

**BAE SYSTEMS**

INSPIRED WORK

# ANNUAL REPORT 2014



# AT BAE SYSTEMS, WE PROVIDE SOME OF THE WORLD'S MOST ADVANCED, TECHNOLOGY-LED DEFENCE, AEROSPACE AND SECURITY SOLUTIONS.

We employ a skilled workforce of 83,400 people<sup>1</sup> in 40 countries. Working with customers and local partners, we develop, engineer, manufacture and support products and systems to deliver military capability, protect national security and people, and keep critical information and infrastructure secure.



**FOR  
FURTHER  
INFORMATION  
VISIT  
BAESYSTEMS.COM**

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 of the 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.

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*The Strategic Report was approved by the board of directors on 18 February 2015.  
David Parkes, Company Secretary*

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**COVER IMAGE: Taranis, the stealthy unmanned combat vehicle demonstrator which successfully completed a second phase of flight testing in 2014, with Typhoon, the advanced multi-role/swing-role combat aircraft.**

1. Including share of equity accounted investments.

# 2014 AT A GLANCE

## IN 2014, BAE SYSTEMS DELIVERED A SOLID OVERALL PERFORMANCE

Sales<sup>1</sup> were £16.6bn. The year-on-year reduction of £1.5bn reflected £0.6bn of adverse exchange rate translation, the expected volume reductions in Land & Armaments and the previous year's benefit from the one-off price settlement for Salam Typhoon.

Underlying EBITA<sup>2</sup> was £1,702m. The year-on-year position was broadly unchanged after allowing for exchange rate translation and the one-off 2013 price settlement.

Margin performance delivered a return on sales of 10.2%.

Underlying earnings<sup>3</sup> per share increased from 37.6p to 38.0p after excluding the benefit from the price escalation settlement in 2013.

£925m returned to shareholders in 2014, from share repurchase programme and dividends.

Large order backlog<sup>1,4</sup> of £40.5bn.

<b>SALES<sup>1</sup></b> <b>KPI</b>	<b>UNDERLYING EBITA<sup>2</sup></b> <b>KPI</b>	<b>UNDERLYING EARNINGS<sup>3</sup> PER SHARE</b> <b>KPI</b>
<b>£16,637M</b> £18,180m (2013)	<b>£1,702M</b> £1,925m (2013)	<b>38.0P</b> 42.0p (2013)
<b>ORDER BACKLOG<sup>1,4</sup></b>	<b>OPERATING PROFIT</b>	<b>BASIC EARNINGS PER SHARE<sup>5</sup></b>
<b>£40.5BN</b> £42.7bn (2013)	<b>£1,300M</b> £806m (2013)	<b>23.4P</b> 5.2p (2013)
<b>OPERATING BUSINESS CASH FLOW<sup>6</sup></b> <b>KPI</b>	<b>NET DEBT (AS DEFINED BY THE GROUP)<sup>7</sup></b> <b>KPI</b>	<b>DIVIDEND PER SHARE</b>
<b>£1,191M</b> £147m (2013)	<b>£(1,032)M</b> £(699)m (2013)	<b>20.5P</b> 20.1p (2013)

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

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 23).

3. Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items and, in 2014, a credit in respect of the re-assessment of existing tax provisions (see note 8 to the Group accounts).

4. Comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.

5. Basic earnings per share in accordance with International Accounting Standard 33, Earnings per Share.

6. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.

7. Comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account (see page 24).

# 2014 AT A GLANCE CONTINUED

## OPERATIONAL AND STRATEGIC HIGHLIGHTS



Further development of the Typhoon aircraft platform, including European partner nation commitment to the full integration of the Captor E-Scan radar and work on enhancing the aircraft's capability



Major milestone achieved with naming and float-up of HMS Queen Elizabeth aircraft carrier. Over £1bn of Royal Navy contracts awarded



Contract awards received for the Armored Multi-Purpose Vehicle and on other land programmes in support of the US combat vehicle industrial base



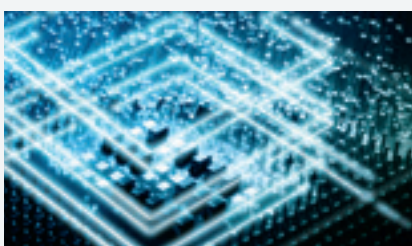
BAE Systems selected to provide the integrated flight control electronics and other systems for next-generation Boeing 777X aircraft, building on positions across multiple major commercial aircraft platforms



Further streamlining of the US-managed business to improve competitiveness, including a sector reorganisation, reduced administrative overhead and agreed sale of the Group's 75% interest in Land Systems South Africa



Reorganisation of industrial partner companies in the Kingdom of Saudi Arabia to support their future growth



Successful acquisition of SilverSky, to enhance the Group's commercial cyber growth strategy, and of Signal Innovations Group, to strengthen the Group's activity-based intelligence capabilities



Applied Intelligence, the Group's UK-headquartered cyber security business, delivered organic sales growth of 10% and increased its order book by a further 37%, following the 60% increase achieved in 2013

# OUTLOOK FOR 2015

## Group outlook

In 2015, the Group's underlying earnings<sup>1</sup> per share are expected to be marginally higher than in 2014, including some reliance on anticipated naval and aircraft orders.

## Segmental outlook\*

### ELECTRONIC SYSTEMS

Sales<sup>2</sup> (in US\$) are expected to be similar to 2014, with growth from commercial business offsetting small reductions in defence.

Margins are expected to be at the top end of a 12% to 14% guidance range.

### PLATFORMS & SERVICES (US)

Sales<sup>2</sup> are expected to reduce by around 10%, or 8% like-for-like excluding the disposal of the South African land business.

Margins are expected to be in a 6% to 8% range, reflecting continued margin dilution from sales trading on the Radford and commercial shipbuilding contracts.

### PLATFORMS & SERVICES (INTERNATIONAL)

Sales<sup>2</sup> in 2015 are expected to be approximately 10% higher than in 2014, including increased levels of support to the Salam Typhoon aircraft now in service and from higher volumes of weapon systems.

Margins are expected to be similar to 2014.

### CYBER & INTELLIGENCE

Comprising the US Intelligence & Security sector (2014 79% of sales) and UK-headquartered Applied Intelligence:

Mid-single digit sales<sup>2</sup> growth expected in 2015; with strong sales growth planned of around 30% in Applied Intelligence offsetting marginally lower sales in Intelligence & Security.

Margins anticipated within an 8% to 10% range, but at the lower end after integration costs of SilverSky and continued investment in the Applied Intelligence business.

### PLATFORMS & SERVICES (UK)

Sales<sup>2</sup> are expected to increase by approximately 5% with higher sales from Salam Typhoon deliveries and the Astute and Successor submarine programmes more than offsetting reduced trading on the Queen Elizabeth Class carrier programme.

Margins expected to be at the lower end of a 10% to 12% range, reflecting the impact of increased UK pension service costs due to the lower discount rate.

### HQ COSTS

HQ costs are expected to be a little higher than those in 2014. Underlying finance costs are expected to be similar to 2014. The effective tax rate is expected to be around 20% with some dependency on the geographic mix of profits.

This outlook is based on an exchange rate planning assumption of US\$1.55/£1.

\*Following a restructuring of its US operations in 2014 to improve competitiveness, including reduced management and administrative overhead, some activities previously included in the Group's Platforms & Services (US) segment will, from 1 January 2015, be reported within the Cyber & Intelligence segment. The impact of the restructuring on the Group's external reporting segments will be reflected in 2015 and, therefore, the segmental outlook for 2015 is based on restated comparatives for 2014.



