	26.03.12	3.05	24.03.12[1,4]	24.03.16
PSP^{TSR}	191,983	–	–	–	191,983	nil	23.03.10	–	–	23.03.13[5]	23.03.17
PSP^{EPS}	191,983	–	–	–	191,983	nil	23.03.10	–	–	23.03.13[5]	23.03.17
PSP^{TSR}	147,376	–	–	–	147,376	nil	18.05.11	–	–	18.05.14[6]	18.05.18
PSP^{EPS}	147,376	–	–	–	147,376	nil	18.05.11	–	–	18.05.14[6]	18.05.18
PSP^{OCF}	–	158,818	–	–	158,818	nil	29.03.12	–	–	29.03.15[6]	29.03.19
PSP^{EPS}	–	158,819	–	–	158,819	nil	29.03.12	–	–	29.03.15[6]	29.03.19
	917,265	**317,637**	**29,280**	**165,165**	**1,040,457**						
ExSOP	133,740	–	–	–	133,740	4.57	30.03.07	–	–	30.03.10[1]	30.03.17
ExSOP^{2012}	–	854,334	–	–	854,334	3.01	29.03.12	–	–	29.03.15[6]	29.03.22
	133,740	**854,334**	**–**	**–**	**988,074**						

LTIPs	1 January 2012	Granted during the year	Vested during the year	Lapsed during the year	31 December 2012	Market price at date of award £	Date of award	Date of lapse	Date of vesting	Market price on vesting £
SMP	99,908	–	42,385	57,523	–	3.43	26.03.09	28.02.12	26.03.12[3]	3.05
SMP	96,383	–	–	–	96,383	3.80	23.03.10	–	23.03.13[5]	–
SMP	219,610	–	–	–	219,610	3.37	18.05.11	–	18.05.14[6]	–
SMP	–	208,032	–	–	208,032	3.01	29.03.12	–	29.03.15[6]	–
	415,901	**208,032**	**42,385**	**57,523**	**524,025**					
RSP	119,743	–	–	–	119,743	3.37	18.05.11	–	18.05.14	–
RSP	–	219,060	–	–	219,060	3.01	29.03.12	–	29.03.15	–
	119,743	**219,060**	**–**	**–**	**338,803**					

Linda Hudson's SMP award that vested on 26 March 2012 attracted reinvested dividends which equated on vesting to an additional 6,590 shares. The market price on vesting was £3.05.

Her PSP awards which vested on 26 March 2012 also attracted reinvested dividends which equated on release to an additional 4,192 shares. The market price on vesting was £3.05.

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on page 111.

1 Subject to a performance condition that has been met.
2 'Date from which exercisable' refers to the date on which the portion of the award released during the year became available for release. The portion of the award of shares outstanding at the year end will be delivered on the fifth anniversary of grant.
3 The award lapsed, or partially lapsed, during the financial year under review having not met the full performance condition.
4 'Date from which exercisable' refers to the date on which the portion of the award released during the year became available for release. The portion of the award of shares remaining at the year end will be delivered in two tranches on the fourth and fifth anniversary of grant.
5 The outstanding award lapsed, or partially lapsed, after the end of the financial year having not met the full performance condition.
6 Subject to a performance condition that is yet to be tested.

Note: Awards granted to Linda Hudson (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 Linda Hudson are included in the directors' gains on LTIPs figure on page 111 whilst PSP gains for the UK-based directors are included in the share option gain figure.

Notes to Table B

Performance Share Plan (PSP)

A full description of the PSP is set out on pages 104 and 105. 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. A secondary financial measure is also used (see page 105). For US participants, this part of the award is based on long-term operating cash flow performance measured at the level of the US businesses (PSP^{OCF}), reflecting an increased emphasis from shareholders on cash generation.

PSP^{EPS} – proportion of the award exercisable is determined by the rate of average annual EPS growth over the three-year performance period, with nil vesting at average annual 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 are exercisable in three tranches at the end of years three, four and five (except for US executives where the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved).

Executive Share Option Plan (ExSOP)

The Plan was established in 2001 and its ten-year life expired in 2011. No options have been granted under it since 2007. 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) **2003 grant** – as in (i) but performance is retested at the end of years four and five against the full period from grant.

Share Option Plan (ExSOP^{2012})

A full description of the ExSOP^{2012} is set out on page 106. 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.

2012 grants – for share option awards made to executive directors only, exercise is subject to a TSR performance condition such that:

- 25% of each option grant is exercisable if the Company's TSR is at the median relative to the comparator group; and
- 100% of each option grant is exercisable if the Company's TSR is in the upper quintile relative to the comparator group. For performance between median and upper quintile, the proportion of options exercisable will be calculated on a straight-line basis.

Share Matching Plan (SMP) – matching shares

A full description of the SMP is set out on page 106. SMP awards attract dividends prior to vesting.

2009-2012 awards – nil match for average EPS growth of less than 5% pa increasing uniformly to a 2:1 match at 11% pa growth.

Rationale for key performance measures for PSP, ExSOP, ExSOP^{2012} 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.

Restricted Share Plan (RSP)

The RSP is the time-vesting long-term incentive plan element applicable to senior executives in the US. Approved by shareholders at the 2011 AGM, it does not have performance elements attached to it other than time-vesting conditions as it seeks to mirror US remuneration practices where performance-related LTIP awards only typically make up around one-third of the overall long-term incentive package for a US executive.

Share price information

The mid-market price for the Company's ordinary shares at 31 December 2012 was 336.9p (2011 285.1p). The range during the year was 270.9p to 363.6p.

Aggregate amount of gains made by directors

The aggregate amount of gains made by directors from the exercise of share options in 2012, as calculated at the date of exercise, was £370,811 (2011 £402,249). The net aggregate value of assets received by directors in 2012 from Long-Term Incentive Plans, as calculated at the date of vesting, was £869,116 (2011 £654,645).

Table C: Directors' remuneration

	2012						2011					
	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	–	725	–	20	–	745	–	673	–	31	–	704
Executive directors												
L P Hudson	660	–	1,012	120	–	1,792	630	–	929	66	–	1,625
I G King	963	–	1,205	34	–	2,202	935	–	1,443	32	–	2,410
P J Lynas[1]	546	–	482	16	–	1,044	390	–	407	12	–	809
G W Rose[2]	n/a	n/a	n/a	n/a	n/a	n/a	160	–	–	10	–	170
Non-executive directors												
P M Anderson	–	95	–	–	23	118	–	95	–	–	20	115
H Green	–	75	–	–	14	89	–	75	–	–	8	83
M J Hartnall[3]	–	25	–	–	–	25	–	87	–	–	8	95
Sir Peter Mason	–	95	–	–	9	104	–	95	–	–	8	103
L A McIntire[1]	–	75	–	–	18	93	–	44	–	–	8	52
R Quarta[2]	n/a	n/a	n/a	n/a	n/a	n/a	–	75	–	–	8	83
P Rosput Reynolds[1]	–	75	–	–	23	98	–	56	–	–	12	68
N C Rose	–	100	–	–	14	114	–	83	–	–	8	91
C G Symon	–	95	–	–	23	118	–	95	–	–	20	115
R K Uppal[2]	n/a	n/a	n/a	n/a	n/a	n/a	–	19	–	–	–	19
	2,169	1,360	2,699	190	124	6,542	2,115	1,397	2,779	151	100	6,542

1 Appointed in 2011.
2 Retired in 2011.
3 Retired in 2012.

All emoluments and compensation paid to the directors during the year are shown above. Where the individual was appointed during the year the amount is shown from appointment.

The benefits received by the UK-based executive directors include, where appropriate, the provision of a car allowance and the private use of a chauffeur-driven car. The benefits received by the Chairman, Dick Olver, include the private use of a chauffeur-driven car.

The benefits received by the US-based executive director include a cash allowance for a car and parking, private use of a chauffeur-driven car, medical examination, dental benefits, and insured life and disability benefits. In addition, her benefit figure includes £66,288 for private use of a Company aircraft (2011 £29,535).

The other pay received by the non-executive directors represents the travel allowance of £4,500 per meeting as set out on page 98.

There were no payments to former directors during the year other than the Company pension payments to Sir Peter Gershon, Sir Richard Lapthorne and George Rose referred to on page 113.

Table D: Directors' post-retirement benefits

	Age	NRA*	Accrued benefit at 1 January 2012[1] £ pa	Accrued benefit at 31 December 2012[1] £ pa	Change in accrued pension after allowing for inflation £ pa	Transfer value at 1 January 2012[2] £	Transfer value at 31 December 2012[2] £	Director's contributions £	Increase in transfer value less director's contributions £
L P Hudson[3]	62	65	722,752	892,405	133,515	589,333	786,233	2,319	194,581
I G King[4]	56	62	677,983	740,270	28,388	11,645,676	13,117,517	84,524	1,387,317
P J Lynas[5]	54	62	282,937	342,552	45,468	4,631,241	5,584,676	47,840	905,595

* Normal Retirement Age

1 Accrued benefits 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 change in transfer value arising from the change in assumptions is: Linda Hudson £13,880; Ian King £(193,884); and Peter Lynas £(171,173).

3 Linda Hudson is a member of a US retirement plan which provides a cash sum at retirement equal to a percentage of career average pay. The accrued benefit shown above is a cash lump sum amount payable at normal retirement age. This benefit comprises £89,675 from a contributory Qualified Plan and £802,730 from Non-Qualified Plans. In addition, Linda Hudson 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 2012, the Company paid contributions of £8,045 into this 401(k) arrangement during the year. Linda Hudson is paid in US dollars. Of the change in the accrued benefit and the transfer value £(40,133) and £(35,358), respectively, is due to currency movements.

4 Ian King has an unfunded unapproved retirement arrangement for benefits in excess of the Lifetime Allowance. The pension and transfer value figures shown are in respect of his total benefit.

5 Peter Lynas has an unfunded unapproved retirement arrangement for benefits in excess of the Lifetime Allowance. The pension and transfer value figures shown are in respect of his total benefit.

Sir Peter Gershon, Sir Richard Lapthorne and George Rose, all former directors, have unfunded pension arrangements. In 2012, the Company paid Sir Peter Gershon a pension of £122,120 (2011 £117,113), Sir Richard Lapthorne a pension of £110,661 (2011 £105,522) and George Rose a pension of £137,274 (2011 £100,204) in respect of these arrangements.

OTHER STATUTORY AND REGULATORY INFORMATION

Principal activities
BAE Systems is a global defence, aerospace and security company. The BAE Systems Group delivers, through its subsidiaries and equity accounted investments, a wide range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services.

Company registration
BAE Systems plc is registered in England and Wales with the registered number 1470151.

Directors
The current directors who served during the 2012 financial year are listed on pages 78 and 79. In addition, Michael Hartnall retired from the Board on 2 May 2012.

Dividend
An interim dividend of 7.8p per share was paid on 30 November 2012. The directors propose a final dividend of 11.7p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 3 June 2013 to shareholders on the share register on 19 April 2013.

Annual General Meeting (AGM)
The Company's AGM will be held on 8 May 2013. 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, Innovation and Skills). 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.

Profit forecast
In its full year results announcement on 16 February 2012 and Annual Report 2011, the Group made the following statement, which is regarded as a profit forecast for the purposes of the Financial Services Authority's Listing Rule 9.2.18:

"Whilst little sales growth can be expected for the Group in 2012 in the current market conditions, modest growth in underlying earnings per share is anticipated, assuming a satisfactory conclusion to Salam negotiations in 2012 and excluding the benefit of the 2011 Research & Development tax settlement."

On 19 December 2012, the Group announced that discussions continued towards agreement of definitive pricing for the supply of 72 Typhoon aircraft to the Royal Saudi Air Force contracted in 2007 under the government-to-government Salam programme and that, in the event of an acceptable agreement not being reached before the Group's full year results announcement on 21 February 2013, the impact on 2012 trading guidance would be to reduce the Group's underlying earnings per share by approximately 3 pence per share. At 20 February 2013, discussions continue and, consequently, modest growth in underlying earnings per share in 2012 has not been achieved. Underlying earnings per share (excluding the R&D tax benefit) was 39.7p in 2011. In 2012, underlying earnings per share was 38.9p.

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 (see www.promptpaymentcode.org.uk), 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 2012 by suppliers was 30 days (2011 35 days).

Employees
Regular internal communication, including newsletters, management meetings and the intranet, keeps employees informed, involved and motivated.

The Group has constructive relationships with trade unions, and regularly communicates and discusses business developments which impact the Group and its employees.

The Group welcomes employees becoming shareholders in BAE Systems, and offers a number of employee share plans to support this.

The Group is committed to giving full and fair consideration to applications for employment from disabled people who meet the requirements for roles, and making available training opportunities and appropriate accommodation to disabled people employed by the Group.

Principal customers
The Group's most significant customers are the governments of the US, UK, Kingdom of Saudi Arabia and Australia. In the US, BAE Systems is subject to a 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. Agreements between the governments of the UK and Kingdom of Saudi Arabia relating to defence co-operation programmes remain essential to the development of the Group's business in Saudi Arabia. In Australia, BAE Systems is subject to an Overarching Deed with the Commonwealth of Australia that protects their national security and other interests, and allows the Group to own certain Australian defence-related industrial assets.

Indian government policy on Foreign Direct Investment mandates that foreign partners can hold a maximum of 26% equity in defence ventures.

Charitable donations
During 2012, the amount donated for charitable purposes in the UK was £1.8m (2011 £1.4m). In line with the Community Investment programme, this included:

- £688,800 given to armed forces charities, including donations to Combat Stress and Soldiers, Sailors, Airmen and Families Association (SSAFA) Forces Help;
- £893,800 donated to education charities, with major donations being made to Enthuse Charitable Trust, EngineeringUK, the Queen Elizabeth Prize for Engineering Foundation and The Prince's Trust; and
- the remaining £249,100 donated for other charitable purposes, including the advance of health and culture/heritage.

Globally, the Group and its employees through its Community Investment programme contributed over £11m* to local, national and international charities and not-for-profit organisations.

Political donations
No political donations were made in 2012.

Issued share capital
As at 31 December 2012, BAE Systems' issued share capital of £89,691,828 comprised 3,587,673,101 ordinary shares of 2.5p each and one Special Share of £1.

Treasury shares
As at 1 January 2012, the number of shares held in treasury totalled 351,756,854 (having a total nominal value of £8,793,921 and representing 9.8% of the Company's called up share capital at 1 January 2012). During 2012, the Company used 14,942,858 treasury shares (having a total nominal value of £373,571 and representing 0.4% of the Company's called up share capital at 31 December 2012) to satisfy awards under the Free and Matching

* See assurance statement on www.baesystems.com/deloitteassurancestatement

elements of the Share Incentive Plan (8,867,329 shares in aggregate), awards vested under the Performance Share Plan (2,728,737 shares), the Restricted Share Plan (47,568 shares) and the Share Matching Plan (2,916,565 shares), and options exercised under the Executive Share Option Plan (382,659 shares). The treasury shares utilised in respect of the Share Incentive Plan, the Performance Share Plan, the Restricted Share Plan and the Share Matching Plan were disposed of by the Company for nil consideration. The 382,659 shares disposed of by the Company in respect of the Executive Share Option Plan were disposed of by the Company for an aggregate consideration of £902,164. As at 31 December 2012, the number of shares held in treasury totalled 336,813,996 (having a total nominal value of £8,420,350 and representing 9.4% of the Company's called up share capital at 31 December 2012).

The rights to treasury shares are restricted in accordance with the Companies Act 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 and entitled to vote shall have one vote, and every proxy entitled to vote shall have one vote (unless the proxy is appointed by more than one member in which case the proxy has one vote for and one vote against if the proxy has been instructed by one or more members to vote for the resolution and by one or more members to vote against the resolution; or if the proxy has been instructed by one or more shareholders to vote either for or against a resolution and by one or more of those shareholders to use his discretion how to vote). 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. There are no redemption rights in relation to the ordinary shares.

Rights and obligations of the Special Share

The Special Share is held on behalf of the Secretary of State for Business, Innovation and Skills (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, 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 holder of 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.

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 31 December 2012, 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	5.00%
Barclays PLC	3.98%
Invesco Limited	13.02%
Franklin Resources Inc., and affiliates	4.92%
Legal & General Group Plc	3.99%
Silchester International Investors LLP	3.01%

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. It is the Board's intention that all directors will stand for election or re-election in 2013 in compliance with the UK Corporate Governance Code.

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, and the requirement that the Chief Executive and any executive Chairman are British.

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 Articles of Association.

At the 2012 AGM, the directors were given the power to buy back a maximum number of 323,805,150 ordinary shares at a minimum price of 2.5p each. The maximum price was the higher of (i) 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, and (ii) the higher of the price of the last independent trade and the highest current independent bid on the London Stock Exchange as stipulated in Article 5(1) of the Buy-back and Stabilisation Regulation. This power will expire at the earlier of the conclusion of the 2013 AGM or 30 June 2013. A special resolution will be proposed at the 2013 AGM to renew the Company's authority to acquire its own shares.

At the 2012 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,981,064. This power will expire on the earlier of the conclusion of the 2013 AGM or 30 June 2013. Accordingly, a resolution will be proposed at the 2013 AGM to renew the Company's authority to issue further new shares. At the 2012 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £26,981,064 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2013 AGM or 30 June 2013, and a resolution will be proposed at the 2013 AGM to renew this additional authority.

Conflicts of interest
As permitted under the Companies Act 2006, the Company's Articles of Association contain provisions which enable the Board to authorise conflicts or potential conflicts that individual directors may have.

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. 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 2012 which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

The directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited, BAE Systems Executive Pension Scheme Trustees Limited and Alvis Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan, the BAE Systems Executive Pension Scheme and the Alvis 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 £2bn Revolving Credit Facility dated 8 December 2010 which provides 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 facility. The Revolving Credit Facility was undrawn as at 31 December 2012.

– 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.

– The Company, BAE Systems, Inc., BAE Systems (Holdings) Limited and BAE Systems Holdings Inc. entered into a Special Security Agreement dated 8 November 2010 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.

– In July 2009, BVT Surface Fleet Limited (now BAE Systems Surface Ships Limited) and the UK MoD entered into a definitive Terms of Business Agreement (ToBA) which sets out a 15-year partnering arrangement, including lead roles for the BVT business on defined surface shipbuilding and support programmes. Where the MoD considers that a proposed Change in Control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the Change in Control shall not proceed until agreement with the MoD is established. In the event that there is a Change in Control of BAE Systems Surface Ships Limited notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the ToBA immediately without compensation or termination charges.

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.