FOR FURTHER INFORMATION VISIT  
[BAESYSTEMS.COM/INVESTORS](http://BAESYSTEMS.COM/INVESTORS)

1. Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items and, in 2014, a credit in respect of the re-assessment of existing tax provisions (see note 8 to the Group accounts).
2. Including share of equity accounted investments.



**P14** Chief Executive's review



**P27** Segmental performance

# CHAIRMAN'S LETTER

## “A YEAR OF STEADY PROGRESS AND ACHIEVEMENT.”

Sir Roger Carr, Chairman



My first year as Chairman of the Company has been both stimulating and engaging. I have visited our businesses throughout the United Kingdom, the United States of America, the Kingdom of Saudi Arabia and Australia.

Without exception, I have been impressed by the remarkable skills of our people, reassured by our commitment to good corporate governance and proud of our determination to serve, supply and protect those that serve and protect us across the world.

The capabilities and pride of our people in what we do was particularly evident at the naming ceremony in Scotland of the HMS Queen Elizabeth aircraft carrier in July, and at the prize-giving ceremony for the Chairman's Awards in Washington, D.C., in December.

The executive team has continued to demonstrate their professionalism by effectively managing cost in a challenging business environment, and delivering underlying growth in earnings per share after adjusting for the one-off, retrospective benefit from the Saudi Arabian price agreement in 2013. Group cash flow has continued to permit the buyback of shares, the support of our pension obligations and the recommendation of a final dividend of 12.3p per share, making a total of 20.5p per share for the year.

The growing uncertainty and political instability in many parts of the world have undoubtedly increased many governments' focus on defence and helped to stabilise budgets.

The message delivered by President Obama and Prime Minister Cameron at the NATO Summit in Wales, UK, calling for members to allocate 2% of Gross Domestic Product to their defence budgets, reflected the change in tone and sentiment, and reinforced the importance of a thriving and innovative defence industry in the UK, US and with other allies overseas.

Throughout the year, the Company continued to enjoy a privileged position as a strategic supplier to the UK, US, Kingdom of Saudi Arabia and Australia. We have earned these positions over time through a mix of product excellence, service ethic and a commitment to working with each host nation to build local capability. This approach was particularly visible this year in the Kingdom of Saudi Arabia, where we announced a reorganisation of our industrial interests which will enhance our local relationships and will provide high-quality employment for young people in the years to come.

In the second quarter of the year, the Board initiated a comprehensive review of all our businesses in order to deepen our understanding of current activity and establish a platform for longer-term strategic planning.

The review confirmed the importance of maintaining the breadth of our geographic balance, continued investment in the development of our wide product offering and the value of the service relationships we enjoy with the armed forces of the countries in which we operate. We will manage the Group's business portfolio to address changes in markets and emerging opportunities. Whilst still a relatively small segment of the Group, prospects for growth in our Applied Intelligence business, which capitalises on our deep intelligence roots and benefits from our wide commercial reach, are encouraging. In electronics, the leading-edge capability we have in military areas was considered to offer material opportunities for further penetration of the civil aircraft and adjacent commercial markets. The review also encompassed our commitment to apprenticeships, lifetime learning and bench-strength development to ensure we continue to attract and retain the finest engineering talent available in the marketplace.

Looking back, it has been a year of steady progress and achievement. We now look to 2015 with confidence based on the existing programmes in which we are engaged and the depth of order backlog we have secured. With some reliance on anticipated naval and aircraft orders, there is, however, no room for complacency in a world where competitive pressures are increasing, customer demands for service and value unrelenting, and government finances constrained. We will respond to these challenges with energy, enthusiasm and vigour, recognising that we cannot rely on past achievement for future success. Picking up the pace, valuing the customer, driving down costs and preserving quality will be the watchwords of the business model and the hallmarks of our performance.

#### Directors

I succeeded Sir Richard Olver as Chairman of the Board on 1 February 2014 and Sir Richard stepped down from the Board on that date.

On 1 February 2014, Linda Hudson retired as President and Chief Executive Officer of BAE Systems, Inc. and as an executive director of BAE Systems plc. Linda made a material contribution to both the development of our US operations and its important role within the Group. On the same date, Jerry DeMuro was appointed as President and Chief Executive Officer of BAE Systems, Inc. and as an executive director of BAE Systems plc.

Paul Anderson, a non-executive director, retired from the Board on 31 December 2014 after six years of service. Throughout the two terms of his appointment, Paul made a major contribution to the strategic thinking of the Company in addition to chairing the Corporate Responsibility Committee.

#### DIVIDEND (PENCE)

**20.5P**  
**+2%**

2014	20.5
2013	20.1
2012	19.5
2011	18.8
2010	17.5

On behalf of colleagues and shareholders, I thank both Linda and Paul for all they have done for the Company and wish them well for the future.

Ian Tyler has now taken over the role of chairman of the Corporate Responsibility Committee.

During the course of the year, the Nominations Committee commenced a long-term succession planning review and agreed that our immediate priority was to search for a replacement for Paul who would have a general management background, international experience, be capable of assuming responsibility for the Remuneration Committee and improve the diversity of the Board. The search is now in process.

#### Dividend

The Board has recommended a final dividend of 12.3p per share making a total of 20.5p per share for the year, an increase of 2% over 2013. At this level, the annual dividend is covered 1.85 times by underlying earnings (2013 2.1 times). Subject to shareholder approval at the 2015 Annual General Meeting, the dividend will be paid on 1 June 2015 to holders of ordinary shares registered on 17 April 2015.



Sir Roger Carr, Chairman

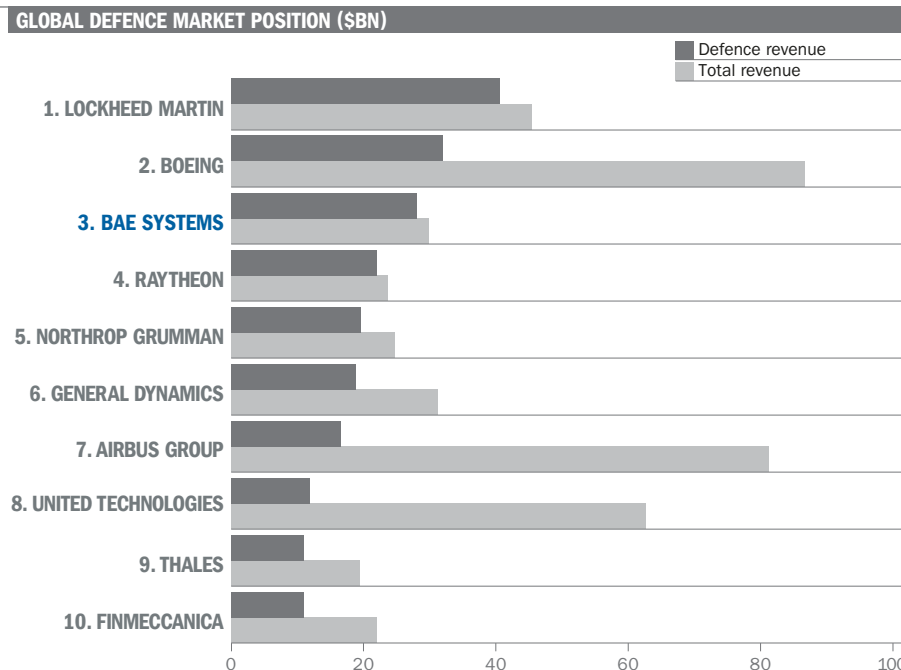
# OUR BUSINESS AT A GLANCE

BAE Systems is an international defence, aerospace and security company with leading **air**, **naval**, **land** and **cyber** capabilities, supplying both defence and commercial customers.