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 International Financial Reporting Standards (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).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company, and of their profit or loss for that period. 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 adequate accounting records that are sufficient to show and explain the parent company's transactions, and 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 2006. 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/she ought to have taken to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

On behalf of the Board

David Parkes
Company Secretary
20 February 2013

Responsibility statement of the directors in respect of the Annual Report and financial statements

Each of the directors listed below confirms that to the best of their 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

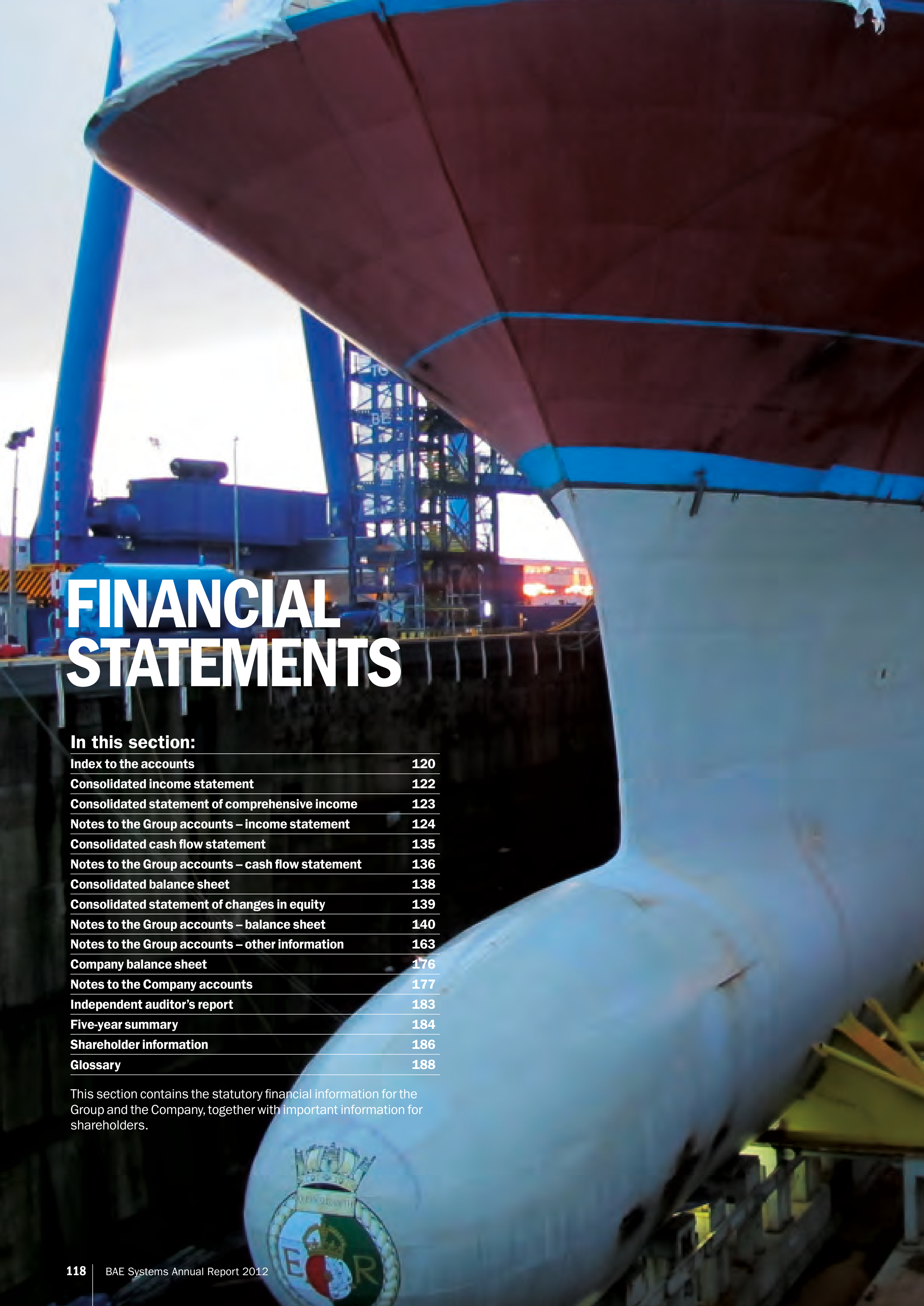
– the Directors' Report includes a fair review of the development and performance of the business, and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

In addition, each of the directors considers that the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

Dick Olver	Chairman
Ian King	Chief Executive
Linda Hudson	President and Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	Group Finance Director
Paul Anderson	Non-executive director
Harriet Green	Non-executive director
Lee McIntire	Non-executive director
Sir Peter Mason	Non-executive director
Paula Rosput Reynolds	Non-executive director
Nick Rose	Non-executive director
Carl Symon	Non-executive director

On behalf of the Board

Dick Olver
Chairman
20 February 2013



FINANCIAL STATEMENTS

In this section:

This section contains the statutory financial information for the Group and the Company, together with important information for shareholders.

Constructing two new aircraft carriers for the Royal Navy

Two aircraft carriers, HMS Queen Elizabeth and HMS Prince of Wales, are being delivered by the Aircraft Carrier Alliance. BAE Systems has an overarching role in managing the programme, as well as playing a central role in the design and build of the ships.

Each 65,000 tonne aircraft carrier will provide the armed forces with a four acre military operating base which can be deployed worldwide. The vessels will be versatile enough to be used for operations ranging from supporting war efforts to providing humanitarian aid and disaster relief.

Assembly of the completed hull sections of the first carrier is being undertaken at Rosyth.

INDEX TO THE ACCOUNTS

Preparation and consolidation

Preparation
The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis as discussed in the Directors' Report on page 84, and in accordance with EU-endorsed International Financial Reporting Standards (IFRS) and the Companies Act 2006 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 following potential key areas of judgement required to be made in applying the Group's accounting policies:

– the determination of the revenue recognition approach to apply to individual contracts;

– the determination of assumptions underpinning the valuation of retirement benefit obligations for defined benefit pension schemes; and

– the determination of assumptions underpinning goodwill impairment testing.

The principal accounting policies applied in the preparation of these consolidated financial statements are set out in note 32. These policies have been consistently applied to all the years presented, unless otherwise stated.

An explanation of the critical accounting estimates and judgements used in producing these consolidated financial statements is made in the Directors' Report on page 38.

Changes in accounting policies
With effect from 1 January 2012, the Group early adopted amendments to IAS 1, Presentation of Financial Statements, which requires items within Other Comprehensive Income that may be reclassified to the income statement to be grouped together. This amendment is concerned with disclosure only and has no impact on the reported results or financial position of the Group.

There were no other changes in accounting policies during the year.

A number of amendments to existing standards are effective for annual periods beginning after 1 January 2013 and have not been applied in preparing these consolidated financial statements. None of these are expected to have a material impact on the consolidated financial statements of the Group except IAS 19 (revised 2011), Employee Benefits, which replaces interest cost and expected return on plan assets with a finance cost component comprising net interest on the net defined benefit pension deficit calculated using the discount rate currently used to measure defined benefit pension liabilities. If this amendment had been applied in 2012, pre-tax profit would have been £173m lower primarily because the discount rate is lower than the expected return on plan assets. The net pension deficit would have been unchanged.

A number of new EU-endorsed standards, which are listed below, are effective for annual periods beginning after 1 January 2013 and have not been applied in preparing these consolidated financial statements. None of these are expected to have a material impact on the consolidated financial statements of the Group and as such they have not been early adopted.

– IFRS 10, Consolidated Financial Statements, defines the principle of control which is the basis for consolidation and sets out the accounting requirements for the preparation of consolidated financial statements.

– IFRS 11, Joint Arrangements, focuses on the rights and obligations of the parties to a joint arrangement rather than its legal form in determining whether it is a joint venture or a joint operation.

– IFRS 12, Disclosures of Interests in Other Entities, includes the disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, special purpose vehicles and other off balance sheet vehicles.

– IFRS 13, Fair Value Measurement, aims to improve consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement disclosure requirements for use across other standards within IFRSs. IFRS 13 does not extend the use of fair value accounting.

There are no other IFRSs or IFRIC interpretations that are not yet effective that are expected to have a material impact on the Group.

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' results accounted for under the equity method, all of which are prepared to 31 December.

Subsidiaries
A subsidiary is an entity controlled by the Group. Control is the power to govern the operating and financial policies of an entity so as to obtain benefits from its activities.

The results of subsidiaries are included in the income statement from the date of acquisition.

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

Equity accounted investments
An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. Joint ventures are accounted for under the equity method where the consolidated income statement includes its share of their profits and losses, and the consolidated balance sheet includes its share of their net assets.

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Notes	2012 £m	2012 Total £m	2011 £m	2011 Total £m
Continuing operations					
Combined sales of Group and share of equity accounted investments	1		**17,834**		19,154
Less: share of sales of equity accounted investments	1		**(1,214)**		(1,384)
Revenue	1		**16,620**		17,770
Operating costs	2		**(15,353)**		(16,478)
Other income	4		**280**		157
Group operating profit			**1,547**		1,449
Share of results of equity accounted investments	1		**93**		131
Underlying EBITA[1]		**1,895**		2,025	
Non-recurring items[2]		**103**		(78)	
EBITA		**1,998**		1,947	
Amortisation		**(226)**		(239)	
Impairment		**(86)**		(109)	
Financial (expense)/income of equity accounted investments	5	**(4)**		8	
Taxation expense of equity accounted investments		**(42)**		(27)	
Operating profit	1		**1,640**		1,580
Financial income		**1,326**		1,294	
Financial expense		**(1,597)**		(1,408)	
Finance costs	5		**(271)**		(114)
Profit before taxation			**1,369**		1,466
Taxation expense	6		**(295)**		(206)
Profit for the year – continuing operations			**1,074**		1,260
Profit/(loss) for the year – discontinued operations	7		**5**		(4)
Profit for the year			**1,079**		1,256
Attributable to:					
Equity shareholders			**1,068**		1,240
Non-controlling interests			**11**		16
			1,079		1,256
Earnings per share	8				
Basic earnings per share			**33.0p**		36.9p
Diluted earnings per share			**32.8p**		36.7p
Earnings per share – continuing operations					
Basic earnings per share			**32.8p**		37.0p
Diluted earnings per share			**32.6p**		36.8p

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
2 Comprises profit on disposal of businesses £103m (2011 loss £29m) and regulatory penalties £nil (2011 £49m).

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December

	Notes	2012 Other reserves[1] £m	2012 Retained earnings £m	2012 Total £m	2011 Other reserves[1] £m	2011 Retained earnings £m	2011 Total £m
Profit for the year		**–**	**1,079**	**1,079**	–	1,256	1,256
Other comprehensive income							
Items that will not be reclassified to the income statement:							
Net actuarial losses on defined benefit pension schemes:							
Subsidiaries		**–**	**(796)**	**(796)**	–	(1,522)	(1,522)
Equity accounted investments		**–**	**(84)**	**(84)**	–	(45)	(45)
Tax on items that will not be reclassified to the income statement	6	**–**	**173**	**173**	–	387	387
Items that may be reclassified to the income statement:							
Currency translation on foreign currency net investments:							
Subsidiaries		**(164)**	**–**	**(164)**	(19)	–	(19)
Equity accounted investments		**(25)**	**–**	**(25)**	(17)	–	(17)
Reclassification of cumulative currency translation reserve on disposal	26	**(97)**	**–**	**(97)**	(14)	–	(14)
Amounts charged to hedging reserve	17	**(21)**	**–**	**(21)**	(56)	–	(56)
Fair value movements on available-for-sale investments	15	**–**	**–**	**–**	–	5	5
Reclassification of fair value movements on available-for-sale investments	5	**–**	**–**	**–**	–	(21)	(21)
Tax on items that may be reclassified to the income statement	6	**5**	**–**	**5**	17	–	17
Total other comprehensive income for the year (net of tax)		**(302)**	**(707)**	**(1,009)**	(89)	(1,196)	(1,285)
Total comprehensive income for the year		**(302)**	**372**	**70**	(89)	60	(29)
Attributable to:							
Equity shareholders		**(302)**	**361**	**59**	(89)	44	(45)
Non-controlling interests		**–**	**11**	**11**	–	16	16
		(302)	**372**	**70**	(89)	60	(29)

1 An analysis of other reserves is provided in note 25.

Financial statements – Income statement

NOTES TO THE GROUP ACCOUNTS – INCOME STATEMENT

1. Segmental analysis

The Group has six reporting segments which align with the Group's strategic direction:

- **Electronic Systems** comprises the US and UK-based electronics activities, including electronic warfare systems and electro-optical sensors, military and commercial digital engine and flight controls, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems;
- **Cyber & Intelligence** comprises the US-based Intelligence & Security business and UK-headquartered BAE Systems Detica business, and covers the Group's cyber, secure government, and commercial and financial security activities;
- **Platforms & Services (US)** comprises the US-headquartered Land & Armaments business, with operations in the US, UK, Sweden and South Africa, together with US-based services and sustainment activities, including ship repair and munitions services;
- **Platforms & Services (UK)** comprises the Group's UK-based air, maritime and combat vehicle activities, and certain shared services activities;
- **Platforms & Services (International)** comprises the Group's businesses in Saudi Arabia, Australia, India and Oman, together with its 37.5% interest in the pan-European MBDA joint venture; and
- **HQ** comprises the Group's head office activities, together with a 49% interest in Air Astana.

Management monitors the results of these reporting segments to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on combined sales of Group and share of equity accounted investments, and underlying EBITA[1]. Underlying EBITA[1] is reconciled below to the reporting segment result and the operating profit in the consolidated financial statements. Finance costs and taxation expense are managed on a Group basis.

Sales and revenue by reporting segment

	Combined sales of Group and share of equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Electronic Systems	**2,507**	2,645	**(52)**	(49)	**52**	49	**2,507**	2,645
Cyber & Intelligence	**1,402**	1,399	**–**	–	**–**	–	**1,402**	1,399
Platforms & Services (US)	**4,539**	5,305	**(70)**	(52)	**1**	2	**4,470**	5,255
Platforms & Services (UK)	**5,646**	6,258	**(1,430)**	(1,476)	**1,346**	1,374	**5,562**	6,156
Platforms & Services (International)	**4,071**	3,794	**(830)**	(1,039)	**–**	–	**3,241**	2,755
HQ	**267**	233	**(267)**	(233)	**–**	–	**–**	–
	18,432	19,634	**(2,649)**	(2,849)	**1,399**	1,425	**17,182**	18,210
Intra-group sales/revenue	**(598)**	(480)	**2**	3	**34**	37	**(562)**	(440)
	17,834	19,154	**(2,647)**	(2,846)	**1,433**	1,462	**16,620**	17,770

	Intra-group revenue		Revenue from external customers	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Electronic Systems	**102**	118	**2,405**	2,527
Cyber & Intelligence	**22**	22	**1,380**	1,377
Platforms & Services (US)	**54**	79	**4,416**	5,176
Platforms & Services (UK)	**375**	214	**5,187**	5,942
Platforms & Services (International)	**9**	7	**3,232**	2,748
	562	440	**16,620**	17,770

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

1. Segmental analysis (continued)

Sales and revenue by customer location

	Sales		Revenue	
	2012 £m	2011 £m	**2012 £m**	2011 £m
United Kingdom	**3,666**	3,893	**3,526**	3,749
Rest of Europe[1]	**2,473**	2,830	**1,724**	1,966
Saudi Arabia	**2,411**	2,460	**2,331**	2,313
Rest of Middle East	**159**	136	**51**	70
United States	**7,348**	7,924	**7,344**	7,921
Canada	**55**	82	**55**	82
Australia	**1,112**	1,071	**1,110**	1,070
Rest of Asia and Pacific	**376**	374	**257**	240
Africa, Central and South America	**234**	384	**222**	359
	17,834	19,154	**16,620**	17,770

Revenue by category

	2012 £m	2011 £m
Long-term contracts	**8,948**	9,380
Sale of goods	**4,000**	4,684
Provision of services	**3,656**	3,698
Royalty income	**16**	8
	16,620	17,770

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2012 £m	2011 £m
UK Ministry of Defence[1]	**4,475**	4,802
US Department of Defense	**4,986**	5,675
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**2,302**	2,276

Revenue from the UK Ministry of Defence and the US Department of Defense was generated by the five principal reporting segments. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was generated by the Platforms & Services (UK) and Platforms & Services (International) reporting segments.

1 Includes £1.3bn (2011 £1.3bn) generated under the Typhoon work share agreement with Eurofighter Jagdflugzeug GmbH.

1. Segmental analysis (continued)

Reporting segment result

	Underlying EBITA[1]		Non-recurring items[2]		Amortisation of intangible assets		Impairment of intangible assets		Reporting segment result	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Electronic Systems	**356**	386	**–**	–	**(22)**	(15)	**(2)**	–	**332**	371
Cyber & Intelligence	**124**	136	**–**	–	**(76)**	(64)	**–**	–	**48**	72
Platforms & Services (US)	**394**	478	**103**	(29)	**(92)**	(118)	**(84)**	(75)	**321**	256
Platforms & Services (UK)	**689**	658	**–**	–	**(28)**	(32)	**–**	(34)	**661**	592
Platforms & Services (International)	**417**	449	**–**	–	**(8)**	(10)	**–**	–	**409**	439
HQ	**(85)**	(82)	**–**	(49)	**–**	–	**–**	–	**(85)**	(131)
	1,895	2,025	**103**	(78)	**(226)**	(239)	**(86)**	(109)	**1,686**	1,599
Financial (expense)/income of equity accounted investments									**(4)**	8
Taxation expense of equity accounted investments									**(42)**	(27)
Operating profit									**1,640**	1,580
Finance costs									**(271)**	(114)
Profit before taxation									**1,369**	1,466
Taxation expense									**(295)**	(206)
Profit for the year – continuing operations									**1,074**	1,260

Share of results of equity accounted investments within reporting segments

	2012 £m	2011 £m
Share of results excluding finance costs and taxation expense:		
Electronic Systems	**(2)**	1
Platforms & Services (US)	**1**	1
Platforms & Services (UK)	**11**	11
Platforms & Services (International)	**108**	116
HQ	**21**	21
	139	150
Financial (expense)/income	**(4)**	8
Taxation expense	**(42)**	(27)
	93	131

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
2 Comprises profit on disposal of businesses £103m (2011 loss £29m) and regulatory penalties £nil (2011 £49m).