We operate principally in the defence sector, with a growing presence in adjacent commercial markets.

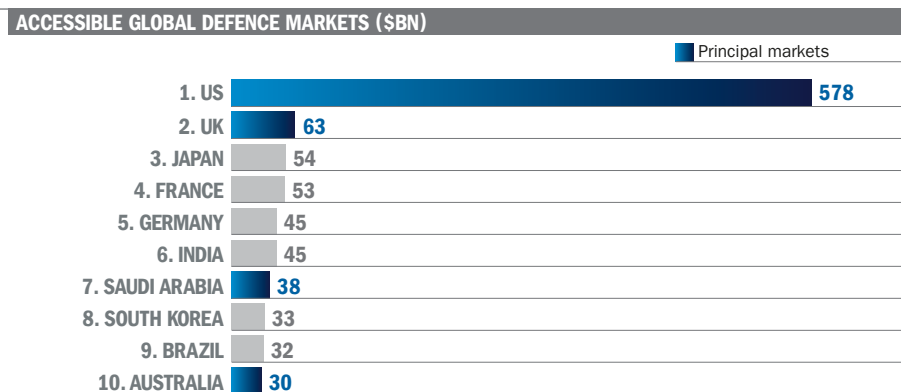
We compete within a peer group of large, multi-national defence and aerospace prime contractors.

BAE Systems is the third largest global defence supplier (based on 2013 revenue).



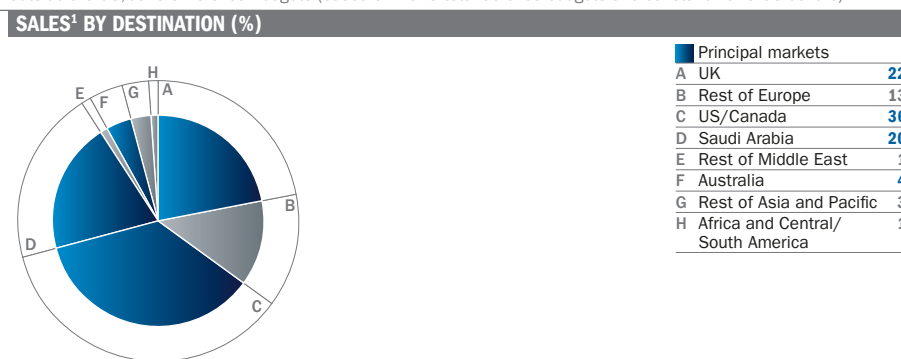
Source: Defense News (based on 2013 revenue)

We are active in all of the top ten accessible global defence markets, with established leading positions in the US, UK, Saudi Arabia and Australia.



Source: 2013 US defence budget (as shown in the Department of Defense Fiscal Year 2015 Budget Request) and, outside the US, Jane's Defence Budgets (based on 2013 total defence budgets and constant 2015 US dollars)

A significant proportion of our sales are from international markets outside the UK and US. In 2014, 35%<sup>2</sup> of our sales<sup>1</sup> came from non-UK/US customers.



1. Including share of equity accounted investments.  
 2. Excludes £1.1bn (7%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH included within Rest of Europe.  
 3. Comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.



We have strong, established positions supplying equipment and services, including advanced electronics, for air, naval and land forces, and commercial aerospace customers.

In addition, we have a growing position in the cyber domain.



**P08** For further information

**SALES<sup>1</sup> BY DOMAIN**

**AIR 50%**



**LAND 15%**



**NAVAL 28%**



**CYBER 7%**



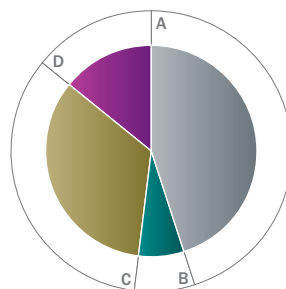
Our £40.5bn order backlog<sup>1,3</sup> provides long-term visibility of sales.

**ORDER BACKLOG<sup>1,3</sup> (£BN)**

2014	<b>40.5</b>
2013	42.7
2012	42.5
2011	39.1

We have a diverse portfolio, broadly balanced between long-term platforms programmes, electronic systems, an enduring services and support business, and activities in cyber security.

**SALES<sup>1</sup> BY ACTIVITY (%)**



A Military and technical services and support	45
B Cyber and intelligence	<b>7</b>
C Platforms	<b>34</b>
D Electronic systems	<b>14</b>

# OUR BUSINESS AT A GLANCE CONTINUED


BAE Systems has strong, established positions in the **air**, **naval** and **land** domains, as well as a growing position in the **cyber** domain.

## AIR 50%

**SALES<sup>1</sup> ANALYSIS (%)**

A	Typhoon	29
B	Tornado	16
C	Hawk	7
D	F-35 Lightning II	6
E	Defence avionics	22
F	Commercial avionics	9
G	Weapons	5
H	Other	6

- Design, manufacture, upgrade and support of combat and trainer aircraft supporting European and other international customers
- Strong positions on the two pre-eminent European and US combat aircraft platforms, Typhoon and F-35 Lightning II
- Supplier of defence electronics equipment across a range of US and other Western military aircraft programmes
- Growing commercial aerospace position in engine and flight controls, cabin and cockpit systems, and aftermarket support services
- 37.5% interest in the MBDA joint venture supplying missiles and missile systems
- Development of next-generation Unmanned Air Systems




**Typhoon combat aircraft**  
European and other international customers

## NAVAL 28%

**SALES<sup>1</sup> ANALYSIS (%)**

A	Surface ships	22
B	Submarines	18
C	US ship repair and commercial shipbuild	19
D	UK naval support	12
E	Naval armaments	10
F	Other	19

- Design, manufacture and support of complex surface ships in the UK and Australia
- Sole provider of design and manufacture of submarines for the Royal Navy
- Major provider of warship repair and modernisation services for the US, UK and Australian navies, and provider of commercial shipbuilding in the US
- Major supplier of large calibre naval gun systems to the US, UK and other international navies
- Design, manufacture and support of torpedoes and radars, and command and combat systems for the Royal Navy

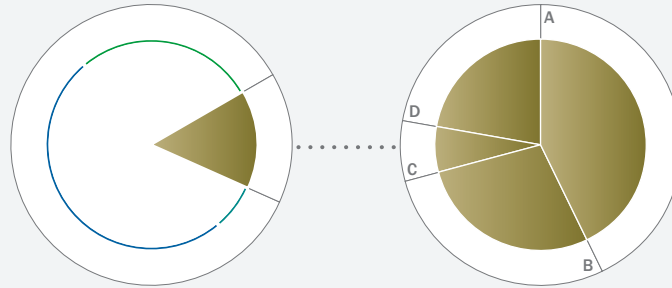


**Sampson naval radar**  
UK

1. Including share of equity accounted investments.

# LAND 15%

SALES<sup>1</sup> ANALYSIS (%)



A	Combat vehicles	43
B	Munitions	28
C	Artillery	7
D	Other	22

Design, manufacture, upgrade and support of tracked and amphibious combat vehicles, servicing both US and international customers

Vehicle upgrade and support to the British Army

Manufacture of ammunition and precision munitions for US and UK armed forces

Supply of artillery systems and missile launchers for US, UK and international armed forces