2. Operating costs

	2012 £m	2011 £m
Raw materials, subcontracts and other bought-in items	**6,174**	6,947
Change in inventories of finished goods and work-in-progress	**23**	198
Cost of inventories expensed	**6,197**	7,145
Staff costs (note 3)	**5,285**	5,356
Depreciation, amortisation and impairment	**669**	695
Loss on disposal of property, plant and equipment, and investment property	**5**	4
Loss on disposal of businesses	**–**	29
Other operating charges	**3,197**	3,249
Operating costs	**15,353**	16,478
Included within the analysis of operating costs are the following expenses:		
Minimum lease and sublease payments	**189**	178
Research and development expense including amounts funded under contract	**1,138**	1,149

Fees payable to the Company's auditor and its associates included in operating costs

	2012			2011		
	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*	**1,570**	**–**	**1,570**	1,535	–	1,535
Fees payable to the Company's auditor and its associates for other services pursuant to legislation:						
The audit of the Company's subsidiaries*	**2,524**	**3,836**	**6,360**	2,435	4,227	6,662
Interim review	**623**	**–**	**623**	604	–	604
Other	**103**	**29**	**132**	96	38	134
Audit-related assurance services:						
Advice on accounting matters	**8**	**20**	**28**	4	25	29
Tax compliance services	**320**	**662**	**982**	550	1,263	1,813
Tax advisory services	**126**	**166**	**292**	227	376	603
Corporate finance services:						
M&A	**236**	**35**	**271**	516	79	595
Other assurance services:						
Due diligence	**–**	**235**	**235**	–	270	270
IT advisory	**56**	**–**	**56**	–	27	27
Other non-audit services	**125**	**73**	**198**	251	18	269
Total fees payable to the Company's auditor and its associates	**5,691**	**5,056**	**10,747**	6,218	6,323	12,541
* Total fees payable to the Company's auditor and its associates for audit services			**7,930**			8,197
Fees in respect of BAE Systems pension schemes:						
Audit	**147**	**268**	**415**	135	229[1]	364
Tax compliance	**85**	**26**	**111**	48	8	56
Tax advisory	**64**	**–**	**64**	26	–	26
	296	**294**	**590**	209	237	446

1 Restated.

Tax services in 2011 included compliance and advisory services in relation to the Group's expatriate employees based around the world. From 1 January 2012, PricewaterhouseCoopers have performed these services.

3. Employees

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2012 Number '000	2011 Number '000	**2012 Number '000**	2011 Number '000
Electronic Systems	**13**	13	**13**	13
Cyber & Intelligence	**8**	8	**8**	9
Platforms & Services (US)	**23**	25	**21**	24
Platforms & Services (UK)	**28**	30	**27**	28
Platforms & Services (International)	**11**	12	**11**	12
HQ	**1**	1	**1**	1
	84	89	**81**	87

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

	2012 £m	2011 £m
Wages and salaries	**4,546**	4,603
Social security costs	**367**	385
Share-based payments (note 28)	**26**	24
Pension costs – defined contribution plans (note 23)	**129**	119
Pension costs – defined benefit plans (note 23)	**212**	225
US healthcare costs (note 23)	**5**	–
	5,285	5,356

4. Other income

	2012 £m	2011 £m
Rental income from operating leases – investment property	**21**	22
Rental income from operating leases – other	**19**	21
Profit on disposal of investment property	**14**	21
Profit on disposal of property, plant and equipment	**10**	12
Profit on disposal of businesses (note 26)	**103**	–
Management recharges to equity accounted investments (note 29)	**18**	17
Pension curtailment gains (note 23)	**26**	–
US healthcare curtailment gains (note 23)	**16**	2
Other[1]	**53**	62
Other income	**280**	157

1 There are no individual amounts in excess of £10m.

5. Finance costs

	2012 £m	2011 £m
Interest income	**39**	30
Income from financial assets at fair value through profit or loss	**–**	4
Expected return on pension scheme assets (note 23)	**874**	989
Reclassification of fair value movements on available-for-sale investments	**–**	21
Gain on remeasurement of financial instruments at fair value through profit or loss	**280**	174
Foreign exchange gains	**133**	76
Financial income	**1,326**	1,294
Interest expense on bonds and other financial instruments[1]	**(187)**	(204)
Charges relating to early redemption of debt	**–**	(13)
Facility fees	**(7)**	(7)
Net present value adjustments	**(56)**	(33)
Interest charge on pension scheme liabilities (note 23)	**(929)**	(965)
Loss on remeasurement of financial instruments at fair value through profit or loss	**(250)**	(163)
Foreign exchange losses	**(168)**	(23)
Financial expense	**(1,597)**	(1,408)
Finance costs	**(271)**	(114)

Additional analysis

	2012 £m	2011 £m
Finance costs:		
Group	**(271)**	(114)
Share of equity accounted investments	**(4)**	8
	(275)	(106)
Analysed as:		
Underlying interest (expense)/income:		
Group[1]	**(211)**	(210)
Share of equity accounted investments	**7**	11
	(204)	(199)
Other:		
Group:		
Net financing (charge)/credit on pensions	**(55)**	24
Market value and foreign exchange adjustments on financial instruments and investments	**(5)**	85
Charges relating to early redemption of debt	**–**	(13)
Share of equity accounted investments	**(11)**	(3)
	(275)	(106)

1 2011 restated to exclude £13m of pre-tax charges relating to early redemption of debt, with £28m that would have been incurred in future years remaining within underlying interest.

6. Taxation expense

	2012 £m	2011 £m
Current taxation		
UK:		
Current tax	**(98)**	(155)
Double tax relief	**1**	2
Adjustment in respect of prior years[1]	**5**	187
	(92)	34
Overseas:		
Current year	**(169)**	(171)
Adjustment in respect of prior years	**12**	5
	(157)	(166)
	(249)	(132)
Deferred taxation		
UK:		
Origination and reversal of temporary differences	**(2)**	(43)
Adjustment in respect of prior years	**2**	7
Tax rate adjustment[2]	**(10)**	(8)
	(10)	(44)
Overseas:		
Origination and reversal of temporary differences	**(23)**	(56)
Adjustment in respect of prior years	**(13)**	26
	(36)	(30)
	(46)	(74)
Taxation expense	**(295)**	(206)
UK[1]	**(102)**	(10)
Overseas	**(193)**	(196)
Taxation expense	**(295)**	(206)

1 2011 includes the benefit of a UK tax agreement of £197m.
2 The UK current tax rate will be reduced from 24% to 23% with effect from 1 April 2013. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 25% to 23%, creating a rate adjustment in 2012, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

6. Taxation expense (continued)

Reconciliation of taxation 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.

	2012 £m	2011 £m
Profit before taxation	**1,369**	1,466
UK corporation tax rate	**24.5%**	26.5%
Expected income tax expense	**(335)**	(388)
Effect of tax rates in foreign jurisdictions, including US state taxes	**(55)**	(67)
Expenses not tax effected	**(15)**	(32)
Income not subject to tax	**12**	24
Research and development tax credits	**24**	40
Goodwill impairment	**(14)**	(28)
Chargeable gains and non-taxable gains/non-deductible losses on disposal of businesses	**17**	(19)
Utilisation of previously unrecognised tax losses	**9**	27
Current year losses not tax effected	**(2)**	(3)
Recoverable deferred tax asset previously unrecognised	**20**	30
Prior year benefit of UK tax agreement[1]	**–**	197
Adjustments in respect of prior years	**6**	28
Adjustments in respect of equity accounted investments	**23**	35
Regulatory penalties	**–**	(13)
Tax rate adjustment[2]	**(10)**	(8)
Other	**25**	(29)
Taxation expense	**(295)**	(206)

1 2011 includes the benefit of an agreement with the UK tax authorities addressing a number of items, including the interpretation of complex tax rules relating to research and development tax credits.

2 The UK current tax rate will be reduced from 24% to 23% with effect from 1 April 2013. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 25% to 23%, creating a rate adjustment in 2012, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

6. Taxation expense (continued)

Tax recognised in other comprehensive income

	2012 Before tax £m	2012 Tax benefit/ (expense) £m	2012 Net of tax £m	2011 Before tax £m	2011 Tax benefit/ (expense) £m	2011 Net of tax £m
Items that will not be reclassified to the income statement:						
Net actuarial losses on defined benefit pension schemes:						
Subsidiaries	(796)	228	(568)	(1,522)	443	(1,079)
Equity accounted investments	(84)	11	(73)	(45)	13	(32)
Share-based payments	–	2	2	–	–	–
Other	–	2	2	–	–	–
Tax rate adjustment[1]	–	(70)	(70)	–	(69)	(69)
Items that may be reclassified to the income statement:						
Currency translation on foreign currency net investments:						
Subsidiaries	(164)	–	(164)	(19)	–	(19)
Equity accounted investments	(25)	–	(25)	(17)	–	(17)
Reclassification of cumulative currency translation reserve on disposal	(97)	–	(97)	(14)	–	(14)
Amounts charged to hedging reserve	(21)	5	(16)	(56)	17	(39)
Fair value movements on available-for-sale investments	–	–	–	5	–	5
Reclassification of fair value movements on available-for-sale investments	–	–	–	(21)	–	(21)
	(1,187)	178	(1,009)	(1,689)	404	(1,285)

	2012 Other reserves £m	2012 Retained earnings £m	2012 Total £m	2011 Other reserves £m	2011 Retained earnings £m	2011 Total £m
Current tax						
Financial instruments	–	–	–	3	–	3
Pensions	–	122	122	–	44	44
Other	–	3	3	–	–	–
	–	125	125	3	44	47
Deferred tax						
Subsidiaries	5	107	112	15	398	413
Tax rate adjustment[1]	–	(70)	(70)	(1)	(68)	(69)
Equity accounted investments – pensions	–	11	11	–	13	13
	5	48	53	14	343	357
Tax on other comprehensive income	5	173	178	17	387	404

1 The UK current tax rate will be reduced from 24% to 23% with effect from 1 April 2013. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 25% to 23%, creating a rate adjustment in 2012, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

7. Discontinued operations

Regional Aircraft

The Asset Management and Support & Engineering businesses, which comprised the Group's Regional Aircraft line of business within the HQ reporting segment, are presented within discontinued operations.

In July 2011, the Group sold the Asset Management business.

The Support & Engineering business is classified as held for sale at 31 December 2012.

Results from discontinued operations

	2012 £m	2011 £m
Revenue	**71**	84
Operating costs[1]	**(67)**	(104)
Other income[2]	**2**	10
Operating profit/(loss)	**6**	(10)
Finance costs	**–**	(3)
Profit/(loss) before taxation	**6**	(13)
Taxation expense	**(1)**	(5)
Profit/(loss) for the year	**5**	(18)
Profit on disposal of discontinued operations	**–**	14
Profit/(loss) for the year – discontinued operations	**5**	(4)

1 2011 includes depreciation and impairment of £56m, including £40m in respect of the carrying value of the Regional Aircraft Asset Management business.
2 Includes profit on disposal of property, plant and equipment of £nil (2011 £9m).

8. Earnings per share

	2012 £m	2012 Basic pence per share	2012 Diluted pence per share	2011 £m	2011 Basic pence per share	2011 Diluted pence per share
Profit for the year attributable to equity shareholders	**1,068**	**33.0**	**32.8**	1,240	36.9	36.7
Represented by:						
Continuing operations	**1,063**	**32.8**	**32.6**	1,244	37.0	36.8
Discontinued operations	**5**	**0.2**	**0.2**	(4)	(0.1)	(0.1)
(Deduct)/add back:						
(Profit)/loss on disposal of businesses	**(103)**			29		
Regulatory penalties	**–**			49		
Net financing charge/(credit) on pensions, post tax	**50**			(18)		
Market value and foreign exchange adjustments on financial instruments and investments, post tax	**4**			(61)		
Charges relating to early redemption of debt, post tax	**–**			10		
Amortisation and impairment of intangible assets, post tax	**192**			188		
Impairment of goodwill	**57**			94		
Underlying earnings, post tax	**1,268**	**39.1**	**39.0**	1,531	45.5	45.3
Represented by:						
Continuing operations	**1,263**	**38.9**	**38.8**	1,535	45.6	45.4
Discontinued operations	**5**	**0.2**	**0.2**	(4)	(0.1)	(0.1)
	1,268	**39.1**	**39.0**	1,531	45.5	45.3
Underlying earnings excluding R&D tax benefit (2011 £197m)				1,334	39.6	39.4
Represented by:						
Continuing operations				1,338	39.7	39.5
Discontinued operations				(4)	(0.1)	(0.1)
				1,334	39.6	39.4

	2012 Millions	2012 Millions	2011 Millions	2011 Millions
Weighted average number of shares used in calculating basic earnings per share	**3,244**	**3,244**	3,365	3,365
Incremental shares in respect of employee share schemes		**14**		17
Weighted average number of shares used in calculating diluted earnings per share		**3,258**		3,382

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.

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December

	Notes	2012 £m	2011 £m
Profit for the year		**1,079**	1,256
Taxation expense	6,7	**296**	211
Share of results of equity accounted investments	1	**(93)**	(131)
Net finance costs	5,7	**271**	117
Depreciation, amortisation and impairment	2,7	**669**	751
Profit on disposal of property, plant and equipment	2,4,7	**(7)**	(17)
Profit on disposal of investment property	2,4	**(12)**	(21)
(Profit)/loss on disposal of businesses	2,4,7	**(103)**	15
Cost of equity-settled employee share schemes		**57**	68
Movements in provisions		**(224)**	(148)
Decrease in liabilities for retirement benefit obligations		**(859)**	(287)
Decrease/(increase) in working capital:			
Inventories		**6**	(85)
Trade and other receivables		**447**	191
Trade and other payables		**931**	(969)
Cash inflow from operating activities		**2,458**	951
Interest paid		**(170)**	(212)
Taxation paid		**(115)**	(257)
Net cash inflow from operating activities		**2,173**	482
Dividends received from equity accounted investments	14	**94**	88
Interest received		**23**	32
Income from financial assets at fair value through profit or loss		**–**	4
Purchases of property, plant and equipment, and investment property		**(359)**	(359)
Purchases of intangible assets		**(43)**	(24)
Proceeds from sale of property, plant and equipment, and investment property		**115**	115
Purchase of subsidiary undertakings (net of cash acquired)	9	**(5)**	(532)
Equity accounted investment funding	14	**(6)**	(1)
Proceeds from sale of subsidiary undertakings (net of cash disposed)	9	**101**	124
Proceeds from sale of financial assets at fair value through profit or loss		**–**	152
Proceeds from sale of other investments		**–**	1
Net proceeds from sale of other deposits/securities	15	**–**	265
Net cash outflow from investing activities		**(80)**	(135)
Purchase of treasury shares		**–**	(503)
Purchase of own shares		**(16)**	(6)
Equity dividends paid	25	**(620)**	(606)
Dividends paid to non-controlling interests		**(11)**	(22)
Cash outflow from matured derivative financial instruments		**(119)**	(34)
Cash outflow from movement in cash collateral		**(2)**	–
Cash inflow from loans		**1,863**	2,693
Cash outflow from repayment of loans		**(1,975)**	(2,541)
Net cash outflow from financing activities		**(880)**	(1,019)
Net increase/(decrease) in cash and cash equivalents[1]		**1,213**	(672)
Cash and cash equivalents at 1 January		**2,136**	2,802
Effect of foreign exchange rate changes on cash and cash equivalents		**(15)**	6
Cash and cash equivalents at 31 December		**3,334**	2,136
Comprising:			
Cash and cash equivalents[2]		**3,355**	2,141
Overdrafts		**(21)**	(5)
Cash and cash equivalents at 31 December		**3,334**	2,136

1 Includes net cash inflow from discontinued operations of £2m (2011 £51m).
2 Includes £nil (2011 £403m) of cash held in Trust for the benefit of the Group's main pension scheme (see note 23).

9. Cash flow analysis

Operating business cash flow

	2012 £m	2011 £m
Cash inflow from operating activities	**2,458**	951
Add back: Amounts already deducted from net cash/(debt) (as defined by the Group)[1]	**458**	–
	2,916	951
Assets contributed to Trust	**(25)**	(137)
Purchases of property, plant and equipment, and investment property	**(359)**	(359)
Purchases of intangible assets	**(43)**	(24)
Proceeds from sale of property, plant and equipment, and investment property	**115**	115
Proceeds from sale of other investments	**–**	1
Equity accounted investment funding	**(6)**	(1)
Dividends received from equity accounted investments	**94**	88
Operating business cash flow	**2,692**	634

	2012 £m	2011 £m
Electronic Systems	**256**	268
Cyber & Intelligence	**113**	123
Platforms & Services (US)	**314**	410
Platforms & Services (UK)	**1,719**	69
Platforms & Services (International)	**506**	80
HQ	**(214)**	(308)
Discontinued operations	**(2)**	(8)
Operating business cash flow	**2,692**	634

1 Comprises the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net cash/(debt).

Cash flows in 2012 from acquisitions and disposals

	Safariland £m	Other £m	Total £m
Proceeds from sale of subsidiary undertakings[2]	77	35	112
Cash and cash equivalents disposed of with subsidiary undertakings	(10)	(1)	(11)
Proceeds from sale of subsidiary undertakings (net of cash disposed)	**67**	**34**	**101**
Purchase of subsidiary undertakings (net of cash acquired)	–	(5)	(5)
Acquisitions and disposals	**67**	**29**	**96**

2 The Group received £108m in respect of the subsidiaries disposed of during 2012 (see note 26) and £4m in respect of sales price adjustments relating to the sale of the Regional Aircraft Asset Management business in 2011.

10. Net cash/(debt) (as defined by the Group)

Movement in net cash/(debt) (as defined by the Group)

	2012 £m	2011 £m
Operating business cash flow (note 9)	**2,692**	634
Interest	**(147)**	(180)
Income from financial assets at fair value through profit or loss	**–**	4
Taxation	**(115)**	(257)
Free cash inflow	**2,430**	201
Acquisitions and disposals (note 9)	**96**	(256)
Equity dividends paid	**(620)**	(606)
Dividends paid to non-controlling interests	**(11)**	(22)
Purchase of own shares, including treasury shares	**(16)**	(509)
Cash outflow from matured derivative financial instruments	**(119)**	(34)
Cash outflow from movement in cash collateral	**(2)**	–
Movement in cash received on customers' account[1]	**1**	13
Foreign exchange adjustment	**92**	(20)
Other non-cash movements	**(25)**	36
Movement in net cash/(debt) (as defined by the Group)	**1,826**	(1,197)
Opening net debt (as defined by the Group)	**(1,439)**	(242)
Closing net cash/(debt) (as defined by the Group)	**387**	(1,439)

Components of net cash/(debt) (as defined by the Group)

	2012 £m	2011 £m
Debt-related derivative financial instrument assets – non-current (note 17)	**22**	56
Cash and cash equivalents	**3,355**	2,141
	3,377	2,197
Loans – non-current (note 21)	**(2,967)**	(2,682)
Loans and overdrafts – current (note 21)	**(21)**	(518)
Less: Cash received on customers' account[1] (note 22)	**(2)**	(3)
Less: Assets held in Trust	**–**	(403)
Less: Cash held for charitable contribution to Tanzania	**–**	(30)
	(2,990)	(3,636)
Net cash/(debt) (as defined by the Group)	**387**	(1,439)

1 Cash received 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. It is included within trade and other payables in the consolidated balance sheet (see note 22).

CONSOLIDATED BALANCE SHEET
as at 31 December

	Notes	2012 £m	2011 £m
Non-current assets			
Intangible assets	11	**10,928**	11,465
Property, plant and equipment	12	**2,285**	2,496
Investment property	13	**122**	130
Equity accounted investments	14	**265**	783
Other investments	15	**5**	5
Other receivables	16	**254**	314
Other financial assets	17	**62**	118
Deferred tax assets	18	**1,375**	1,409
		15,296	16,720
Current assets			
Inventories	19	**655**	716
Trade and other receivables including amounts due from customers for contract work	16	**2,873**	3,369
Current tax		**11**	60
Other financial assets	17	**64**	77
Cash and cash equivalents		**3,355**	2,141
Assets held for sale		**20**	18
		6,978	6,381
Total assets	20	**22,274**	23,101
Non-current liabilities			
Loans	21	**(2,967)**	(2,682)
Trade and other payables	22	**(1,481)**	(571)
Retirement benefit obligations	23	**(4,607)**	(4,673)
Other financial liabilities	17	**(66)**	(74)
Deferred tax liabilities	18	**(13)**	(26)
Provisions	24	**(449)**	(501)
		(9,583)	(8,527)
Current liabilities			
Loans and overdrafts	21	**(21)**	(518)
Trade and other payables	22	**(8,067)**	(8,531)
Other financial liabilities	17	**(88)**	(284)
Current tax		**(422)**	(468)
Provisions	24	**(297)**	(453)
Liabilities held for sale		**(22)**	(21)
		(8,917)	(10,275)
Total liabilities		**(18,500)**	(18,802)
Net assets		**3,774**	4,299
Capital and reserves			
Issued share capital	25	**90**	90
Share premium		**1,249**	1,249
Other reserves	25	**5,079**	5,381
Retained earnings – deficit		**(2,698)**	(2,480)
Total equity attributable to equity holders of the parent		**3,720**	4,240
Non-controlling interests		**54**	59
Total equity		**3,774**	4,299

Approved by the Board on 20 February 2013 and signed on its behalf by:

I G King
Chief Executive

P J Lynas
Group Finance Director

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December

	Attributable to equity holders of the parent						
	Issued share capital £m	Share premium £m	Other reserves[1] £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2012	90	1,249	5,381	(2,480)	4,240	59	4,299
Profit for the year	–	–	–	1,068	1,068	11	1,079
Total other comprehensive income for the year	–	–	(302)	(707)	(1,009)	–	(1,009)
Share-based payments	–	–	–	57	57	–	57
Purchase of own shares	–	–	–	(16)	(16)	–	(16)
Ordinary share dividends	–	–	–	(620)	(620)	(11)	(631)
Other	–	–	–	–	–	(5)	(5)
At 31 December 2012	**90**	**1,249**	**5,079**	**(2,698)**	**3,720**	**54**	**3,774**
At 1 January 2011	90	1,249	5,470	(1,477)	5,332	71	5,403
Profit for the year	–	–	–	1,240	1,240	16	1,256
Total other comprehensive income for the year	–	–	(89)	(1,196)	(1,285)	–	(1,285)
Share-based payments	–	–	–	68	68	–	68
Purchase of own shares	–	–	–	(6)	(6)	–	(6)
Purchase of treasury shares	–	–	–	(503)	(503)	–	(503)
Ordinary share dividends	–	–	–	(606)	(606)	(22)	(628)
Other	–	–	–	–	–	(6)	(6)
At 31 December 2011	90	1,249	5,381	(2,480)	4,240	59	4,299

1 An analysis of other reserves is provided in note 25.

NOTES TO THE GROUP ACCOUNTS – BALANCE SHEET

11. Intangible assets

	Goodwill £m	Programme and customer related[1] £m	Other[2] £m	Total £m
Cost or valuation				
At 1 January 2011	13,588	1,944	465	15,997
Additions:				
Acquired separately	–	–	17	17
Internally developed	–	–	7	7
Acquisition of subsidiaries	291	179	91	561
Adjustment on finalisation of provisional goodwill	5	–	–	5
Business disposals	(33)	(10)	(6)	(49)
Transfer from property, plant and equipment	–	–	3	3
Foreign exchange adjustments	49	11	–	60
At 31 December 2011	13,900	2,124	577	16,601
Additions:				
Acquired separately	–	–	39	39
Internally developed	–	–	8	8
Adjustment on finalisation of provisional goodwill (note 26)	2	–	–	2
Transfer from property, plant and equipment	–	–	40	40
Transfer to held for sale[3]	(227)	(165)	(94)	(486)
Business disposals	(12)	(37)	(4)	(53)
Foreign exchange adjustments	(305)	(63)	(15)	(383)
At 31 December 2012	**13,358**	**1,859**	**551**	**15,768**
Amortisation and impairment				
At 1 January 2011	3,123	1,373	285	4,781
Amortisation charge	–	158	81	239
Impairment charge	94	13	2	109
Business disposals	–	(9)	(5)	(14)
Foreign exchange adjustments	7	10	4	21
At 31 December 2011	3,224	1,545	367	5,136
Amortisation charge	–	160	66	226
Impairment charge	57	11	18	86
Transfer from property, plant and equipment	–	–	6	6
Transfer to held for sale[3]	(227)	(155)	(81)	(463)
Business disposals	(12)	(25)	(4)	(41)
Foreign exchange adjustments	(50)	(51)	(9)	(110)
At 31 December 2012	**2,992**	**1,485**	**363**	**4,840**
Net book value				
At 31 December 2012	**10,366**	**374**	**188**	**10,928**
At 31 December 2011	10,676	579	210	11,465
At 1 January 2011	10,465	571	180	11,216

1 Relates to intangible assets recognised on acquisition of subsidiary companies, mainly in respect of ongoing programme relationships and the acquired order book.
2 Includes patents, trademarks, software and internally funded development costs.
3 Represents Safariland (net book value £23m).

The Group has no indefinite life intangible assets other than goodwill.

Impairment testing
In order to calculate the recoverable amount of the Group’s goodwill, all goodwill balances have been considered with regard to value-in-use calculations.

The value-in-use 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 growth rate assumptions applied. The IBP process includes the use of historic experience, available government spending data and the Group’s order backlog. Pre-tax discount rates, derived from the Group’s post-tax weighted average cost of capital of 6.72% (2011 7.37%) (adjusted for risks specific to the market in which the cash-generating unit (CGU) operates), have been used in discounting these projected risk-adjusted cash flows.

11. Intangible assets (continued)

Significant CGUs

Goodwill allocated to CGUs which are largely dependent on US government spending on defence, aerospace and security represents £8.5bn (2011 £8.9bn) of the Group's total goodwill balance.

		Allocated goodwill		Pre-tax discount rate	
Significant CGUs	Key assumptions	**2012 £bn**	2011 £bn	**2012 %**	2011 %
Electronic Systems	Continued demand from the US government for electronic warfare systems (where the business has a leadership position), other technology-based solutions and growth in the commercial avionics market	**3.1**	3.2	**8.2**	9.2
Intelligence & Security (within Cyber & Intelligence)	Continued demand in the US for the Group's services in the areas of homeland security, law enforcement and counter-intelligence	**1.3**	1.4	**8.2**	9.2
Support Solutions (within Platforms & Services (US))	Continued demand in the US for complex infrastructure, maritime and aviation services, and operations support	**1.0**	1.0[1]	**8.2**	9.2
Land & Armaments (within Platforms & Services (US))	Continued demand in the Group's principal markets for existing and successor military wheeled and tracked vehicles, naval guns, missile launchers, artillery systems, munitions, upgrade programmes, and support	**3.1**	3.3[1]	**7.7**	8.8

1 Re-presented for the transfer of the Protection Systems business from Land & Armaments to Support Solutions.

The final year growth rate assumption in the value-in-use calculations, after adjusting for assumed 3% inflation, is 0% (2011 0%).

The Group monitors changes in defence budgets on an ongoing basis. There is continuing uncertainty as to the potential impact of a sequestration or other budget reductions that could result in indiscriminate cuts to US government spending. The future cash flow projections used in the IBP do not include the potential full impact of a sequestration.

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2012 and the value-in-use calculations, for the CGUs listed above is shown below. The table also shows the headroom assuming a 1% reduction in the final year growth rate assumption used in the value-in-use calculations.

	Headroom as at 31 December		Headroom assuming a 1% reduction in final year growth rate assumption	
	2012 £bn	2011 £bn	**2012 £bn**	2011 £bn
Electronic Systems	**3.7**	2.6	**2.2**	1.5
Intelligence & Security	**0.5**	0.2	**0.1**	(0.1)
Support Solutions	**1.5**	1.0	**0.9**	0.6
Land & Armaments	**1.8**	1.4	**0.7**	0.4

Other CGUs

The remaining goodwill balance of £1.9bn (2011 £1.8bn) is allocated across multiple CGUs, including £0.5bn in the BAE Systems Detica CGU, with no other individual CGU exceeding 5% of the Group's total goodwill balance. The majority of the projected cash flows within these CGUs are underpinned by expected levels of primarily UK government spending on defence, aerospace and security, and the Group's ability to capture a broadly consistent market share. In the case of BAE Systems Detica, the future cash flow projections are based on the expectation of growth in cyber and intelligence, both in the UK and overseas government markets, with increasing demand for products and services in commercial markets.

Impairment – goodwill

In 2012, the impairment charge of £57m comprises the Safariland (£27m) and Tensylon (£12m) businesses disposed of during the year (see note 26) and the Commercial Armored Vehicles business (£18m), all within the Land & Armaments CGU. The impairment in respect of the Commercial Armored Vehicles business reflects the agreement to sell the business at a price below its carrying value.

In 2011, the impairment charge of £94m comprised the Safety Products business within the Land & Armaments CGU (£60m) and Naval Ships (£34m).

Impairment – intangible assets

In 2012, the impairment charge of £29m primarily relates to the Land & Armaments business within the Platforms & Services (US) reporting segment and includes £21m in respect of the Safariland business disposed of during the year.

In 2011, the impairment charge of £15m related to the Land & Armaments business within the Platforms & Services (US) reporting segment.

12. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Cost				
At 1 January 2011	2,477	2,681	701	5,859
Additions	89	240	7	336
Acquisition of subsidiaries	8	2	–	10
Adjustment on finalisation of provisional fair values on acquisitions	–	(2)	–	(2)
Transfer (to)/from inventories	–	(5)	1	(4)
Transfer to investment properties	(7)	–	–	(7)
Transfer to other intangible assets	–	(3)	–	(3)
Transfer to held for sale[1]	(4)	(72)	(643)	(719)
Reclassification between categories	8	1	(9)	–
Disposals	(84)	(142)	(42)	(268)
Business disposals	(2)	(17)	–	(19)
Foreign exchange adjustments	8	8	(15)	1
At 31 December 2011	2,493	2,691	–	5,184
Additions	81	256	–	337
Transfer to other intangible assets	–	(40)	–	(40)
Transfer to held for sale[2]	(15)	(11)	–	(26)
Reclassification between categories	(17)	17	–	–
Disposals	(88)	(122)	–	(210)
Business disposals	(3)	(14)	–	(17)
Foreign exchange adjustments	(66)	(53)	–	(119)
At 31 December 2012	**2,385**	**2,724**	**–**	**5,109**
Depreciation and impairment				
At 1 January 2011	741	1,859	545	3,145
Depreciation charge for the year	133	188	10	331
Impairment charge for the year	30	11	44	85
Impairment write back	(16)	–	(1)	(17)
Transfer to inventories	–	(5)	–	(5)
Transfer to held for sale[1]	(4)	(72)	(543)	(619)
Reclassification between categories	5	3	(8)	–
Disposals	(55)	(130)	(34)	(219)
Business disposals	–	(9)	–	(9)
Foreign exchange adjustments	4	5	(13)	(4)
At 31 December 2011	838	1,850	–	2,688
Depreciation charge for the year	128	191	–	319
Impairment charge for the year	28	7	–	35
Transfer to other intangible assets	–	(6)	–	(6)
Transfer to held for sale[2]	(3)	(8)	–	(11)
Reclassification between categories	(5)	5	–	–
Disposals	(13)	(118)	–	(131)
Business disposals	(1)	(12)	–	(13)
Foreign exchange adjustments	(21)	(36)	–	(57)
At 31 December 2012	**951**	**1,873**	**–**	**2,824**
Net book value				
At 31 December 2012	**1,434**	**851**	**–**	**2,285**
At 31 December 2011	1,655	841	–	2,496
At 1 January 2011	1,736	822	156	2,714

1 Comprises the Regional Aircraft Asset Management (net book value £95m) and Regional Aircraft Support & Engineering (net book value £5m) businesses.
2 Represents Safariland (net book value £15m).

12. Property, plant and equipment (continued)

Net book value

	Land and buildings £m	Plant and machinery £m	Total £m
Freehold property	1,230	–	1,230
Long leasehold property	93	–	93
Short leasehold property	111	–	111
Plant and machinery	–	772	772
Fixtures, fittings and equipment	–	79	79
At 31 December 2012	**1,434**	**851**	**2,285**

Net impairment

	2012 £m	2011 £m
Electronic Systems	**–**	2
Platforms & Services (US)	**15**	7
Platforms & Services (International)	**20**	12
Discontinued operations	**–**	47
	35	68

2012

The impairment charge of £35m mainly comprises charges in respect of the carrying value of land and buildings in Saudi Arabia (£20m), and assets of US businesses prior to their disposal (£7m).

2011

The net impairment charge of £68m comprised £21m from continuing operations and £47m in respect of the Regional Aircraft line of business within discontinued operations (note 7).

Assets in the course of construction

	Land and buildings £m	Plant and machinery £m	Total £m
At 31 December 2012	**23**	**115**	**138**
At 31 December 2011	57	144	201

Operating leases

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:

	2012 £m	2011 £m
Receipts due:		
Not later than one year	**24**	21
Later than one year and not later than five years	**96**	82
Later than five years	**139**	157
	259	260

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations. There is no lease income relating to assets held by the Group under capitalised finance leases within the above.

13. Investment property

	£m
Cost	
At 1 January 2011	177
Additions	21
Transfer from property, plant and equipment	7
Disposals	(29)
At 31 December 2011	176
Additions	20
Disposals	(25)
At 31 December 2012	**171**
Depreciation and impairment	
At 1 January 2011	43
Depreciation charge for the year	3
Impairment	1
Disposals	(1)
At 31 December 2011	46
Depreciation charge for the year	3
At 31 December 2012	**49**
Net book value	
At 31 December 2012	**122**
At 31 December 2011	130
At 1 January 2011	134

Fair value	
At 31 December 2012	**197**
At 31 December 2011	228

The fair values above are based on and reflect current market values as prepared by in-house professionals who have the appropriate professional qualifications and recent experience of valuing properties in the location and of the type being valued.

14. Equity accounted investments

Principal equity accounted investments

Joint ventures	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
Eurofighter Jagdflugzeug GmbH *(Held by BAE Systems plc)*	Management and control of the European 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

The Company has taken advantage of the exemption under Section 410(2) of the Companies Act 2006 by providing information only in relation to equity accounted investments whose results or financial position, in the opinion of the directors, principally affected the financial statements. Accordingly, the equity accounted investments listed in the table above are those that represent more than 5% of total Group sales or underlying EBITA[1]. A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2012 will be annexed to the Company's next annual return filed with the Registrar of Companies.

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Carrying value (including goodwill)

	£m
At 1 January 2011	787
Share of results after tax	131
Acquisitions	1
Equity accounted investment funding	1
Dividends received	(88)
Actuarial losses on defined benefit pension schemes, net of tax	(32)
Foreign exchange adjustment	(17)
At 31 December 2011	783
Share of results after tax	93
Equity accounted investment funding	6
Dividends received	(94)
Non-cash special dividend (note 29)	(424)
Actuarial losses on defined benefit pension schemes, net of tax	(73)
Adjustment on finalisation of provisional fair values on acquisitions	(1)
Foreign exchange adjustment	(25)
At 31 December 2012	**265**

Share of assets and liabilities

	2012 £m	2011 £m
Assets:		
Non-current assets	**781**	745
Current assets	**2,278**	3,108
	3,059	3,853
Liabilities:		
Non-current liabilities	**(443)**	(462)
Current liabilities	**(2,351)**	(2,608)
	(2,794)	(3,070)
Carrying value	**265**	783

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

15. Other investments

	2012 £m	2011 £m
Non-current		
Available-for-sale financial assets		
Equity securities	**5**	5
	5	5

Reconciliation of movements

	2012 £m	2011 £m
Non-current		
At 1 January	**5**	11
Disposals	**–**	(1)
Reclassification of fair value movements[1]	**–**	(5)
At 31 December	**5**	5
Current		
At 1 January	**–**	260
Additions	**–**	13
Disposals	**–**	(278)
Fair value movements	**–**	5
At 31 December	**–**	–

1 Relates to the acquisition of the remaining 91.3% interest in Fairchild Imaging, Inc.

16. Trade and other receivables

	2012 £m	2011 £m
Non-current		
Pension prepayments (note 23)	**47**	53
Prepayments and accrued income	**9**	16
US deferred compensation plan assets	**187**	180
Other receivables	**11**	65
	254	314
Current		
Long-term contract balances	**6,521**	6,459
Less: Attributable progress payments	**(5,703)**	(5,532)
Amounts due from contract customers	**472**	552
Amounts due from customers for contract work[1]	**1,290**	1,479
Trade receivables	**882**	1,141
Amounts owed by equity accounted investments (note 29)	**163**	234
Prepayments and accrued income	**270**	268
Other receivables	**268**	247
	2,873	3,369

1 There are no retentions against long-term contracts (2011 £nil) and no amounts that are past due within amounts due from customers for contract work (2011 £nil).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2012 are estimated to be £31.4bn (2011 £30.3bn).

The ageing of trade receivables is detailed below:

	2012			2011		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due and not impaired	**659**	**–**	**659**	942	–	942
Up to 180 days overdue and not impaired	**142**	**–**	**142**	121	–	121
Up to 180 days overdue and impaired	**1**	**(1)**	**–**	–	–	–
Past 180 days overdue and not impaired	**81**	**–**	**81**	78	–	78
Past 180 days overdue and impaired	**30**	**(30)**	**–**	39	(39)	–
	913	**(31)**	**882**	1,180	(39)	1,141

Trade receivables are disclosed net of a provision for impairment losses. Movements on the provision are as follows:

	2012 £m	2011 £m
At 1 January	**39**	41
Created	**20**	18
Released	**(18)**	(20)
Utilised	**(7)**	(2)
Foreign exchange adjustments	**(1)**	(1)
Other	**(2)**	3
At 31 December	**31**	39

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

	2012 Assets £m	2012 Liabilities £m	2011 Assets £m	2011 Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**25**	**(66)**	38	(67)
Other foreign exchange/interest rate contracts	**15**	**–**	24	(7)
Debt-related derivative financial instruments – assets[1]	**22**	**–**	56	–
	62	**(66)**	118	(74)
Current				
Cash flow hedges – foreign exchange contracts	**32**	**(58)**	42	(58)
Other foreign exchange/interest rate contracts	**32**	**(30)**	35	(226)
	64	**(88)**	77	(284)

1 Includes fair value hedges of £13m (2011 £15m).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (see note 21).

The notional principal amounts of the outstanding contracts are detailed in note 27.

Cash flow hedges

The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts debited to the hedging reserve in respect of cash flow hedges were £21m (2011 £56m).

The amount debited from equity and included in contract-related non-financial assets and liabilities was £6m (2011 credit £11m).