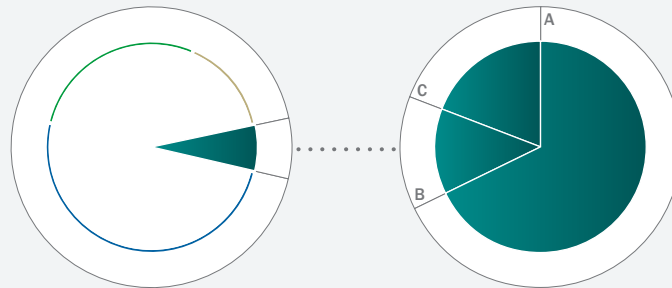
Designing and developing precision imaging and targeting solutions for the US Army



CV90 combat vehicle  
Sweden

# CYBER 7%

SALES<sup>1</sup> ANALYSIS (%)



A	US government	68
B	UK and other governments	13
C	Commercial	19

Leading supplier of cyber, intelligence and security capabilities to government agencies

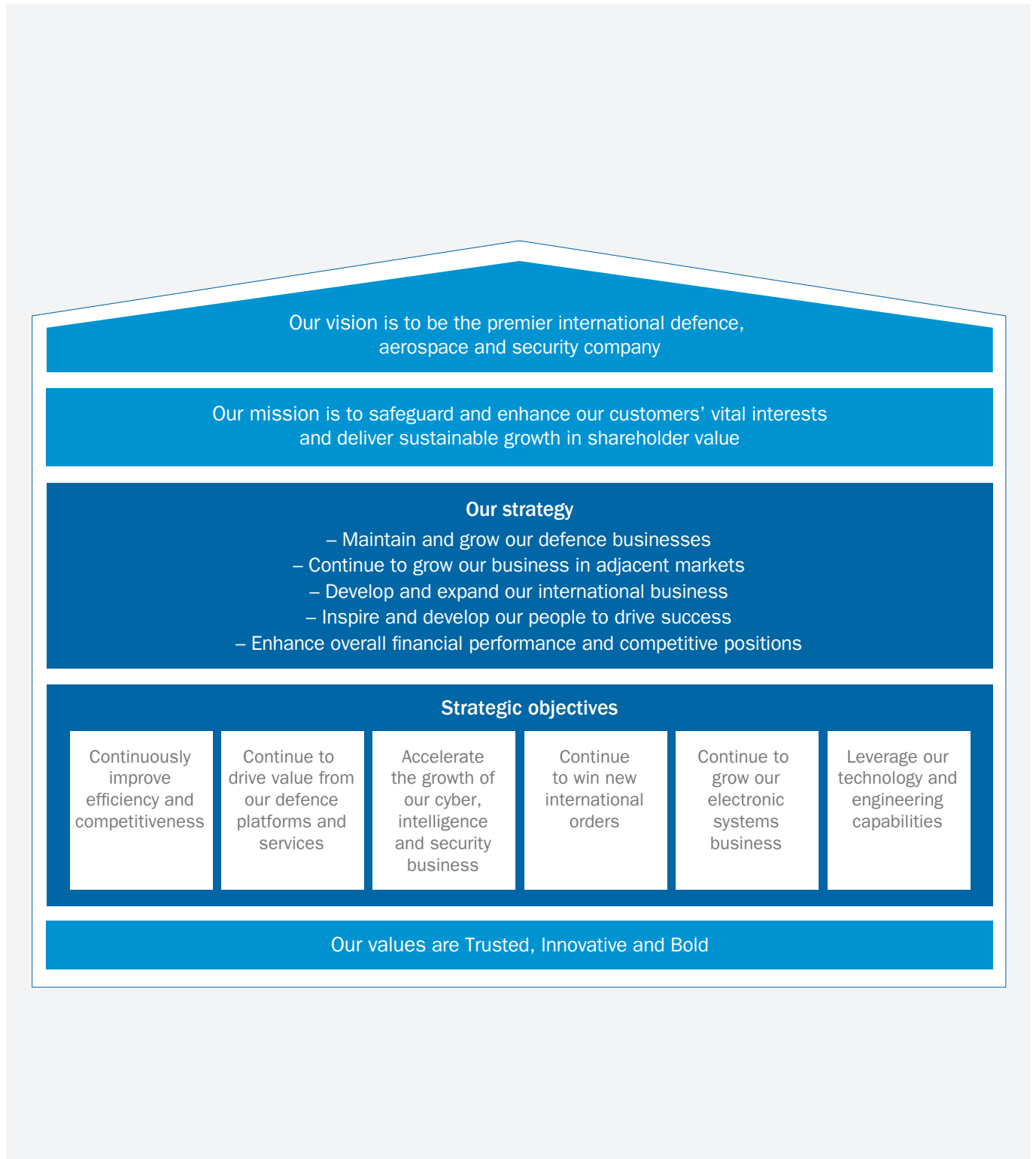
Growing supplier of cyber and network security capabilities for the commercial market



Activity-based intelligence analysts  
US

# GROUP STRATEGIC FRAMEWORK

Our strategy sets out what we aim to achieve as a company.



Our strategy has guided us through challenging market conditions in recent years. Government spending is still under pressure in the US and UK, our largest markets, and competition is increasing around the world. We have responded by focusing on meeting our commitments to customers and on improving efficiency, affordability and financial performance.

All of these are essential to sustaining and winning new business in these competitive times. We have also continued to invest in our business and people and to develop the technology and skills we need to drive the business forward.

The operating environment is still challenging, but we have positive momentum and a strong foundation to build on. Our strategy has evolved in a number of areas, to provide a clear focus for our stakeholders.

**Vision**

Our vision is to be the premier international defence, aerospace and security company – a change from ‘global’ to recognise that, as a defence contractor, not all markets are accessible to the Group.

**Mission**

Our mission has been updated to recognise the important role we play in protecting and enhancing our customers’ vital interests, from defence and national security to critical infrastructure and commercial information.

**Strategy**

Our strategy sets out five key longer-term areas of focus to help us achieve our vision. Maintaining and growing our defence businesses remains a core part of our strategy. We also continue to pursue growth in adjacent markets, including cyber security and commercial avionics. We are a trusted partner to the governments of a number of countries around the world and we continue to expand our international business. We will continue to support and develop our people and enhance competitiveness to drive success.

**Strategic objectives**

We define our strategic objectives, which set near-term priorities and help employees to align their personal objectives to the Group’s strategy. This year, we have added a sixth strategic objective to accelerate plans to use our technology and engineering capabilities to find new ways to create value.

Each year, the Group has an overall objective to meet its financial targets and each Executive Committee member has specific annual objectives which focus on deliverables in support of the Group’s six strategic objectives.

**Values**

Our values underpin our strategy, define how we work and represent a clear definition of our corporate culture.



**P12** How our business works



**P18** Performance against our 2014 objectives

# HOW OUR BUSINESS WORKS

## WE CREATE VALUE FOR OUR SHAREHOLDERS BY...

### ...IDENTIFYING OPPORTUNITIES WITH CUSTOMERS...

We deliver advanced defence, aerospace and security solutions as a strategic partner to many governments and customers around the world.

Our largest customers are governments, but we also sell to large prime contractors and commercial businesses.

We work with our customers to understand their requirements and to identify new business opportunities.

We take on and solve some of our customers' most complex and challenging engineering and technology projects, including responding to urgent operational requirements for our government customers.

### ...IN OUR FOUR PRINCIPAL MARKETS...

 US

 UK

 Saudi Arabia

 Australia

### ...AND, INCREASINGLY, IN INTERNATIONAL EXPORT MARKETS.



**P06** Sales by destination

## OUR VALUE CHAIN COMPRISES...

### ...BIDDING AND CONTRACTING

We assess opportunities and risk rigorously before deciding to bid.