Fair value hedges

The loss arising in the income statement on fair value hedging instruments was £2m (2011 £10m). The gain arising in the income statement on the fair value of the underlying hedged items was £2m (2011 £11m). There was no ineffective portion recognised in the income statement arising from fair value hedges (2011 gain £15m).

Fair value hierarchy

The fair value measurement hierarchy is as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

All of the financial assets and liabilities above are classified as level 2 using the fair value hierarchy.

18. Deferred tax

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Property, plant and equipment	**7**	–	**(88)**	(106)	**(81)**	(106)
Intangible assets	**–**	–	**(91)**	(176)	**(91)**	(176)
Provisions and accruals	**317**	367	**–**	–	**317**	367
Goodwill	**–**	–	**(186)**	(151)	**(186)**	(151)
Pension/retirement schemes:						
Deficits	**1,144**	1,239	**–**	–	**1,144**	1,239
Additional contributions and other[1]	**137**	101	**–**	–	**137**	101
Share-based payments	**16**	11	**–**	–	**16**	11
Financial instruments	**19**	27	**(11)**	(14)	**8**	13
Other items	**62**	40	**–**	(2)	**62**	38
Rolled over capital gains	**–**	–	**(15)**	(16)	**(15)**	(16)
Capital losses carried forward	**15**	16	**–**	–	**15**	16
Trading losses carried forward	**36**	47	**–**	–	**36**	47
Deferred tax assets/(liabilities)	**1,753**	1,848	**(391)**	(465)	**1,362**	1,383
Set off of tax	**(378)**	(439)	**378**	439	**–**	–
Net deferred tax assets/(liabilities)	**1,375**	1,409	**(13)**	(26)	**1,362**	1,383

1 Includes deferred tax assets on US deferred compensation plans.

18. Deferred tax (continued)

Movement in temporary differences during the year

	At 1 January 2012 £m	Foreign exchange adjustments £m	Acquisitions and disposals[1] £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2012 £m**
Property, plant and equipment	(106)	4	1	20	–	**(81)**
Intangible assets	(176)	4	9	64	8	**(91)**
Provisions and accruals	367	(13)	(2)	(35)	–	**317**
Goodwill	(151)	7	(3)	(39)	–	**(186)**
Pension/retirement schemes:						
Deficits	1,239	(12)	–	(76)	(7)	**1,144**
Additional contributions and other[3]	101	(5)	–	6	35	**137**
Share-based payments	11	(1)	–	4	2	**16**
Financial instruments	13	(2)	–	(7)	4	**8**
Other items	38	(1)	–	25	–	**62**
Rolled over capital gains	(16)	–	–	1	–	**(15)**
Capital losses carried forward	16	–	–	(1)	–	**15**
Trading losses carried forward	47	(2)	(1)	(8)	–	**36**
	1,383	(21)	4	(46)	42	**1,362**

	At 1 January 2011 £m	Foreign exchange adjustments £m	Acquisitions and disposals[2] £m	Recognised in income £m	Recognised in equity £m	At 31 December 2011 £m
Property, plant and equipment	(104)	–	(13)	11	–	(106)
Intangible assets	(207)	1	(53)	75	8	(176)
Provisions and accruals	394	1	5	(33)	–	367
Goodwill	(110)	(2)	1	(40)	–	(151)
Pension/retirement schemes:						
Deficits	1,060	5	–	(159)	333	1,239
Additional contributions and other[3]	18	1	–	93	(11)	101
Share-based payments	11	–	–	–	–	11
Financial instruments	8	–	–	(9)	14	13
Other items	56	–	11	(29)	–	38
Rolled over capital gains	(17)	–	–	1	–	(16)
Capital losses carried forward	17	–	–	(1)	–	16
Trading losses carried forward	28	1	1	17	–	47
	1,154	7	(48)	(74)	344	1,383

1 Includes net deferred tax liabilities on disposal of subsidiaries (£6m) and the transfer of net deferred tax assets to held for sale (Safariland £2m).
2 Includes net deferred tax liabilities on acquisitions (Norkom £18m, ETI £14m and other £3m) and the transfer of net deferred tax assets to held for sale (£13m).
3 Includes deferred tax assets on US deferred compensation plans.

18. Deferred tax (continued)

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2012 £m	2011 £m
Deductible temporary differences, including tax credits	**3**	11
Capital losses carried forward	**59**	43
Trading and other losses carried forward	**68**	86
	130	140

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.

Future changes in tax rates

The UK current tax rate was reduced from 26% to 24% with effect from 1 April 2012. Under the Finance Act 2012, the UK current tax rate will reduce to 23% with effect from 1 April 2013. The Chancellor has also proposed to reduce further the current tax rate to 21% with effect from 1 April 2014. This will reduce future current tax charges accordingly.

The reduction from 24% to 23% was substantively enacted before 31 December 2012. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 25% to 23%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income. Accordingly, both recognised and unrecognised UK deferred tax balances as at 31 December 2012 have been calculated at 23%.

The reduction in the rate from 23% to 21% has not yet been substantively enacted. If this reduction had been substantively enacted by 31 December 2012, the effect would have been to reduce the net deferred tax asset at that date from £1,362m to £1,282m. Of this reduction, it is estimated that £10m would have been charged to the consolidated income statement and £70m charged to the consolidated statement of comprehensive income. In addition, unrecognised deferred tax assets as at 31 December 2012 would have been reduced from £130m to £123m.

19. Inventories

	2012 £m	2011 £m
Short-term work-in-progress	**385**	251
Raw materials and consumables	**203**	276
Finished goods and goods for resale	**67**	189
	655	716

The Group recognised £10m (2011 £6m) as a write down of inventories to net realisable value.

20. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Notes	2012 £m	2011 £m
United Kingdom		**2,402**	2,515
Rest of Europe		**707**	1,274
Saudi Arabia		**615**	703
United States		**9,464**	10,000
Australia		**599**	617
Rest of Asia and Pacific		**4**	7
Africa, Central and South America		**21**	24
Non-current reporting segment assets		**13,812**	15,140
Financial instruments	17	**104**	139
Inventories	19	**655**	716
Trade and other receivables	16	**2,873**	3,369
Total reporting segment assets		**17,444**	19,364
Tax		**1,386**	1,469
Pension prepayments	23	**47**	53
Assets held for sale		**20**	18
Cash (as defined by the Group)	10	**3,377**	2,197
Consolidated total assets		**22,274**	23,101

21. Loans and overdrafts

	2012 £m	2011 £m
Non-current		
Euro-Sterling £100m 10¾% bond, repayable 2014	**100**	100
US$500m 4.95% bond, repayable 2014	**308**	321
US$750m 5.2% bond, repayable 2015	**459**	482
US$350m 3.5% bond, repayable 2016	**214**	224
Albertville Hangar Bond, repayable 2018	**6**	6
US$1bn 6.375% bond, repayable 2019	**626**	656
US$500m 4.75% bond, repayable 2021	**307**	320
£400m 4.125% bond, repayable 2022	**397**	–
US$500m 7.5% bond, repayable 2027	**306**	319
US$400m 5.8% bond, repayable 2041	**243**	254
Debt-related derivative financial instruments – liabilities	**1**	–
	2,967	2,682
Current		
Loans and overdrafts	**21**	5
US$ Commercial Paper	**–**	513
	21	518

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 2012				
Carrying amount	**21**	**1,094**	**1,873**	**2,988**
Debt-related derivative financial instruments – assets (note 17)	**–**	**(13)**	**(9)**	**(22)**
Carrying amount including debt-related derivative financial instruments – assets	**21**	**1,081**	**1,864**	**2,966**
Contractual cash flows, including future interest payments	**187**	**1,605**	**2,657**	**4,449**
At 31 December 2011				
Carrying amount	518	1,142	1,540	3,200
Debt-related derivative financial instruments – assets (note 17)	–	(15)	(41)	(56)
Carrying amount including debt-related derivative financial instruments – assets	518	1,127	1,499	3,144
Contractual cash flows, including future interest payments	661	1,636	2,336	4,633

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 4.95% bond, repayable 2014, was converted on issue to a floating rate bond utilising a series of interest rate swaps giving an effective rate during 2012 of 2.58%.

US$500m of the US$1bn 6.375% bond, repayable 2019, has been converted to a floating rate bond utilising a series of interest rate swaps that mature in December 2014 and give an effective rate during 2012 of 5.52%. This portion is measured at fair value and has been classified as level 2 in the fair value hierarchy (see note 17 for definitions).

The US$500m 7.5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising cross-currency swaps and has an effective interest rate of 7.73%.

The debt-related derivative financial instruments represent the fair value of certain interest rate and cross-currency derivatives relating to the US$1bn 6.375% bond, repayable 2019, and the US$500m 7.5% bond, repayable 2027. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

22. Trade and other payables

	2012 £m	2011 £m
Non-current		
Amounts due to long-term contract customers	**988**	93
Accruals and deferred income	**46**	47
US deferred compensation plan liabilities	**222**	220
Other payables	**225**	211
	1,481	571
Current		
Amounts due to long-term contract customers	**4,457**	4,354
Amounts due to other customers	**242**	254
Cash received on customers' account[1]	**2**	3
Trade payables	**710**	966
Amounts owed to equity accounted investments (note 29)[2]	**708**	1,161
Other taxes and social security costs	**63**	63
Accruals and deferred income[3]	**1,291**	1,236
Other payables	**594**	494
	8,067	8,531

	2012 £m	2011 £m
Included above:		
Amounts due to long-term contract customers	**5,445**	4,449
Advances from long-term contract customers, including progress payments in respect of work not yet performed	**5,132**	4,164

1 Cash received 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. This includes £nil (2011 £2m) in respect of long-term contract customers.
2 Reduction primarily relates to the £424m non-cash special dividend received in 2012.
3 Includes £131m (2011 £125m) in respect of the settlement reached on the terminated Trinidad and Tobago contract for Offshore Patrol Vessels, of which £101m was paid in January 2013, with the remainder due in May 2013.

23. Retirement benefit obligations

Pension schemes

BAE Systems plc operates pension schemes for the Group's qualifying employees in the UK, US and other countries. The principal schemes in the UK and US are funded defined benefit schemes, and the assets are held in separate trustee administered funds. The schemes in other countries are primarily defined contribution schemes. Pension scheme valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19, Employee Benefits, deficit.

The disclosures below relate to post-retirement benefit schemes in the UK, US and other countries which are accounted for as defined benefit schemes 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 as updated to take account of the requirements of IAS 19 to assess the deficits of the schemes at 31 December each year.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit schemes, 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 schemes, covering retiree medical and life insurance schemes in certain US subsidiaries, were performed by independent actuaries as at 1 January 2012. These schemes were rolled forward to reflect the information at 31 December 2012. The method of accounting for these is similar to that used for defined benefit pension schemes.

Principal financial assumptions used to calculate liabilities for the UK and US schemes

	UK			US		
	2012 %	2011 %	2010 %	**2012** %	2011 %	2010 %
Discount rate	**4.5**	4.8	5.5	**4.1**	5.0	5.5
Inflation	**2.9**	2.9	3.4	**n/a**	n/a	n/a
Rate of increase in salaries[1]	**3.4**	3.4	4.4	**3.7**	4.5	4.5
Rate of increase for pensions in payment	**1.8 – 3.5**	1.9 – 3.4	2.3 – 3.6	**n/a**	n/a	n/a
Rate of increase for deferred pensions[2]	**2.3/2.9**	2.0/2.9	2.8/3.4	**n/a**	n/a	n/a
Long-term healthcare cost increases	**n/a**	n/a	n/a	**5.2**	5.3	5.3

1 The rate of increase in salaries for the UK schemes is assumed to be 0.5% (2011 0.5%) above the Retail Prices Index (RPI) inflation of 2.9% (2011 2.9%), plus a promotional scale. From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.
2 The assumption for the rate of increase for deferred pensions is 2.3% (2011 2.0%) in respect of those schemes which refer to the Consumer Prices Index as the relevant measure and 2.9% (2011 2.9%) where RPI is the relevant measure.

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 values of scheme 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 values of scheme liabilities, which are derived from cash flow projections over long periods and therefore inherently uncertain, as at 31 December are shown in the following tables.

Discount rate assumptions are based on third-party AA corporate bond indices and yields that reflect the maturity profile of the expected benefit payments. In the UK, the inflation assumptions are derived by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, or advice from the local actuary depending on the available information. The inflation assumptions are used to derive the rate of increase for pensions in payment and the rate of increase for deferred pensions where there is such an increase.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2012, used the SAPS S1 mortality 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 scheme members. In addition, to allow for future improvements in longevity, the CMI 2010 tables (published by the Institute of Actuaries) have been used, with an assumed long-term rate of future annual mortality improvements of 1%, for both pensioner and non-pensioner members. The mortality tables used for the US pension arrangements have been updated this year, from the 2012 IRS Static Tables, to the most recently published tables, the 2013 IRS Static Tables. The mortality tables are projected to 2020 for pensioners and to 2028 for non-pensioners. The current life expectancies underlying the value of the accrued liabilities for the main UK schemes range from 22 to 24 years for current male pensioners at age 65 and 24 to 25 years for current female pensioners at age 65 and, for the main US schemes, 19 years for current male pensioners at age 65 and 21 years for current female pensioners at age 65.

In February 2013, with the agreement of the Company, the trustees of the BAE Systems 2000 Pension Plan (2000 Plan) entered into an arrangement with Legal & General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. This will reduce the funding volatility relating to increasing life expectancy.

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 8.5% in 2013 reducing to 5% by 2020 for pre-retirement and 8.0% in 2013 reducing to 5% by 2019 for post-retirement.

A summary of the movements in the retirement benefit obligations is shown in the following table. The full disclosures, as required by IAS 19, are provided in the subsequent information.

23. Retirement benefit obligations (continued)

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total IAS 19 deficit at 1 January 2012	(4,676)	(909)	(5,585)
Actual return on assets above expected return	478	211	689
Increase in liabilities due to changes in assumptions and experience	(1,307)	(416)	(1,723)
Additional contributions in excess of service cost	698	–	698
Recurring contributions in excess of service cost	145	92	237
Past service cost	(26)	(1)	(27)
Curtailment gains	–	26	26
Net financing (charge)/credit	(107)	35	(72)
Foreign exchange adjustment	–	38	38
Movement in US healthcare schemes	–	11	11
Total IAS 19 deficit at 31 December 2012	**(4,795)**	**(913)**	**(5,708)**
Allocated to equity accounted investments and other participating employers	1,148	–	1,148
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers at 31 December 2012	**(3,647)**	**(913)**	**(4,560)**

During the year, the Group contributed £25m into Trust for the benefit of the 2000 Plan. On 27 September, £387m was paid out of the Trust into the BAE Systems Pension Scheme (Main Scheme) and £25m was paid out of the Trust into the 2000 Plan. In December, the remaining £16m was paid into the Main Scheme. These payments are included within additional contributions in excess of service cost in the table above. The Group considers the contributions made to the Trust to be equivalent to the other lump sum contributions it makes into the Group's pension schemes and, accordingly, presents below a definition of the pension deficit including them.

	2012 £m	2011 £m
Group's share of IAS 19 deficit, net	**(4,560)**	(4,620)
Assets held in Trust	**–**	403
Pension deficit (as defined by the Group)	**(4,560)**	(4,217)

Amounts recognised on the balance sheet

	2012				2011			
	UK defined benefit pension schemes £m	**US and other pension schemes £m**	**US healthcare schemes £m**	**Total £m**	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Present value of unfunded obligations	**(53)**	**(142)**	**(5)**	**(200)**	(50)	(145)	(10)	(205)
Present value of funded obligations	**(21,353)**	**(3,609)**	**(129)**	**(25,091)**	(19,636)	(3,315)	(136)	(23,087)
Fair value of scheme assets	**16,611**	**2,843**	**129**	**19,583**	15,010	2,567	130	17,707
Total IAS 19 deficit, net	**(4,795)**	**(908)**	**(5)**	**(5,708)**	(4,676)	(893)	(16)	(5,585)
Allocated to equity accounted investments and other participating employers	**1,148**	**–**	**–**	**1,148**	965	–	–	965
Group's share of IAS 19 deficit, net	**(3,647)**	**(908)**	**(5)**	**(4,560)**	(3,711)	(893)	(16)	(4,620)
Represented by:								
Pension prepayments (within trade and other receivables)	**–**	**38**	**9**	**47**	–	34	19	53
Retirement benefit obligations	**(3,647)**	**(946)**	**(14)**	**(4,607)**	(3,711)	(927)	(35)	(4,673)
	(3,647)	**(908)**	**(5)**	**(4,560)**	(3,711)	(893)	(16)	(4,620)
Group's share of IAS 19 deficit of equity accounted investments	**(137)**	**–**	**–**	**(137)**	(129)	–	–	(129)

23. Retirement benefit obligations (continued)

Amounts for the current and previous four years are as follows:

Defined benefit pension schemes	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Defined benefit obligations	**(25,157)**	(23,146)	(21,158)	(20,488)	(17,133)
Fair value of scheme assets	**19,454**	17,577	17,076	14,915	12,978
Total deficit before tax and allocation to equity accounted investments and other participating employers	**(5,703)**	(5,569)	(4,082)	(5,573)	(4,155)
Actuarial (loss)/gain on scheme liabilities	**(1,723)**	(1,405)	55	(3,342)	1,433
Actuarial gain/(loss) on scheme assets at bid value	**689**	(422)	1,043	1,258	(3,724)

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £5.0bn (2011 £4.1bn).

Certain of the Group's equity accounted investments participate in the Group's defined benefit schemes as well as Airbus SAS, the Group's share of which was disposed of in 2006. As these schemes are multi-employer schemes, the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and Airbus SAS based upon a 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. In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote.

Assets of defined benefit pension schemes

	2012							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	**8,412**	**51**	**7.10**	**1,678**	**59**	**8.10**	**10,090**	**52**
Bonds	**6,639**	**40**	**3.23**	**982**	**35**	**4.10**	**7,621**	**39**
Property[1]	**1,240**	**7**	**6.00**	**183**	**6**	**7.40**	**1,423**	**7**
Other	**320**	**2**	**1.00**	**–**	**–**	**–**	**320**	**2**
Total	**16,611**	**100**	**5.35**	**2,843**	**100**	**6.67**	**19,454**	**100**

	2011							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	7,548	50	7.25	1,452	57	8.70	9,000	51
Bonds	6,164	41	3.40	912	35	4.50	7,076	40
Property[1]	1,117	8	6.00	203	8	7.30	1,320	8
Other	181	1	1.00	–	–	–	181	1
Total	15,010	100	5.50	2,567	100	7.10	17,577	100

1 Includes £255m (2011 £185m) of properties occupied by Group companies.

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.

23. Retirement benefit obligations (continued)

Changes in the fair value of scheme assets are as follows:

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Value of scheme assets at 1 January 2011	14,580	2,496	127	17,203
Expected return on assets	967	195	9	1,171
Actuarial loss	(305)	(117)	(6)	(428)
Actual return on assets	662	78	3	743
Contributions by employer	474	111	4	589
Contributions by employer in respect of employee salary sacrifice arrangements	103	–	–	103
Total contributions by employer	577	111	4	692
Members' contributions (including Department for Work and Pensions rebates)	36	15	–	51
Foreign exchange gain	–	18	1	19
Benefits paid	(845)	(151)	(5)	(1,001)
Value of scheme assets at 31 December 2011	15,010	2,567	130	17,707
Expected return on assets	825	198	9	1,032
Actuarial gain/(loss)	478	211	(1)	688
Actual return on assets	1,303	409	8	1,720
Contributions by employer	1,021	136	4	1,161
Contributions by employer in respect of employee salary sacrifice arrangements	99	–	–	99
Total contributions by employer	1,120	136	4	1,260
Members' contributions (including Department for Work and Pensions rebates)	23	14	–	37
Foreign exchange loss	–	(119)	(6)	(125)
Benefits paid	(845)	(164)	(7)	(1,016)
Value of scheme assets at 31 December 2012	**16,611**	**2,843**	**129**	**19,583**

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 schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Defined benefit obligations at 1 January 2011	(18,018)	(3,140)	(148)	(21,306)
Current service cost	(161)	(49)	(2)	(212)
Contributions by employer in respect of employee salary sacrifice arrangements	(103)	–	–	(103)
Total current service cost	(264)	(49)	(2)	(315)
Members' contributions (including Department for Work and Pensions rebates)	(36)	(15)	–	(51)
Past service (cost)/credit	(45)	(2)	2	(45)
Actuarial (loss)/gain on liabilities	(1,192)	(213)	3	(1,402)
Curtailment gains	–	–	2	2
Interest expense	(976)	(164)	(7)	(1,147)
Foreign exchange loss	–	(28)	(1)	(29)
Benefits paid	845	151	5	1,001
Defined benefit obligations at 31 December 2011	(19,686)	(3,460)	(146)	(23,292)
Current service cost	(178)	(44)	(2)	(224)
Contributions by employer in respect of employee salary sacrifice arrangements	(99)	–	–	(99)
Total current service cost	(277)	(44)	(2)	(323)
Members' contributions (including Department for Work and Pensions rebates)	(23)	(14)	–	(37)
Past service cost	(26)	(1)	(3)	(30)
Actuarial loss on liabilities	(1,307)	(416)	(6)	(1,729)
Curtailment gains	–	26	16	42
Interest expense	(932)	(163)	(6)	(1,101)
Foreign exchange gain	–	157	6	163
Benefits paid	845	164	7	1,016
Defined benefit obligations at 31 December 2012	**(21,406)**	**(3,751)**	**(134)**	**(25,291)**

23. Retirement benefit obligations (continued)

Contributions

During the year, a total of £428m was paid into the Main Scheme and 2000 Plan from the Trust. In addition, £75m was contributed by the Group to the Main Scheme upon sale of certain properties. The total Group contributions made to the defined benefit schemes in the year ended 31 December 2012 were £1,029m (2011 £515m) excluding those amounts allocated to equity accounted investments and participating employers of £128m (2011 £70m).

In 2013, the Group expects to make regular contributions at a similar level to the recurring contributions made in 2012 and additional contributions, such that total deficit funding, in excess of service cost, is expected to be approximately £0.4bn.

The Group incurred a charge in respect of the cash contributions of £129m (2011 £119m) paid to defined contribution schemes for employees.

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2012				2011			
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Included in operating costs:								
Current service cost	**(141)**	**(44)**	**(2)**	**(187)**	(131)	(49)	(2)	(182)
Past service cost	**(26)**	**(1)**	**(3)**	**(30)**	(43)	(2)	2	(43)
	(167)	**(45)**	**(5)**	**(217)**	(174)	(51)	–	(225)
Included in other income:								
Pension curtailment gains	**–**	**26**	**–**	**26**	–	–	–	–
US healthcare curtailment gains	**–**	**–**	**16**	**16**	–	–	2	2
	–	**26**	**16**	**42**	–	–	2	2
Included in finance costs:								
Expected return on scheme assets	**667**	**198**	**9**	**874**	785	195	9	989
Interest on obligations	**(760)**	**(163)**	**(6)**	**(929)**	(794)	(164)	(7)	(965)
	(93)	**35**	**3**	**(55)**	(9)	31	2	24
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	**(7)**	**–**	**–**	**(7)**	(7)	–	–	(7)
Group's share of equity accounted investments' finance costs	**(4)**	**–**	**–**	**(4)**	(1)	–	–	(1)

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
(Increase)/decrease in the aggregate of service cost and interest cost	(0.2)	0.1
(Increase)/decrease in defined benefit obligations	(3.0)	2.3

A 0.5 percentage point change in discount rates used to value liabilities would have the following effect:

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Decrease/(increase) in defined benefit obligations	1.9	(2.2)

24. Provisions

	Warranties and after-sales service £m	Reorganisations – continuing operations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	96	65	266	74	501
Current	86	143	177	47	453
At 1 January 2012	182	208	443	121	954
Created	56	22	77	23	178
Released	(43)	(56)	(29)	(16)	(144)
Utilised	(61)	(101)	(73)	(14)	(249)
Adjustment on finalisation of provisional fair values on acquisitions	–	–	–	2	2
Discounting	–	–	19	4	23
Reclassifications	–	–	3	(3)	–
Foreign exchange adjustments	(4)	–	(9)	(5)	(18)
At 31 December 2012	**130**	**73**	**431**	**112**	**746**
Represented by:					
Non-current	66	19	294	70	449
Current	64	54	137	42	297
	130	**73**	**431**	**112**	**746**

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.

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, contractual and environmental
The Group holds provisions for expected legal, contractual and environmental 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.

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

Other
There are no individually significant provisions included within other provisions.

25. Share capital and other reserves

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
Issued and fully paid					
At 1 January 2011	3,587	90	1	1	90
Exercise of options	1	–	–	–	–
At 1 January 2012 and 31 December 2012	**3,588**	**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, Innovation and Skills (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, 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.

Treasury shares

In 2011, 184,393,049 ordinary shares of 2.5p were repurchased under the buyback programme.

As at 31 December 2012, 336,813,996 (2011 351,756,854) ordinary shares of 2.5p each with an aggregate nominal value of £8,420,350 (2011 £8,793,921) were held in treasury. During 2012, 14,942,858 treasury shares were used to satisfy awards and options under the Share Incentive Plan, Share Matching Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan (2011 11,013,823 in respect of the Share Incentive Plan, Share Matching Plan, Performance Share Plan and Executive Share Option Plan).

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.

BAE Systems ESOP Trust

The Group has an Employee Share Option Plan (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 November 2012.

At 31 December 2012, the ESOP held 2,633,198 (2011 2,402,305) ordinary shares of 2.5p each with a market value of £9m (2011 £7m). 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 2012 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 November 2012 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

Capital

The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2012, the Group's capital was £3,782m (2011 £4,291m), which comprises total equity of £3,774m (2011 £4,299m), excluding amounts accumulated in equity relating to cash flow hedges of £8m debit (2011 £8m credit). Net cash (as defined by the Group) was £387m (2011 net debt £1,439m).

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. The Group's policy is to maintain an investment grade credit rating and ensure operating flexibility, whilst: meeting its pension obligations; continuing to pursue organic investment opportunities; paying dividends in line with the Group's policy of long-term sustainable cover of around two times underlying earnings (see note 8); making accelerated returns of capital to shareholders when the balance sheet allows; and investing in value-enhancing acquisitions, where market conditions are right and where they deliver on the Group's strategy.

25. Share capital and other reserves (continued)

Equity dividends

	2012 £m	2011 £m
Prior year final 11.3p dividend per ordinary share paid in the year (2011 10.5p)	**367**	359
Interim 7.8p dividend per ordinary share paid in the year (2011 7.5p)	**253**	247
	620	606

After the balance sheet date, the directors proposed a final dividend of 11.7p. The dividend, which is subject to shareholder approval, will be paid on 3 June 2013 to shareholders registered on 19 April 2013. The ex-dividend date is 17 April 2013.

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 10 May 2013.

Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Total £m
At 1 January 2011	4,589	202	10	622	47	5,470
Currency translation on foreign currency net investments:						
Subsidiaries	–	–	–	(19)	–	(19)
Equity accounted investments	–	–	–	(17)	–	(17)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	(14)	–	(14)
Amounts charged to hedging reserve	–	–	–	–	(56)	(56)
Tax on other comprehensive income	–	–	–	–	17	17
At 1 January 2012	4,589	202	10	572	8	5,381
Currency translation on foreign currency net investments:						
Subsidiaries	–	–	–	(164)	–	(164)
Equity accounted investments	–	–	–	(25)	–	(25)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	(97)	–	(97)
Amounts charged to hedging reserve	–	–	–	–	(21)	(21)
Tax on other comprehensive income	–	–	–	–	5	5
At 31 December 2012	**4,589**	**202**	**10**	**286**	**(8)**	**5,079**

Merger reserve
The merger reserve arose on the acquisition of the Marconi Electronic Systems (MES) business by British Aerospace in 1999 to form BAE Systems, and represents the amount by which the fair value of the shares issued by British Aerospace as consideration exceeded their nominal value.

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.

Revaluation reserve
The revaluation reserve relates to the revaluation at fair value of the net assets of the BVT joint venture previously held as an equity accounted investment on the acquisition of the remaining 45% interest in 2009.

Translation reserve
The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

Hedging reserve
The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

26. Acquisition and disposal of subsidiaries

Subsidiaries disposed of during 2012 – continuing operations
In March, the Group completed the sale of its BAE Systems Safety Products Inc. and Schroth Safety Products GmbH businesses (Safety Products) in the US and Germany for cash consideration of approximately $32m (£21m).

In July, the US-based Safariland, LLC (Safariland) business was sold for cash consideration (after adjustment) of approximately $124m (£78m).

Also in July, the Group sold the assets comprising its BAE Systems Tensylon High Performance Materials Inc. (Tensylon) business for cash consideration of $18m (£12m).

Summary

	Safariland £m	Other £m	Total £m
Cash consideration	78	33	111
Transaction costs paid	(1)	(2)	(3)
Cash proceeds	**77**	**31**	**108**
Transaction costs accrued	(1)	–	(1)
Net proceeds	**76**	**31**	**107**
Net assets disposed:			
Intangible assets	(23)	(12)	(35)
Property, plant and equipment	(15)	(4)	(19)
Inventories	(16)	(14)	(30)
Trade and other receivables	(22)	(3)	(25)
Deferred tax	(2)	6	4
Trade and other payables	13	2	15
Cash and cash equivalents	(10)	(1)	(11)
	(75)	**(26)**	**(101)**
Cumulative currency translation gain	84	13	97
Profit on disposal of businesses – continuing operations	**85**	**18**	**103**

Safariland and Tensylon were written down to fair value less costs to sell prior to their disposal incurring impairment charges to intangible assets of £48m and £12m, respectively.

Subsidiaries acquired during 2011
The Group acquired L-1 Identity Solutions, Inc.'s Intelligence Services Group (L-1 ISG), Norkom Group plc (Norkom), ETI A/S (ETI), Fairchild Imaging, Inc. (Fairchild) and stratsec.net Pty Limited (stratsec). With the exception of Fairchild, the Group acquired 100% of the shares of these entities. The Group acquired the remaining 91.3% interest in Fairchild which it did not already own.

If the acquisitions had occurred on 1 January 2011, combined sales of Group and share of equity accounted investments would have been £19.2bn, revenue £17.8bn and profit £1,252m from continuing operations for the year ended 31 December 2011.

For all acquisitions made during 2011, fair values were finalised in 2012. In accordance with IFRS 3, Business Combinations, the Group has adjusted the fair values attributable to the Norkom and ETI acquisitions during 2012. The net increase in goodwill of £2m is not material to the consolidated accounts and, as such, the Group has not restated the balance sheet at 31 December 2011.

Material acquisitions

			Consolidated results for the period from acquisition to 31 December 2011		
Acquisition	Acquisition date	Total consideration £m	Revenue £m	EBITA[1] £m	Loss after tax[2] £m
L-1 ISG	15 February 2011	180	112	8	(2)
Norkom	18 February 2011	177	42	9	(3)
ETI	21 March 2011	135	39	5	(9)

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense excluding integration costs.
2 Includes amortisation charges on acquired intangible assets totalling £39m.

27. 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.

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 values of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;

– the fair values 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 values of loans and overdrafts have 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.

Carrying values and fair values of certain financial assets and liabilities

Carrying values	Notes	2012 Assets £m	2012 Liabilities £m	2011 Assets £m	2011 Liabilities £m
Non-current					
Available-for-sale financial assets[1]	15	**5**	**–**	5	–
Other receivables	16	**207**	**–**	261	–
Other financial assets	17	**62**	**–**	118	–
Loans	21	**–**	**(2,967)**	–	(2,682)
Other financial liabilities	17	**–**	**(66)**	–	(74)
Current					
Other financial assets	17	**64**	**–**	77	–
Cash and cash equivalents		**3,355**	**–**	2,141	–
Loans and overdrafts	21	**–**	**(21)**	–	(518)
Other financial liabilities	17	**–**	**(88)**	–	(284)

1 Net carrying amount approximates to estimated fair value as there is no active market.

Fair values approximate to carrying values except for non-current loans which have an estimated fair value of £3,407m (2011 £3,554m).

Hedging instruments

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange and interest rate contracts, classified by year of maturity.

	31 December 2012				31 December 2011			
	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 foreign exchange (sales)/purchase contracts								
US dollar	**(882)**	**187**	**54**	**(641)**	(1,332)	66	4	(1,262)
Euro	**1,155**	**1,018**	**95**	**2,268**	1,531	470	43	2,044
Other	**519**	**(184)**	**–**	**335**	560	(18)	–	542
	792	**1,021**	**149**	**1,962**	759	518	47	1,324
Interest rate swaps – US dollar	**–**	**616**	**–**	**616**	–	643	–	643
Cross-currency swaps – US dollar	**–**	**–**	**308**	**308**	772	–	322	1,094

27. Financial risk management (continued)

Interest rate risk

The Group's objective is to manage its exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, mainly interest rate swaps.

The Group's interest rate management policy is that a minimum of 50% and a maximum of 90% (2011 75%) of gross debt is maintained at fixed interest rates. At 31 December 2012, the Group had 79% (2011 63%) of fixed rate debt and 21% (2011 37%) of floating rate debt based on a gross debt of £3.0bn, including debt-related derivative financial assets (2011 £3.1bn).

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	Less than one year £m	Between one and two years £m	More than two years £m
Cash and cash equivalents	3,355	–	–
Loans and overdrafts	(647)	(626)	(6)

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 2012, the Group had a total of $1.0bn (2011 $1.8bn) of this type of swap outstanding with a weighted average duration of 1.7 years (2011 2.8 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 10.1 years (2011 10.4 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 2.7% (2011 3.1%), 2.7% on US dollars (2011 3.1% on US dollars and 2.5% on sterling). The cost of the fixed rate debt was 5.7% (2011 6.0%).

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 (2011 £12m).

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 £7m (2011 £7m).

Liquidity risk

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2012, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2011 £2bn). The RCF is contracted until 2015 and was undrawn throughout the year. The RCF also acts as a back stop to Commercial Paper issued by the Group. At 31 December 2012, the Group had no Commercial Paper in issue (2011 £513m).

Cash flow forecasting is performed by the businesses on a monthly basis. The Group monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet operational needs and maintain adequate headroom.

Surplus cash held by the businesses over and above balances required for working capital management is loaned to the Group's centralised treasury department. Surplus cash is invested in interest bearing current accounts, term deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient headroom as determined by cash forecasts.

Credit risk

The Group's objective is to monitor and control counterparty credit risk and credit limit utilisation. The Group adopts a conservative approach to the investment of its surplus cash. It is deposited with financial institutions with the strongest credit ratings for short periods. The cash and cash equivalents balance at 31 December 2012 of £3,355m (2011 £2,141m) was invested with 29 (2011 24) financial institutions. A credit limit is allocated to each institution taking account of its market capitalisation, credit rating and credit default swap price. The Group has no exposure to Greek, Irish, Italian, Portuguese or Spanish banks. Additionally, the Group monitors its exposure to banks which have exposure to these countries.

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 through this process.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered to be an issue. For the remaining trade receivables, no one counterparty constitutes more than 8% of the balance (2011 6%).

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

The Group's objective is to reduce its exposure to volatility in earnings and cash flows from movements in foreign currency exchange rates, mainly the US dollar, Euro and Saudi Riyal.

The Group is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. All material firm transactional exposures are hedged, unless otherwise approved as exceptions by the Treasury Review Management Committee, and the Group aims, where possible, to apply hedge accounting to these transactions.

The Group is exposed to movements in foreign currency exchange rates in respect of the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of foreign subsidiaries and equity accounted investments it regards as long-term investments.

28. Share-based payments

Details of the terms and conditions of each share-based payment plan are given in the Remuneration report on pages 93 to 113.

Expense/(credit) in year

	2012			2011		
	Equity-settled £m	Cash-settled £m	Total £m	Equity-settled £m	Cash-settled £m	Total £m
Executive Share Option Plan (ExSOP)	2	2	4	–	(2)	(2)
Performance Share Plan (PSP)	11	–	11	18	–	18
Restricted Share Plan (RSP)	9	–	9	1	–	1
Share Matching Plan (SMP)	2	–	2	7	–	7
	24	2	26	26	(2)	24

The Group also incurred a charge of £33m (2011 £42m) in respect of the equity-settled all-employee free shares and matching Partnership Shares elements of the Share Incentive Plan.

ExSOP

Equity-settled options

	2012		2011	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	10,624	3.61	12,607	3.67
Granted during the year	15,940	3.02	–	–
Exercised during the year	(807)	2.29	(390)	2.15
Expired during the year	(2,743)	3.70	(1,593)	4.38
Outstanding at the end of the year	23,014	3.24	10,624	3.61
Exercisable at the end of the year	8,307	3.62	10,624	3.61

Cash-settled share appreciation rights

	2012		2011	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	5,243	2.19	5,857	2.20
Exercised during the year	(1,057)	2.14	(544)	2.29
Expired during the year	(123)	2.36	(70)	2.43
Outstanding at the end of the year	4,063	2.20	5,243	2.19
Exercisable at the end of the year	4,063	2.20	5,243	2.19

	2012		2011	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	1.72 – 4.79	1.72 – 3.56	1.72 – 4.79	1.72 – 3.56
Weighted average remaining contracted life (years)	7	2	4	3
Weighted average fair value of options granted (£)	0.41	–	–	–

28. Share-based payments (continued)

PSP

Equity-settled awards

	2012 Number of shares '000	2011 Number of shares '000
Outstanding at the beginning of the year	**31,698**	28,277
Granted during the year	**7,550**	10,892
Exercised during the year	**(2,056)**	(2,112)
Expired during the year	**(10,358)**	(5,359)
Outstanding at the end of the year	**26,834**	31,698
Exercisable at the end of the year	**416**	707

Cash-settled share appreciation rights

	2012 Number of shares '000	2011 Number of shares '000
Outstanding at the beginning of the year	**25**	25
Expired during the year	**(25)**	–
Outstanding at the end of the year	**–**	25
Exercisable at the end of the year	**–**	25

	2012		2011	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Weighted average remaining contracted life (years)	**5**	**–**	5	–
Weighted average fair value of awards granted (£)	**2.62**	**–**	2.61	–

The exercise price for the PSP is £nil (2011 £nil).