Defence export sales, which are subject to export control regulations, are agreed with government customers either on a prime contract or subcontract basis, or through government-to-government agreements as subcontractors. Export contracts may include agreeing industrial participation, skills or technology transfer arrangements.

### DESIGNING, DEVELOPING AND MANUFACTURING

We design, develop, build, test and deliver products and/or services. For some contracts, we do this via a partnering agreement or joint venture.

We engineer and manufacture some of the world's most advanced, technology-centred platforms, products and systems across the physical and digital world.

### SUPPORT AND SUSTAINMENT

We provide through-life support, including maintenance, upgrade and training.

45% of our sales are services-related contracts that are typically longer term.

### RENEWING AND DISPOSING...

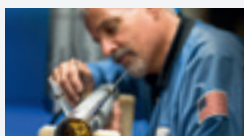
We may assist with disposal at the end of a product's life, or re-contract to provide a new product, or both.



**P07** Sales by activity

## ...REPORTED THROUGH FIVE PRINCIPAL REPORTING SEGMENTS.

### ELECTRONIC SYSTEMS



**P28**

### CYBER & INTELLIGENCE



**P31**

### PLATFORMS & SERVICES (US)



**P34**

### PLATFORMS & SERVICES (UK)



**P37**

### PLATFORMS & SERVICES (INTERNATIONAL)



**P40**

## THROUGH OUR CAPITAL ALLOCATION POLICY, WE AIM TO DELIVER SUSTAINABLE VALUE FOR OUR SHAREHOLDERS BY...

– meeting our pension obligations

– continuing to pursue organic investment opportunities

– paying dividends in line with our policy of long-term sustainable cover

– making accelerated returns of capital to shareholders when the balance sheet allows

– investing in value-enhancing acquisitions



**P22** Financial review

## OUR BUSINESS IS ENABLED BY OUR **OUTSTANDING RESOURCES...**



**We:**

- have 83,400 employees<sup>1</sup> worldwide
- have a talented and diverse workforce
- invest in education and training, including apprentice and graduate opportunities for the next generation of highly-skilled engineers, and the continuous professional development of our existing workforce



**We:**

- focus on technology innovation and engineering excellence
- invest in next-generation research and technology programmes to improve the manufacturing and service of products, generating substantial intellectual property
- spent £1,343m (2013 £1,037m) in 2014 on R&D, of which £137m (2013 £157m) was funded by the Group



**We:**

- have comprehensive project management skills and processes
- have a Lifecycle Management process that promotes the application of best practice programme execution



**We:**

- choose suppliers who share our values and meet our standards
- manage supplier performance, risks and opportunities
- operate sustainable procurement, focusing on reducing the environmental impact of the products and services we buy
- support suppliers by sharing best practice

## ...SUPPORTED BY **STRONG GOVERNANCE PROCESSES...**

### OPERATIONAL FRAMEWORK P58

Our Operational Framework sets out how business is done across BAE Systems. It is based on principles of good governance, and details the values, policies and processes that are mandated, and how the Board delegates authority to the executive team.

### RISK MANAGEMENT P48

We have robust procedures for risk management and internal control to identify, analyse, evaluate and mitigate both financial and non-financial risks.

### CODE OF CONDUCT P44

We operate to high standards of ethical business conduct as a responsible and trusted partner.

## ...RESPONSIBLE TRADING PRINCIPLES...

**1.** We understand and support our customers' national security and other requirements.

**2.** We work to BAE Systems' values (Trusted, Innovative and Bold) in all that we do.

**3.** We assess carefully our products and services with the objective that neither BAE Systems nor our customers are exposed to significant reputational risk.

**4.** We are as open as practicable about the nature of our business.

## ...AND A FOCUS ON THE **WIDER IMPACTS** OF OUR BUSINESS.

### SAFETY P45

We continue to embed a 'safety first' approach by providing training and tools for employees. We apply robust standards of product safety as it is critical that the Group's products perform as designed.

### DIVERSITY AND INCLUSION P45

We are committed to creating an inclusive workplace where a diverse range of talented people can work together.

### ENVIRONMENT P47

We focus on minimising the impact on the environment of our operations and products, and using resources more efficiently.

### COMMUNITY INVESTMENT P46

We are committed to investing in the communities in which we operate.

1. Including share of equity accounted investments.

# CHIEF EXECUTIVE'S REVIEW

“BAE SYSTEMS HAS DELIVERED A SOLID OVERALL PERFORMANCE IN 2014.”

Ian King, Chief Executive



2014 has seen signs of greater stability and improving clarity emerge in markets where budgets have been constrained in recent years by the wider economic backdrop. In this challenging but stabilising environment, BAE Systems has delivered a solid overall performance in 2014, building on the good programme execution of recent years.

Defence and security continues as a high priority in a number of the Group's domestic and international markets, including the Kingdom of Saudi Arabia. The Group has also continued to win significant new business. Order intake of £4.3bn was achieved from international markets outside the US and the UK contributing to the £40.5bn order backlog at year end. That large order backlog provides good, multi-year visibility across many of the Group's businesses. In addition, the Group has achieved over £10bn of order intake in the US and UK each year over the last three years. These US and UK programmes provide the Group with the intellectual property which can be used to develop international and support businesses for the future.

## US

In January 2014, a US bipartisan budget agreement provided a two-year window of defence funding visibility and some emerging stability. Only minor trading disruption was apparent in the last quarter of 2014 as the government operated under a Continuing Resolution until the mid-December passage of an omnibus appropriations bill for the 2015 fiscal year. This included stable Department of Defense funding compared with 2014, and included funding for ground vehicle programmes and for additional F-35 Lightning II aircraft.

US budgets are now relatively stable, with some early indications of a modest improvement in 2016.

On 1 February 2014, Jerry DeMuro was appointed as President and Chief Executive Officer of BAE Systems, Inc. Following his appointment, and recognising the need for continued competitive enhancement, the Group's US organisation was streamlined into three operating sectors with resultant reductions to administrative overhead.

The Group's Intelligence & Security business continued to face a challenging environment serving US government security community customers.

## TOP 12 PROGRAMMES (BY SALES' VALUE IN 2014)

The Group's top 12 programmes, which include platforms, services and electronic systems contracts, contributed 43% of the Group's sales<sup>1</sup> in 2014. These contracts are multi-year and will continue to deliver a significant proportion of the Group's sales<sup>1</sup> over the next five years, providing long-term visibility and sustainment of revenues.

At 31 December 2014, these programmes represented 36% of the £40.5bn order backlog<sup>1,2</sup>.

1. Including share of equity accounted investments.

2. Comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.



The Group's Electronic Systems activities benefited from the broad base of high-technology defence systems and equipment and continued good growth in commercial aircraft electronics. We have maintained our leadership position in the US electronic warfare market. The selection of BAE Systems to supply an advanced, integrated electronic flight control system for Boeing's new 777X programme was a notable achievement, expected to generate significant new business in future years. The award adds to established positions providing flight and engine controls across multiple commercial aircraft platforms.

There was strong margin performance in the Land & Armaments business and a number of order awards on programmes that sustain key combat vehicle industrial base capabilities. In December, BAE Systems was awarded a contract for the engineering and manufacturing development phase of the Armored Multi-Purpose Vehicle programme, which will sustain these capabilities in the longer term.

BAE Systems is a major provider of ship repair services to the US Navy. Consistent with the US Navy's increased focus on Asia-Pacific operations, the Group committed a \$103m (£66m) investment to install new floating dry dock facilities in its San Diego shipyard.