RSP

All awards are equity-settled.

	2012 Number of shares '000	2011 Number of shares '000
Outstanding at the beginning of the year	**1,383**	–
Granted during the year	**7,310**	1,465
Exercised during the year	**(92)**	(3)
Expired during the year	**(1,082)**	(79)
Outstanding at the end of the year	**7,519**	1,383
Exercisable at the end of the year	**8**	2

	2012	2011
Weighted average remaining contracted life (years)	**6**	6
Weighted average fair value of awards granted (£)	**3.01**	2.92

The exercise price for the RSP is £nil (2011 £nil).

28. Share-based payments (continued)

SMP

All awards are equity-settled.

	2012 Number of shares '000	2011 Number of shares '000
Outstanding at the beginning of the year	**16,621**	13,025
Granted during the year	**3,952**	5,979
Exercised during the year	**(2,521)**	(1,209)
Expired during the year	**(4,718)**	(1,174)
Outstanding at the end of the year	**13,334**	16,621
Exercisable at the end of the year	**–**	–

	2012	2011
Weighted average remaining contracted life (years)	**1**	1
Weighted average fair value of awards granted (£)	**3.01**	3.37

The exercise price for the SMP is £nil (2011 £nil).

Details of options/awards granted in the year

The fair value of equity-settled options/awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

ExSOP – Binomial model

PSP – Monte Carlo

RSP and SMP – Dividend valuation model

	2012	2011
Range of share price at date of grant (£)	**3.01 – 3.29**	2.64 – 3.37
Expected option/award life (years)	**3 – 10**	3 – 4
Volatility (%)	**24**	25 – 32
Risk free interest rate (%)	**0.3 – 0.5**	0.8 – 1.4

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 £3.10 (2011 £3.04).

29. Related party transactions

The Group has a related party relationship with its directors and key management personnel (see below), equity accounted investments (note 14) and pension schemes (note 23).

Transactions occur with the equity accounted investments in the normal course of business, 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		Management recharges	
Related party	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Advanced Electronics Company Limited	**–**	–	**19**	153	**–**	1	**–**	–	**–**	–
CTA International SAS	**1**	2	**–**	–	**2**	2	**–**	–	**–**	–
Eurofighter Jagdflugzeug GmbH	**1,324**	1,353	**–**	–	**136**	206	**161[1]**	142[1]	**–**	–
FADEC International LLC	**52**	49	**–**	–	**–**	–	**–**	–	**–**	–
Gripen International KB	**–**	–	**–**	–	**17**	10	**60[1]**	68[1]	**–**	–
MBDA SAS	**21**	24	**166**	65	**7**	9	**487[1,2]**	951[1]	**18[1]**	17[1]
Panavia Aircraft GmbH	**35**	34	**65**	98	**1**	4	**–**	–	**–**	–
Other	**–**	–	**–**	1	**–**	2	**–**	–	**–**	–
	1,433	1,462	**250**	317	**163**	234	**708**	1,161	**18**	17

1 Also relates to disclosures under Financial Reporting Standard 8, Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2012, £705m (2011 £1,158m) was owed by BAE Systems plc and £3m (2011 £3m) by other Group subsidiaries.
2 Reduction primarily relates to the £424m non-cash special dividend received in 2012.

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 93 to 113. Total emoluments for directors and key management personnel were:

	2012 £'000	2011 £'000
Short-term employee benefits	**14,375**	14,807
Post-employment benefits	**2,163**	1,310
Share-based payments	**4,029**	5,534
	20,567	21,651

30. Contingent liabilities and commitments

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 and shipyards under non-cancellable operating lease agreements. The leases have varying terms including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2012 £m	2011 £m
Payments due:		
Not later than one year	**169**	184
Later than one year and not later than five years	**518**	551
Later than five years	**621**	772
	1,308	1,507
Total of future minimum sublease income under non-cancellable subleases	**188**	234

Capital commitments
Capital expenditure contracted for but not provided for in the accounts is as follows:

	2012 £m	2011 £m
Property, plant and equipment	**103**	171
Intangible assets	**2**	15
	105	186

31. 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 Information Solutions Inc. *(Held via BAE Systems Technology Solutions & Services Inc.)*	Full-service information technology solution provider	100% Common	US	US
BAE Systems Land & Armaments LP *1300 North 17th Street, Suite 1400, 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 Surface Ships Limited *(Held via BAE Systems Surface Ships (Holdings) Limited)*	Designs, develops and constructs surface ships in the naval arena, and provides fleet support services	100% Ordinary	UK	England and Wales

The Company has taken advantage of the exemption under Section 410(2) of the Companies Act 2006 by providing information only in relation to subsidiary undertakings whose results or financial position, in the opinion of the directors, principally affected the financial statements. Accordingly, the subsidiaries listed in the table above are those that represent more than 5% of total Group sales or underlying EBITA[1]. A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2012 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group accounts.

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

32. Accounting policies

The principal accounting policies applied in the preparation of the consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

Revenue and profit recognition

Sales include the Group's net share of sales of equity accounted investments. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of equity accounted investments.

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.

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. Profit is recognised progressively as risks have been mitigated or retired.

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. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

Sales and profits on intercompany trading are determined on an arm's length basis.

Lease income

Rental income is recognised in other income 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.

Underlying EBITA

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 non-recurring items. This definition is referred to as Underlying EBITA. Underlying EBITA is the measure of profit on which segmental performance is monitored by management. As such, it is disclosed in note 1 to the Group accounts on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature.

Finance costs

Financial income comprises interest income on funds invested, changes in the fair value of financial instruments at fair value through profit or loss, and gains on hedging instruments that are recognised in profit or loss.

Financial expense comprises interest expense on borrowings, unwinding of the discounts on provisions, changes in the fair value of financial instruments at fair value through profit or loss, and losses on hedging instruments that are recognised in profit or loss.

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) are capitalised as part of the cost of that asset, until such time as the assets are ready for their intended use or sale.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

Tax

Income tax expense comprises current and deferred tax. Current and deferred tax is recognised in profit or loss except to the extent that it relates to a business combination, or items recognised directly in equity or other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Current tax payable also includes any tax liability arising from the declaration of dividends.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for temporary differences:

– on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss;

– related to investments in subsidiaries and equity accounted investments to the extent that it is probable that they will not reverse in the foreseeable future; and

– arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different taxable entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

32. Accounting policies (continued)

Discontinued operations
A discontinued operation is a component of the Group's business that represents a separate major line of business or geographical area of operations that has been disposed of or meets the criteria as held for sale. When an operation is classified as a discontinued operation, the comparative income statement is re-presented as if the operation had been discontinued from the start of the comparative period.

Dividends
Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

Intangible assets
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.

Business combinations on or after 1 January 2010 (IFRS 3, Business Combinations)
Business combinations are accounted for using the acquisition method as at the acquisition date, which is the date on which control is transferred to the Group. The Group measures goodwill as the acquisition-date fair value of the consideration transferred, including the amount of any non-controlling interest in the acquiree, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed, including contingent liabilities as required by IFRS 3.

Consideration transferred includes the fair values of assets transferred, liabilities incurred by the Group to the previous owners of the acquiree, equity interests issued by the Group, contingent consideration, and share-based payment awards of the acquiree that are replaced in the business combination. Any contingent consideration payable is recognised at fair value at the acquisition date. Subsequent changes to the fair value of contingent consideration that is not classified as equity are recognised in the income statement. If a business combination results in the termination of pre-existing relationships between the Group and the acquiree, then the lower of the termination amount, as contained in the agreement, and the value of the off-market element, is deducted from the consideration transferred and recognised in other expenses.

Transaction costs that the Group incurs in connection with a business combination, such as finder's fees, legal fees, due diligence fees, and other professional and consulting fees, are expensed as incurred.

Non-controlling interests are measured at either the non-controlling interest's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised or at fair value. The method used is determined on an acquisition-by-acquisition basis.

Accounting for acquisition of non-controlling interests that do not result in a change in control
Acquisitions of non-controlling interests are accounted for as transactions with equity holders in their capacity as equity holders and, therefore, no goodwill or profit or loss in the income statement is recognised as a result of such transactions.

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 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.

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 programs 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. The most significant intangible assets recognised by the Group on businesses acquired to date are in relation to programmes. For programme-related intangibles, amortisation is set on a programme-by-programme basis over the life of the individual programme. Amortisation for customer-related intangibles is also set on an individual basis.

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:

Programme and customer related	up to 15 years
Other:	
Acquired computer software licences	2 to 5 years
Capitalised software development	2 to 5 years
Capitalised research and development expenditure	up to 10 years
Trademarks and licences	up to 20 years
Other intangibles	up to 10 years

32. 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
Plant and machinery:	
Computing equipment, motor vehicles and short-life works equipment	3 to 5 years
Research equipment	8 years
Other equipment	10 to 15 years, or the project life if shorter

For certain items of plant and equipment 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.

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 goodwill and intangible assets that are not yet available for use, impairment testing is performed annually. 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 carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill, and is assessed for impairment as a single asset.

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.

The recoverable amount of other assets is the greater of their fair value less costs 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.

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 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.

Leases

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.

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 instruments with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity; and

(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.

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.

32. Accounting policies (continued)

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 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. Receivables with a short-term duration are not discounted.

An impairment loss is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

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.

Derivative financial instruments and hedging activities
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. 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. Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement for the period.

Cash flow hedges
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 in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified 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.

Fair value hedges
Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

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.

Held for sale
Disposal groups held for sale comprise assets and liabilities that are expected to be recovered primarily through sale rather than continuing use.

The disposal group is measured at the lower of its carrying value and fair value less costs to sell.

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.

Trade and other payables
Trade and other payables are stated at their cost.

32. Accounting policies (continued)

Pension obligations

Obligations for contributions to defined contribution pension schemes are recognised as an expense in the income statement as incurred.

For defined benefit retirement schemes, 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 comprehensive income. 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. Curtailments due to the material reduction of the expected years of future services of current employees or the elimination of the accrual of defined benefits for some or all of the future services for a significant number of employees are recognised immediately as a gain or loss in the income statement.

The retirement benefit obligation recognised in the Group's balance sheet represents 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 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.

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.

Share-based payment compensation

The Group has granted equity-settled share options and Long-Term Incentive Plan (LTIP) arrangements, and cash-settled share appreciation rights to employees.

Equity-settled share options and LTIP arrangements 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. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number 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.

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 income statement.

For consolidation purposes, the assets and liabilities of overseas subsidiary entities and equity accounted investments 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 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.

COMPANY BALANCE SHEET
as at 31 December

	Notes	2012 £m	2011 £m
Fixed assets			
Tangible assets		**9**	13
Investments in subsidiary undertakings	2	**8,055**	7,113
		8,064	7,126
Current assets			
Debtors due within one year	3	**8,412**	8,132
Debtors due after one year		**9**	9
Other financial assets due within one year	4	**116**	135
Other financial assets due after one year	4	**100**	140
Cash at bank and in hand		**2,679**	1,088
		11,316	9,504
Liabilities falling due within one year			
Loans and overdrafts	5	**(21)**	(5)
Creditors	6	**(13,846)**	(11,480)
Other financial liabilities	4	**(113)**	(311)
		(13,980)	(11,796)
Net current liabilities		**(2,664)**	(2,292)
Total assets less current liabilities		**5,400**	4,834
Liabilities falling due after one year			
Loans	5	**(1,262)**	(898)
Creditors	6	**(30)**	(40)
Other financial liabilities	4	**(95)**	(101)
		(1,387)	(1,039)
Provisions for liabilities and charges	7	**(52)**	(49)
Net assets		**3,961**	3,746
Capital and reserves			
Issued share capital	9	**90**	90
Share premium account	11	**1,249**	1,249
Statutory reserve	11	**202**	202
Other reserves	11	**90**	98
Profit and loss account	11	**2,330**	2,107
Equity shareholders' funds		**3,961**	3,746

Approved by the Board on 20 February 2013 and signed on its behalf by:

I G King
Chief Executive

P J Lynas
Group Finance Director

NOTES TO THE COMPANY ACCOUNTS

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 408(3) of the Companies Act 2006, 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 11 to these accounts. The Company has no other recognised gains or losses in the current or preceding year and, therefore, no statement of recognised gains or losses is presented.

Relief under Sections 612 and 616 of the Companies Act 2006 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.

Cash flow statement
The Company is exempt under the terms of FRS 1, Cash Flow Statements, 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 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
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 is stated at cost less provision for impairment.

Financial instruments
The policies disclosed in the Group accounting policies on page 174 for recognition, measurement and presentation of financial instruments are applied in the Company accounts.

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 schemes operated in the UK. Details of the principal schemes and the financial assumptions used are contained in the consolidated accounts of the Group. As permitted by FRS 17, Retirement Benefits, the schemes are accounted for as defined contribution schemes, as the employer cannot identify its share of the underlying assets and liabilities of the schemes. 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.

Share-based payment compensation
The Company has granted equity-settled share options and Long-Term Incentive Plan (LTIP) arrangements to Group employees. Equity-settled share options and LTIP arrangements are measured at fair value at the date of grant. 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 Urgent Issues Task Force (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 and LTIP arrangements granted, except where the employee has agreed to settle the employer's national insurance liability as a condition of grant.

Own shares held
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.

Dividends
Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

2. Investments in subsidiary undertakings

	£m
Cost	
At 1 January 2012	7,174
Additions[1]	942
At 31 December 2012	**8,116**
Impairment provisions	
At 1 January 2012 and 31 December 2012	**61**
Net carrying value	
At 31 December 2012	**8,055**
At 31 December 2011	7,113

1 The additions to investments in subsidiary undertakings includes investments in BAE Systems (Holdings) Limited (£0.9bn).

3. Debtors

	2012 £m	2011 £m
Due within one year		
Corporation tax recoverable	**32**	16
Amounts owed by subsidiary undertakings	**8,340**	8,077
Amounts owed by Group joint ventures	**7**	6
Prepayments and accrued income	**25**	14
Other debtors	**8**	19
	8,412	8,132

4. Other financial assets and liabilities

	2012 Assets £m	**2012 Liabilities £m**	2011 Assets £m	2011 Liabilities £m
Due within one year				
Cash flow hedges – foreign exchange contracts	**1**	**(1)**	4	–
Other foreign exchange/interest rate contracts	**115**	**(112)**	131	(311)
	116	**(113)**	135	(311)
Due after one year				
Cash flow hedges – foreign exchange contracts	**–**	**(1)**	3	–
Other foreign exchange/interest rate contracts	**91**	**(94)**	96	(101)
Debt-related derivative financial instruments – assets[1]	**9**	**–**	41	–
	100	**(95)**	140	(101)

1 The debt-related derivative financial instrument assets are presented as other financial assets. Debt-related derivative financial instrument liabilities are presented as a component of loans and overdrafts (see note 5).

Full disclosures relating to the Group's other financial assets and liabilities, and financial risk management strategies are given in the Financial Performance section of the Directors' Report, and notes 17 and 27 to the Group accounts.

5. Loans and overdrafts

	2012 £m	2011 £m
Due within one year		
Loans and overdrafts	**21**	5
	21	5
Due after one year		
Euro-Sterling £100m 10¾% bond, repayable 2014	**100**	100
US$350m 3.5% bond, repayable 2016	**214**	224
US$500m 4.75% bond, repayable 2021	**307**	320
£400m 4.125% bond, repayable 2022	**397**	–
US$400m 5.8% bond, repayable 2041	**243**	254
Debt-related derivative financial instruments – liabilities	**1**	–
	1,262	898

Loans and overdrafts due within one year are at a floating rate of interest.

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 2012					
Carrying amount	**21**	**100**	**214**	**948**	**1,283**
At 31 December 2011					
Carrying amount	5	–	324	574	903

6. Creditors

	2012 £m	2011 £m
Due within one year		
Amounts owed to subsidiary undertakings	**12,802**	9,996
Amounts owed to Group joint ventures[1]	**705**	1,158
Accruals and deferred income	**42**	36
Other creditors	**297**	290
	13,846	11,480
Due after one year		
Other creditors	**30**	40
	30	40

1 Reduction primarily relates to the £424m non-cash special dividend received in 2012.

7. Provisions for liabilities and charges

	Contracts and other £m
At 1 January 2012	49
Created	8
Utilised	(9)
Released	(1)
Discounting	5
At 31 December 2012	**52**

The Company holds provisions for expected contractual costs that it expects to incur over an extended period. These costs are based on past experience of similar items and represent management's best estimate of the likely outcome.

8. Contingent liabilities

Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £1,699m (2011 £2,289m) which are included in the Group's borrowings have been guaranteed by the Company.

9. 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
Issued and fully paid					
At 1 January 2011	3,587	90	1	1	90
Exercise of options	1	–	–	–	–
At 1 January 2012 and 31 December 2012	**3,588**	**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, Innovation and Skills (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, 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.

Treasury shares

In 2011, 184,393,049 ordinary shares of 2.5p were repurchased under the buyback programme.

As at 31 December 2012, 336,813,996 (2011 351,756,854) ordinary shares of 2.5p each with an aggregate nominal value of £8,420,350 (2011 £8,793,921) were held in treasury. During 2012, 14,942,858 treasury shares were used to satisfy awards and options under the Share Incentive Plan, Share Matching Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan (2011 11,013,823 in respect of the Share Incentive Plan, Share Matching Plan, Performance Share Plan and Executive Share Option Plan).

10. Employee share plans

Options over shares of the ultimate parent undertaking, BAE Systems plc, have been granted to employees of the Company under various plans. Details of the terms and conditions of each share-based payment plan are given in the Remuneration report on pages 93 to 113 of this report.

	Executive Share Option Plan			
	2012		2011	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**5,539**	**3.64**	6,175	3.68
Granted during the year	**4,975**	**3.02**	–	–
Exercised during the year	**(200)**	**2.39**	(96)	1.99
Expired during the year	**(713)**	**4.29**	(540)	4.39
Outstanding at the end of the year	**9,601**	**3.30**	5,539	3.64
Weighted average remaining contracted life (years)		**6**		4
Weighted average fair value of options granted (£)		**0.38**		–
Range of exercise price of outstanding options (£)		**1.72 – 4.79**		1.72 – 4.79
Expense recognised for the year (£m)		**1**		–

	Share Matching Plan		Performance Share Plan		Restricted Share Plan	
	2012 Number of shares '000	2011 Number of shares '000	**2012 Number of shares '000**	2011 Number of shares '000	**2012 Number of shares '000**	2011 Number of shares '000
Outstanding at the beginning of the year	**5,732**	4,998	**11,910**	11,057	**9**	–
Granted during the year	**2,055**	1,922	**2,426**	3,969	**83**	9
Exercised during the year	**(958)**	(714)	**(805)**	(880)	**–**	–
Expired during the year	**(1,139)**	(474)	**(3,012)**	(2,236)	**9**	–
Outstanding at the end of the year	**5,690**	5,732	**10,519**	11,910	**101**	9
Weighted average remaining contracted life (years)	**1**	1	**5**	5	**6**	6
Weighted average fair value of awards granted (£)	**3.01**	3.37	**2.29**	2.60	**3.01**	2.93
Expense recognised for the year (£m)	**1**	2	**5**	2	**–**	–

The exercise price for the Share Matching Plan, Performance Share Plan and Restricted Share Plan is £nil (2011 £nil).

Information on options/awards granted in the year can be found in note 28 to the Group accounts.

11. Reserves

	Share premium account £m	Statutory reserve £m	Other reserves £m	Profit and loss account £m
At 31 December 2011	1,249	202	98	2,107
Profit for the year	–	–	–	797
Dividends paid	–	–	–	(620)
Share-based payments	–	–	–	48
Purchase of own shares	–	–	–	(2)
Movements in hedging reserve	–	–	(8)	–
At 31 December 2012	**1,249**	**202**	**90**	**2,330**

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.

Other reserves
Other reserves for the Company comprise: capital reserve £24m (2011 £24m); hedging reserve £1m debit (2011 £7m credit); and non-distributable reserve arising from property disposals to other Group undertakings £67m (2011 £67m). 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 are transferred to the profit and loss account as distributable when the related properties are disposed of outside the Group, or written down following impairment.

Profit and loss account
The Company's profit for the financial year was £797m (2011 £1,222m). The non-distributable portion of the profit and loss account is £196m (2011 £736m).

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.

BAE Systems ESOP Trust
The Group has an Employee Share Option Plan (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 November 2012.

At 31 December 2012, the ESOP held 2,633,198 (2011 2,402,305) ordinary shares of 2.5p each with a market value of £9m (2011 £7m). 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 2012 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 November 2012 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

12. Other information

Employees
The total number of employees of the Company at 31 December 2012 was 801 (2011 820). Total staff costs, excluding charges for share-based payments, were £129m (2011 £112m).

Total directors' emoluments, excluding Company pension contributions, were £6,542,000 (2011 £6,542,000). 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 £1,570,000 (2011 £1,535,000).

Related party transactions
Details of related party transactions are detailed in note 29 to the Group accounts.

The Company also has a related party relationship with its directors and key management personnel, and pension schemes.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF BAE SYSTEMS PLC

We have audited the financial statements of BAE Systems plc for the year ended 31 December 2012 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Group and Parent Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity and related notes. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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
As explained more fully in the Directors' Responsibilities Statement set out on page 117, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements
A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate

Opinion on financial statements
In our opinion:

– the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2012 and of the Group's profit for the year then ended;

– the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;

– the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and

– the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006
In our opinion:

– the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and

– the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

– adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or

– the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or

– certain disclosures of directors' remuneration specified by law are not made; or

– we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

– the directors' statement, set out on page 84, in relation to going concern;

– the part of the Corporate Governance Statement on pages 83 to 89 in the Directors' Report relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and

– certain elements of the report to shareholders by the Board on directors' remuneration.

A G Cates (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
London
E14 5GL

20 February 2013

FIVE-YEAR SUMMARY

Income statement for the year ended 31 December

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Continuing operations[1]					
Sales including Group's share of equity accounted investments					
Electronic Systems	**2,507**	2,645	2,969	2,899	2,375
Cyber & Intelligence	**1,402**	1,399	1,201	1,302	957
Platforms & Services (US)	**4,539**	5,305	7,671	8,414	7,626
Platforms & Services (UK)	**5,646**	6,258	6,529	6,153	4,639
Platforms & Services (International)	**4,071**	3,794	4,325	3,658	2,755
HQ	**267**	233	209	172	171
Intra-group sales	**(598)**	(480)	(629)	(756)	(532)
	17,834	19,154	22,275	21,842	17,991
Underlying EBITA[2]					
Electronic Systems	**356**	386	455	348	333
Cyber & Intelligence	**124**	136	108	107	82
Platforms & Services (US)	**394**	478	728	747	666
Platforms & Services (UK)	**689**	658	522	661	501
Platforms & Services (International)	**417**	449	449	402	415
HQ	**(85)**	(82)	(83)	(114)	(101)
	1,895	2,025	2,179	2,151	1,896
Profit/(loss) on disposal of businesses	**103**	(29)	1	68	238
Pension curtailment gains	**–**	–	2	261	–
Regulatory penalties	**–**	(49)	(18)	(278)	–
EBITA	**1,998**	1,947	2,164	2,202	2,134
Amortisation and impairment of intangible assets	**(312)**	(348)	(517)	(1,259)	(303)
Finance costs including share of equity accounted investments	**(275)**	(106)	(194)	(694)	712
Profit before taxation	**1,411**	1,493	1,453	249	2,543
Taxation expense including share of equity accounted investments	**(337)**	(233)	(462)	(344)	(649)
Profit/(loss) for the year – continuing operations	**1,074**	1,260	991	(95)	1,894
Profit/(loss) for the year – discontinued operations	**5**	(4)	90	50	(126)
Profit/(loss) for the year	**1,079**	1,256	1,081	(45)	1,768

Balance sheet as at 31 December

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Intangible assets	**10,928**	11,465	11,216	11,306	12,306
Property, plant and equipment, and investment property	**2,407**	2,626	2,848	2,663	2,558
Non-current investments	**270**	788	798	852	1,040
Inventories	**655**	716	644	887	926
Assets held in Trust	**–**	403	261	227	–
Payables (excluding cash on customers' account) less receivables	**(6,419)**	(5,386)	(6,159)	(6,918)	(5,866)
Other financial assets and liabilities	**(50)**	(219)	(10)	(45)	240
Retirement benefit obligations	**(4,607)**	(4,673)	(3,456)	(4,679)	(3,365)
Provisions	**(746)**	(954)	(1,077)	(929)	(845)
Net tax	**951**	975	580	896	256
Net cash/(debt) (as defined by the Group)	**387**	(1,439)	(242)	403	39
Disposal groups held for sale	**(2)**	(3)	–	–	–
Non-controlling interests	**(54)**	(59)	(71)	(72)	(55)
Total equity attributable to equity holders of the parent	**3,720**	4,240	5,332	4,591	7,234

Movement in net cash/(debt) (as defined by the Group) for the year ended 31 December

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Cash inflow from operating activities	**2,458**	951	1,535	2,232	2,009
Add back: Amounts already deducted from net cash/(debt) (as defined by the Group)[3]	**458**	–	–	–	–
	2,916	951	1,535	2,232	2,009
Net capital expenditure[4]	**(293)**	(268)	(364)	(489)	(503)
Dividends received from equity accounted investments	**94**	88	71	77	89
Assets contributed to Trust	**(25)**	(137)	(25)	(225)	–
Cash held for charitable contribution to Tanzania	**–**	–	(30)	–	–
Operating business cash flow	**2,692**	634	1,187	1,595	1,595
Acquisitions and disposals	**96**	(256)	(88)	(254)	(1,038)
Interest	**(147)**	(176)	(173)	(186)	(98)
Tax and dividends	**(746)**	(885)	(958)	(889)	(750)
Purchase of equity shares	**(16)**	(509)	(520)	(20)	(27)
Foreign exchange adjustment	**92**	(20)	(20)	262	(374)
Other movements[5]	**(146)**	2	(80)	(132)	5
Net increase/(decrease) in net funds	**1,825**	(1,210)	(652)	376	(687)
Movement in cash on customers' account	**1**	13	7	(12)	26
Movement in net cash/(debt) (as defined by the Group)	**1,826**	(1,197)	(645)	364	(661)
Opening net (debt)/cash (as defined by the Group)	**(1,439)**	(242)	403	39	700
Closing net cash/(debt) (as defined by the Group)	**387**	(1,439)	(242)	403	39

Other information

	2012	2011	2010	2009	2008
Continuing operations[1]					
Basic earnings/(loss) per share – total (pence)	**32.8**	37.0	27.9	(3.3)	53.2
Basic earnings per share – underlying[6] (pence)	**38.9**	45.6	39.8	39.1	37.1
Order backlog[7] including the Group's share of equity accounted investments (£bn)	**42.4**	39.1	n/a	n/a	n/a
Including discontinued operations					
Dividend per ordinary share (pence)	**19.5**	18.8	17.5	16.0	14.5
Number of employees, excluding share of employees of equity accounted investments, at year end	**81,000**	87,000	92,000	98,000	94,000
Capital expenditure including leased assets (£m)	**404**	381	437	522	552

1 The Regional Aircraft line of business and Saab AB are presented as discontinued operations.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. For 2008, non-recurring items are profit on disposal of businesses and uplift on acquired inventories. For 2009 to 2011, non-recurring items are profit/loss on disposal of businesses, pension curtailment gains and regulatory penalties. For 2012, non-recurring items comprises profit on disposal of businesses.
3 Comprises the £428m contribution from Trust to the UK pension schemes and the £29.5m charitable contribution for the benefit of the people of Tanzania in connection with the global settlement with the UK's Serious Fraud Office in 2010, both made in 2012, as the amounts had been deducted from the Group's net cash/(debt).
4 Includes net expenditure on property, plant and equipment, investment property, intangible assets, and other investments, and equity accounted investment funding.
5 Includes cash flows from matured derivative financial instruments, cash collateral and other non-cash movements.
6 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items. For 2008, non-recurring items are profit on disposal of businesses and uplift on acquired inventories. For 2009 to 2011, non-recurring items are profit/loss on disposal of businesses, pension curtailment gains and regulatory penalties. For 2012, non-recurring items comprises profit on disposal of businesses.
7 Order backlog comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.

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

If you have any queries regarding your shareholding or need to notify any changes to your personal details, please contact Equiniti.

Equiniti's website (https://help.shareview.co.uk) includes a comprehensive set of answers to many frequently asked questions relating to managing a shareholding. If you cannot find the answer to your question, there is an online e-mail form, which helps to ensure your question is directed to the most appropriate team for a response. Alternatively, you can call the BAE Systems Helpline on 0871 384 2044* or, from outside the UK, +44 121 415 7058.

* Calls to this number cost 8p per minute plus network extras. Lines are open from 8.30am to 5.30pm Monday to Friday.

Shareview – online access to your shareholding
Shareview is a free portfolio service offered by Equiniti to investors which gives shareholders online access to more information on their investments, including balance movements, indicative share prices and information on recent payments. It can also be used to sign up to receive all shareholder communications electronically and, once registered, arrange for dividends to be mandated or update your address.

To take advantage of Shareview, register online at www.shareview.co.uk
Click on 'Register' and follow the four easy steps.

Details of software and equipment requirements are given on the website.

Dividend mandate
Over the past two years, Equiniti has processed over 17,000 dividend bank mandates. Shareholders with a dividend bank mandate receive their dividend in their bank account on the payment date and receive one consolidated tax voucher for payments made within the tax year. This helps us save on printing and postage costs.

If you have a UK bank or building society account and would like to apply a bank mandate to your shareholding, a mandate form can be obtained from our website or by contacting Equiniti. Alternatively, bank details can be submitted in writing to Equiniti, electronically via Shareview or, if the shareholding is held in a sole name, Equiniti can take instructions over the telephone.

Do you have an overseas bank account? Instead of waiting for a sterling cheque to arrive by post, why not take advantage of Equiniti's overseas payments service? Equiniti can arrange payment for over 90 countries worldwide. It normally costs less than paying in a sterling cheque and only takes a few days for the money to arrive into the account after the dividend payment date. For more information on the terms and conditions of this service, and to obtain the appropriate mandate form, visit the Shareview website (www.shareview.com/overseas) or contact Equiniti.

Electronic shareholder communications
An increasing number of shareholders receive communications from the Company using e-mail and web-based communications.

The use of electronic communications, rather than printed paper documents, helps us reduce the environmental impact of our activities and assists us in managing our costs.

We regularly consult with shareholders to check how they wish to receive information from us. Shareholders may receive electronic communications in one of two ways:

- Via e-mail – This option is available through Shareview. Shareholders receive an e-mail notification when a new document is made available, which contains a link to the document.
- Via our website – Shareholders receive a notification by post when a new document is made available.

A shareholder is taken to have agreed to website communications if a response to a consultation has not been received. Any document or information required to be sent to shareholders is made available on the Company's website and a notification of availability is sent. Shareholders who receive such a notification are entitled to request a hard copy of the document at any time and may also change the way they receive communications at any time by contacting Equiniti.

Notwithstanding any election, the Company may, at its sole and absolute discretion, send any notification or information to shareholders in hard copy form.

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. 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

Alternatively:

- call the BAE Systems Helpline on 0871 384 2044* (+44 121 415 7058 from outside the UK); or
- a copy of the terms and conditions of the dividend reinvestment plan, along with the mandate form, can be downloaded from our website.

* Calls to this number cost 8p per minute plus network extras. Lines are open from 8.30am to 5.30pm Monday to Friday.

ShareGift
ShareGift, the share donation charity (registered charity number 1052686), accepts donations of 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 2012 was 336.9p and the range during the year was 270.9p to 363.6p.

American Depositary Receipts
BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter (OTC) market 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
USA

Email: jpmorgan.adr@wellsfargo.com

Telephone number for general queries: (800) 990 1135

Telephone number from outside the US: +1 651 453 2128

Warning to shareholders – boiler room fraud and other investment scams
The Company has been alerted to the fact that a number of shareholders have received unsolicited telephone calls from fraudsters purporting to either represent BAE Systems in an alleged 'secret takeover' of another company, or represent another company which is allegedly 'taking control' of BAE Systems. These fraudsters are offering to buy shares in BAE Systems at inflated prices, which generally entail a request for the shareholder to sign non-disclosure agreements, provide bank details, make payment or release share certificates.

Details of any share dealing facilities that the Company endorses will be included in Company mailings.

We have also been made aware of shareholders who have received telephone calls from bogus companies purporting to be dealing with various matters on behalf of the Company. For example the purchase of carbon credits, or seeking feedback on specific activities.

The tactics employed by these criminals, who can be very persistent and extremely persuasive, are constantly changing. Shareholders are therefore advised to be very wary and remain vigilant at all times about any unsolicited telephone calls. Authorised firms are unlikely to contact you out of the blue with investment opportunities and a legitimate company is unlikely to use harassment, high-pressure sales tactics, or long and persistent phone calls, to get you to invest.

The Financial Services Authority's (FSA) website contains information about many of the most common and latest scams: www.fsa.gov.uk/consumerinformation/scamsandswindles

If you do receive any such unsolicited telephone calls or investment advice:

- Make sure you get the correct name of the person and organisation.
- Check that they are properly authorised by the FSA before getting involved by visiting www.fsa.gov.uk/register/. Contact the firm using the details on the register – many fraudsters pretend to be from a legitimate firm, but are in fact from a 'cloned firm'.
- Report the matter via the FSA's Consumer Helpline on 0845 606 1234 or by visiting www.fsa.gov.uk/consumerinformation/scamsandswindles
- If the calls persist, hang up.

If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme.

Financial calendar

Financial year end	31 December
Annual General Meeting	8 May 2013
2012 final ordinary dividend payable	3 June 2013
2013 half-yearly results announcement	1 August 2013
2013 interim ordinary dividend payable	2 December 2013
2013 full year results – preliminary announcement	February 2014
– report and accounts	March 2014
2013 final ordinary dividend payable	June 2014

Analysis of share register at 31 December 2012

	Ordinary shares of 2.5p			
	Accounts		Shares	
	Number '000	%	Number million	%
By category of shareholder				
Individuals	95.2	92.5	94.9	2.7
Nominee companies	6.7	6.5	3,025.7	84.3
Banks	–	–	0.1	–
Other	1.0	1.0	467.0	13.0
	102.9	**100.0**	**3,587.7**	**100.0**
By size of holding				
1 – 99	21.3	20.7	1.0	–
100 – 499	29.6	28.8	7.9	0.2
500 – 999	20.0	19.4	14.2	0.4
1,000 – 9,999	29.9	29.1	72.3	2.0
10,000 – 99,999	1.4	1.3	33.6	1.0
100,000 – 999,999	0.4	0.4	164.8	4.6
1,000,000 and over	0.3	0.3	3,293.9	91.8
	102.9	**100.0**	**3,587.7**	**100.0**

GLOSSARY

ADF	Australian Defence Force.
AGM	Annual General Meeting.
ATTAC	Availability Transformation Tornado Aircraft Contract.
C4I	Command, Control, Communications, Computers and Intelligence.
C-IED	Counter Improvised Explosive Device.
CPI	Consumer Prices Index.
CR	Corporate Responsibility.
CV90	Combat Vehicle 90.
DEWS	Digital Electronic Warfare System.
EADS	European Aeronautic Defence and Space Company.
EBITA	Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
EC	Executive Committee.
EPS	Earnings per Share.
EU	European Union.
ExPS	Executive Pension Scheme.
ExSOP	Executive Share Option Plan.
FMTV	Family of Medium Tactical Vehicles.
FPE	Final Pensionable Earnings.
FPP	Final Pensionable Pay.
FRS	Financial Reporting Standard.
GAAP	Generally Accepted Accounting Practice.
GCV	Ground Combat Vehicle.
GEOINT	Geospatial Intelligence.
IAS	International Accounting Standard.
IBP	Integrated Business Plan.
IDIQ	Indefinite Delivery, Indefinite Quantity.
IFRS	International Financial Reporting Standard.
ISR	Intelligence, Surveillance and Reconnaissance.
KPI	Key Performance Indicator.
LCM	Lifecycle Management.
LHD	Landing Helicopter Dock.
LRIP	Low-Rate Initial Production.
LTA	Lifetime Allowance.
LTIP	Long-Term Incentive Plan.
M777	A lightweight 155mm field howitzer.
M&A	Mergers and Acquisitions.
MoD	Ministry of Defence.
MRAP	Mine Resistant Ambush Protected.
NGA	National Geospatial-Intelligence Agency.
OAS	Operational Assurance Statement.
OECD	Organisation for Economic Co-operation and Development.
OPV	Offshore Patrol Vessel.
PIM	Paladin Integrated Management.
PSP	Performance Share Plan.
QBR	Quarterly Business Review.
R&D	Research and Development.
RAF	Royal Air Force.
RCF	Revolving Credit Facility.
RPI	Retail Prices Index.
RSAF	Royal Saudi Air Force.
RSNF	Royal Saudi Naval Forces.
RSP	Restricted Share Plan.
SBDCP	Saudi British Defence Co-operation Programme.
SHE	Safety, Health and Environment.
SIP	Share Incentive Plan.
SMM	Safety Maturity Matrix.
SMP	Share Matching Plan.
ToBA	Terms of Business Agreement.
TPL	Total Performance Leadership.
TRMC	Treasury Review Management Committee.
TSP	Tornado Sustainment Programme.
TSR	Total Shareholder Return.
UAS	Unmanned Air System.
UITF	Urgent Issues Task Force.

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