Performance issues identified in 2013 in commercial shipbuilding continued to depress margins in the US Support Solutions business. There were also further charges taken in 2014. The operational challenges identified in 2013 on the Radford ammunition facility maintenance contract have been mitigated significantly during the year.

In November, the Group was disappointed to learn that the Republic of Korea had decided to terminate for convenience the US Air Force's Foreign Military Sales contract with BAE Systems to upgrade Korea's F-16 aircraft fleet.

**UK**

In the UK, the defence and security market has been stable. Notwithstanding the continued constraints on public spending in some sectors, BAE Systems continues to benefit from long-term contracts in the air and naval domains. Both major political parties

in the UK are committed to carrying out a Strategic Defence and Security Review after the general election in May. The Group benefits from a large order backlog of long-term committed programmes with many key decisions now addressed for several years.

We recognise that the economic environment in the UK remains challenging, placing further pressure on many areas of public spending, including the UK defence budget. Through a continued focus on cost control, programme execution and efficiency, the Group is working to deliver continuous improvements in affordability for the UK customer to ensure that the Group's large, long-term contracts deliver both value and world-class capability.

In the air domain, Typhoon production and the Group's extensive in-service military aircraft support and upgrade business in the UK provide a strong core of high-performing business. 2014 has seen a significant acceleration of capability expansion onto the Typhoon combat aircraft platform. Activity is underway to integrate additional weapons and sensors onto the aircraft for the four European partner nations and international customers. In November, the formal launch of a funded, multi-nation development programme for an advanced, electronically-scanned radar was a key milestone in the Typhoon platform's evolution.

Our participation in the F-35 Lightning II combat aircraft programme includes UK-manufactured rear fuselage and empennage assemblies as well as electronic systems content from the Group's US-based business. The Group expects significant growth in production volume with the planned acceleration of aircraft deliveries.

The outlook for the Group's UK maritime businesses is robust. The build of two Queen Elizabeth Class aircraft carriers is progressing well. The first of Class was named in a formal ceremony by Her Majesty The Queen on 4 July and subsequently floated out of the dock in which she was assembled, enabling assembly of blocks for the second vessel to commence as the first vessel continues outfitting alongside. BAE Systems welcomed the decision, announced by Prime Minister David Cameron at the NATO Summit held in the UK in October, to commit to the operation of both vessels, providing a continuous-at-sea UK carrier capability.



**F-35 Lightning II**

End-user: Air forces of more than ten countries

BAE Systems has a significant workshare on the world's largest defence programme. The Group designs and manufactures sub-assemblies, including the aft fuselage and empennage, in the UK and provides key capabilities, including the electronic warfare suite, in the US.

**P29/P38**



**Bradley Fighting Vehicle modification**

End-user: US Army

BAE Systems is executing contracts for Bradley modifications. With its Bradley-based solution, BAE Systems has been awarded a contract for engineering and manufacturing development on the US Army's Armored Multi-Purpose Vehicle programme that will help to sustain the Group's US combat vehicle industrial base.

**P35**



**US ship repair**

End-user: US Navy

A series of Multi-Ship, Multi-Option contracts for non-nuclear naval ship repair, maintenance and upgrade at facilities located on the East, West and Gulf coasts of the US, as well as Hawaii. This repair and modernisation work is central to the US Navy's lifecycle maintenance and service life objectives.

**P35**



**European Typhoon aircraft**

End-user: Air forces of the UK, Germany, Italy and Spain

Manufacture of 236 Tranche 2 and 88 Tranche 3A Typhoon combat aircraft. There were 16 Tranche 2 aircraft deliveries in 2014. As at 31 December 2014, 219 of the 236 contracted Tranche 2 aircraft had been delivered to the four partner nations.

**P38**

# CHIEF EXECUTIVE'S REVIEW CONTINUED

Actions continue to implement and finalise contracts for the restructuring of the Group's naval ships business following last year's agreement with the UK government. In August, the Group was awarded a contract for the build of three Offshore Patrol Vessels for the Royal Navy, sustaining shipbuilding skills between the Carrier programme and the start of manufacture for the anticipated Type 26 frigate programme. The Group continues to work on the Type 26 assessment phase and is discussing proposals with the UK Ministry of Defence for the future phases of the programme. The Type 26 programme will provide long-term clarity for UK complex warship manufacture, including at the Group's facilities on the River Clyde in Scotland.

Following the Scottish independence referendum in September, the people of Scotland decided to remain within the Union. The decision was welcomed, removing uncertainty for the Group's employees and its business based in Scotland.

In October, the Group agreed a multi-year Maritime Support Delivery Framework contract for the operation of the Royal Naval Base at Portsmouth and global support for half of the Royal Navy's surface fleet.

In December, a significant contract for the upgrade of the Spearfish torpedo was secured.

In the submarines business, Artful, the third of a planned seven Astute Class submarines, was launched in May. Alongside build of Astute Class boats, engineering work continues to accelerate as part of the assessment phase of the Successor submarine programme. The Successor programme is the potential replacement of Vanguard Class submarines, intended to enter service towards the end of the next decade.

### Cyber security

BAE Systems continues to develop its strategy for commercial cyber security, with growth being delivered and a number of important contract wins in the year. Order backlog in the Applied Intelligence business grew by 37% in the year, building on the 60% increase in 2013.

We continue to target strong growth opportunities in commercial cyber security markets and the acquisition of SilverSky in December accelerates the Group's strategy to grow in the commercial cyber market, providing an established channel to US customers.

### International

In Saudi Arabia, the Group delivered a further 11 Typhoon aircraft in the year and developed its position as a key part of the Kingdom's defence industrial base.

In February 2014, agreement was reached with the Saudi Arabian government on price escalation for the Salam Typhoon programme under the current 72-aircraft contract.

In June, we announced a reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia and an enhancement of its existing relationship with Riyadh Wings Aviation Academy LLC (Riyadh Wings). The reorganisation brings together shareholdings of BAE Systems and Riyadh Wings in Saudi companies specialising in training, electronics and IT systems engineering under a single holding company. The reorganisation is intended to enhance the growth prospects of this portfolio of businesses and reinforce an ongoing commitment to increasing local employment.

In Australia, where BAE Systems is the largest defence contractor, the government approved, in May 2014, a commitment to grow defence spending within a decade to 2% of Gross Domestic Product.

The Group delivered the first of two Canberra Class Landing Helicopter Dock (LHD) vessels for the Royal Australian Navy and manufacture of the second ship is progressing well. Following the high level of activity on this programme, there is currently no material follow-on workload contracted. BAE Systems and the Australian government continue to discuss options to sustain industrial capabilities and meet future naval requirements following on from the high level of workload on the LHD programme.

BAE Systems is a 37.5% shareholder in the MBDA guided weapons joint venture. MBDA benefits from sales to equip a range of air and naval platforms across European and wider international applications. In December, MBDA received a €301m (£234m) contract to supply the air-to-air missiles for India's Jaguar aircraft fleet. The MBDA business has seen increased bidding interest on ground-based air defence systems in some regions.

## TOP 12 PROGRAMMES (CONTINUED)



### European Typhoon support

End-user: Air forces of the UK, Germany, Italy and Spain

Availability-based service contracts for support to the customers' operational commitments on Typhoon aircraft, including maintenance, support and training.

P38



### Queen Elizabeth Class aircraft carriers

End-user: Royal Navy

Design and manufacture of two 65,000 tonne aircraft carriers. The first of class, HMS Queen Elizabeth, achieved float-up in July and continues outfitting in advance of sea trials in 2016. Block build for the second ship is 80% complete and assembly at Rosyth has commenced. The ships are expected to enter service in 2017 and 2019, respectively.

P39



### UK ship support

End-user: Royal Navy

The five-year Maritime Support Delivery Framework contract for support to half of the Royal Navy's surface fleet on UK and global operations, as well as the management of Portsmouth Naval Base.

P39



### Astute Class submarines

End-user: Royal Navy

Design and manufacture of seven nuclear-powered attack submarines. Artful, the third of class, was launched in May and completed her maiden dive in October. The remaining four boats are at various stages of manufacture, with the seventh and final boat expected to enter service towards the middle of the next decade.

P39

**M&A**

In August, the Group announced an agreement for the proposed sale of its 75% holding in BAE Systems Land Systems South Africa (Pty) Limited to Denel (SOC) Limited for cash consideration of approximately 641 million Rand (£36m), subject to closing adjustments. The sale is expected to be completed in 2015.

As part of the reorganisation of the Group's interests in Saudi Arabia, in September, BAE Systems acquired an additional 59% shareholding in Saudi Development and Training Company for 440 million Saudi Riyal (£72m).

In September, the Group completed the \$21m (£13m) acquisition of Signal Innovations Group, Inc., a small-scale, high-technology provider of imaging technologies and analytics to the US intelligence community.

In December, BAE Systems completed the acquisition of SilverSky for \$232m (£149m).

In December, BAE Systems entered into an agreement with Esterline Corporation for the proposed acquisition of Eclipse Electronic Systems, Inc. for cash consideration of approximately \$28m (£18m), subject to closing adjustments. The Texas-based business employs approximately 90 people and provides highly-advanced Intelligence, Surveillance and Reconnaissance products and services to the US defence and intelligence community. The proposed acquisition has not yet completed.

**Balance sheet and capital allocation**

Following the triennial funding valuations of all of the Group's UK pension schemes and subsequent discussions with trustees, new funding agreements have been concluded, with overall deficit funding remaining broadly consistent with 2014.

In February 2013, the Group initiated a share repurchase programme of up to £1bn over three years. As at 31 December 2014, BAE Systems had purchased 119 million shares for £495m under the programme.

The Group's balance sheet continues to be managed conservatively in line with the Group's policy to retain its investment grade credit rating and to ensure operating flexibility. Consistent with this approach, the Group meets its pension obligations, pursues organic investment opportunities, plans to pay dividends in line with its policy of long-term sustainable cover of around

two times underlying earnings and to make accelerated returns of capital to shareholders when the balance sheet allows. Investment in value-enhancing acquisitions are considered where market conditions are right and where they deliver on the Group's strategy.

**Responsible business**

The way the Group conducts its business is of equal importance as product delivery. We continue to embed responsible business conduct throughout the Group. During 2014, our employees received business conduct refresher training and our Code of Conduct was updated and will be rolled out to all employees during the first half of 2015.

The safety of our employees and those using our products is a priority for the Group. We continue to drive safety improvements and, in 2014, achieved an 11% reduction in the Recordable Accident Rate (see page 20), which represents the seventh consecutive year of improvement.

**Management**

Kevin Taylor, previously Group Strategy Director, has been appointed as Managing Director, Applied Intelligence, to lead the business as it enters the next phase of its strategy to target accelerated growth and further develop our technology for government and commercial customers. Kevin will remain an Executive Committee member.

**Looking forward**

BAE Systems benefits from a large order backlog, long-term programmes and high-technology capabilities. The Group continues to address customers' needs across a broad international market base. In addition, BAE Systems has established a good balance of business activities in both advanced products and value-added support services. The Group is well positioned to continue to deliver shareholder value by addressing customers' continuing defence and security needs as economies recover in domestic markets and defence priorities continue to evolve.



Ian King, Chief Executive



**Successor submarine**

End-user: Royal Navy

Design and development of a nuclear-powered submarine as the potential replacement for the Vanguard Class fleet to carry the UK's Trident nuclear deterrent towards the end of the next decade.

P39



**Salam Typhoon aircraft**

End-user: Royal Saudi Air Force

Supply of 72 Typhoon combat aircraft. As at 31 December 2014, 45 aircraft had been delivered under the contract. We continue to advance the capability and through-life support of these aircraft.

P41



**Salam Typhoon support**

End-user: Royal Saudi Air Force

Five-year output-based maintenance, support and training contract awarded in 2013 for Typhoon aircraft as they progressively enter service. Flying hours and key performance indicators continue to meet contracted levels.

P41






**Saudi British Defence Co-operation Programme**

End-user: Royal Saudi Air Force and Royal Saudi Naval Forces

Provision of support to operational capability, including contracts awarded in 2012 to provide manpower, logistics and training to the end of 2016 and to upgrade training aircraft, and in 2013 to upgrade Tornado aircraft.

P41

# PERFORMANCE AGAINST OUR 2014 OBJECTIVES

OBJECTIVE	MEASUREMENT	2014 PERFORMANCE	KEY PERFORMANCE INDICATOR						
<b>1. FINANCIAL PERFORMANCE</b> Meet 2014 financial targets	<b>Order intake<sup>1</sup> (£bn)</b> Order intake represents the value of funded orders received from customers in the year. Order intake is a measure of in-year performance and supports future years' sales performance.	UK/US order intake <sup>1</sup> , which increased by 8% to £10.8bn (2013 £10.0bn), benefited from the award of over £1bn of Royal Navy contracts. Non-UK/US order intake <sup>2</sup> was lower than last year at £4.3bn (2013 £9.3bn) reflecting the five-year support contracts in Saudi Arabia renewed during 2013.	<b>£15.1BN</b>  <table border="1"> <tr> <td>2014</td> <td>15.1</td> </tr> <tr> <td>2013</td> <td>19.3</td> </tr> <tr> <td>2012</td> <td>22.3</td> </tr> </table>	2014	15.1	2013	19.3	2012	22.3
	2014	15.1							
2013	19.3								
2012	22.3								
<b>15%</b> UK executive directors' annual bonus <sup>5</sup>	<input checked="" type="checkbox"/> Target <sup>7</sup> achieved	<input type="checkbox"/> <input type="checkbox"/> <b>P72</b>							
	<b>Sales<sup>1</sup> (£bn)</b> 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.	Prior year sales <sup>1</sup> included a £0.3bn retrospective benefit from the trading of the price escalation on the Salam Typhoon programme. The volume reductions in the Land & Armaments business were as expected. Approximately £0.6bn of the reduction in sales <sup>1</sup> was due to exchange translation.	<b>£16.6BN</b> <b>-8%</b>  <table border="1"> <tr> <td>2014</td> <td>16.6</td> </tr> <tr> <td>2013</td> <td>18.2</td> </tr> <tr> <td>2012</td> <td>17.9</td> </tr> </table>	2014	16.6	2013	18.2	2012	17.9
2014	16.6								
2013	18.2								
2012	17.9								
		<input type="checkbox"/> <input type="checkbox"/> <b>P108</b> Note 1 to the Group accounts							
	<b>Underlying EBITA<sup>2</sup> (£m)</b> Underlying EBITA excludes amortisation and impairment of intangible assets, finance costs and taxation expense, and non-recurring items (profit/loss on disposal of businesses). Underlying EBITA is used by the Group for internal performance analysis as a measure of operating profitability that is comparable over time.	Prior year underlying EBITA <sup>2</sup> included a £183m retrospective benefit from the Salam price escalation settlement. Charges totalling £74m were taken in 2014 on commercial shipbuilding programmes in the US Support Solutions business. Adverse exchange translation amounted to £49m.	<b>£1,702M</b> <b>-12%</b>  <table border="1"> <tr> <td>2014</td> <td>1,702</td> </tr> <tr> <td>2013</td> <td>1,925</td> </tr> <tr> <td>2012</td> <td>1,862</td> </tr> </table>	2014	1,702	2013	1,925	2012	1,862
2014	1,702								
2013	1,925								
2012	1,862								
		<input type="checkbox"/> <input type="checkbox"/> <b>P108</b> Note 1 to the Group accounts							







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 23).

3. Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items and, in 2014, a credit in respect of the re-assessment of existing tax provisions (see note 8 to the Group accounts).

4. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.

The Executive Committee sets annual objectives which focus on deliverables in support of both short-term results and the overall long-term strategy. The Board uses a range of quantitative and qualitative performance indicators to monitor performance against these objectives. Executive directors' remuneration is linked to certain of these measures.

OBJECTIVE	MEASUREMENT	2014 PERFORMANCE	KEY PERFORMANCE INDICATOR						
<b>1. FINANCIAL PERFORMANCE</b> Meet 2014 financial targets	<b>Underlying earnings<sup>3</sup> per share (pence)</b> 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, non-recurring items and, in 2014, a credit in respect of the re-assessment of existing tax provisions. Underlying earnings per share provides a measure of shareholder return that is comparable over time.	Prior year underlying earnings <sup>3</sup> per share included a 4.4p retrospective benefit from the Salam price escalation settlement. The other principal drivers of the year-on-year variance are shown in the underlying earnings <sup>3</sup> per share bridge chart on page 23.	<b>38.0P</b> <b>-10%</b> <table border="1"> <tr> <td>2014</td> <td>38.0</td> </tr> <tr> <td>2013</td> <td>42.0</td> </tr> <tr> <td>2012</td> <td>38.7</td> </tr> </table>  P117 Note 8 to the Group accounts	2014	38.0	2013	42.0	2012	38.7
	2014	38.0							
2013	42.0								
2012	38.7								
<b>40%</b> UK executive directors' annual bonus <sup>6</sup>	 Target <sup>7</sup> achieved	 P72							
	<b>Operating business cash flow<sup>4</sup> (£m)</b> Operating business cash flow represents net cash flow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments. Operating business cash flow is the measure used to assess the operating cash generation of the Group.	Operating business cash flow <sup>4</sup> benefited from the sale and leaseback of two properties in Saudi Arabia, for which £418m was received in the year. Some £200m of receivables in the Saudi Arabian business were collected in December, earlier than expected.	<b>£1,191M</b> <table border="1"> <tr> <td>2014</td> <td>1,191</td> </tr> <tr> <td>2013</td> <td>147</td> </tr> <tr> <td>2012</td> <td>2,692</td> </tr> </table>  P145 Note 24 to the Group accounts	2014	1,191	2013	147	2012	2,692
	2014	1,191							
2013	147								
2012	2,692								
<b>25%</b> UK executive directors' annual bonus <sup>6</sup>	 Target <sup>7</sup> achieved	 P72							
	<b>Net (debt)/cash as defined by the Group<sup>5</sup> (£m)</b> Net (debt)/cash comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account.	Net debt <sup>5</sup> increased by £333m. The £925m returned to shareholders and the £230m cash cost of business acquisitions was funded by operating business cash flow <sup>4</sup> . There was adverse exchange translation of £146m.	<b>£(1,032)M</b> <table border="1"> <tr> <td>2014</td> <td>(1,032)</td> </tr> <tr> <td>2013</td> <td>(699)</td> </tr> <tr> <td>2012</td> <td>387</td> </tr> </table>  P146 Note 25 to the Group accounts	2014	(1,032)	2013	(699)	2012	387
	2014	(1,032)							
2013	(699)								
2012	387								

5. Comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account (see page 24).

6. 85% of the UK executive directors' bonuses are based on the achievement of objectives aligned to certain Executive Committee objectives measured on Group-level quantitative key performance indicators, with the remaining 15% based on the achievement of personal objectives aligned to the delivery of specific elements of the Group's strategy measured using both quantitative and qualitative performance indicators.

7. The target is the Group's budget for the year, which represents the first year of the five-year Integrated Business Plan (see page 60).

# PERFORMANCE AGAINST OUR 2014 OBJECTIVES CONTINUED

OBJECTIVE	MEASUREMENT	2014 PERFORMANCE	KEY PERFORMANCE INDICATOR
<h2>2. CUSTOMER FOCUS AND PROGRAMME EXECUTION</h2> <p>Continued focus on improving customer satisfaction and programme execution</p>	<p><b>Programme margin variation</b> 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.</p>	<p>Overall, there was a net improvement in programme margin over the year.</p>	<p>The data for the programme margin variation metric covers 101 contracts, representing more than 60% of the Group's funded order backlog.</p>

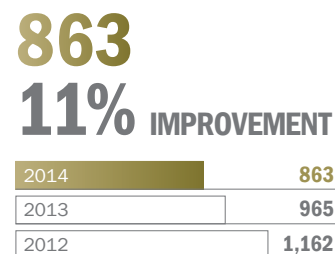
## 3. RESPONSIBLE BEHAVIOUR

Progress towards recognised leading positions

**Safety**  
The Recordable Accident Rate, which focuses on the number of accidents, is the principal metric used by the Group's businesses to monitor performance in safety and drive improvements in accident prevention. The Group also monitors programmes to reduce safety risk and to drive improvements in safety awareness and culture.

The Group achieved an 11% reduction in the Recordable Accident Rate<sup>1</sup>, consistent with the target for the year. The number of major (most serious) injuries<sup>1</sup> reduced from 65 to 44, which is an improvement of more than 30%. Each area of the business demonstrated improvements in safety risk management, and progressed a range of activities to increase awareness and enhance further a strong safety culture.

**Recordable Accident Rate (per 100,000 employees)<sup>1</sup>**



**5%** UK executive directors' annual bonus<sup>2</sup>

Target achieved

P72

**Diversity and inclusion, and environment**  
The Group has improvement plans in place to address diversity and inclusion, and environment.

Plans were set and implemented at business level to address specific issues or strategic aims. All businesses reported progress.

Plans to increase diversity and inclusion in line with business goals are included within each Executive Committee member's annual performance review.

The individual businesses set site or business-specific environmental targets covering energy, water and waste improvement.

## 4. ENGAGEMENT

Inspire and engage our people to deliver success

**Employee Pulse survey**  
As part of BAE Systems' journey to become a great workplace, employees had the opportunity once again to share their views through the 2014 Employee Pulse survey. Employees were invited to participate in the survey. As US employees completed a full survey in 2013, 20% were selected to participate in 2014.






Across BAE Systems, employees provided feedback on their pride in working for the Group and the high levels of trust present in their teams as they work to support customers. This reflects the Group's ongoing commitment to creating environments in which employees can contribute to the success of the Group.

**59%** participation rate (2013 58%)

**65%** employee engagement (2013 66%)

1. See summary of Deloitte assurance on page 47.

2. 85% of the UK executive directors' bonuses are based on the achievement of objectives aligned to certain Executive Committee objectives measured on Group-level quantitative key performance indicators, with the remaining 15% based on the achievement of personal objectives aligned to the delivery of specific elements of the Group's strategy measured using both quantitative and qualitative performance indicators.

OBJECTIVE	2014 PERFORMANCE	REFERENCE
<p><b>5. ELECTRONIC SYSTEMS</b></p> <p>Be agile, sustain revenues and deliver strong bottom line performance</p>	<p>Electronic Systems outperformed its major competitors by delivering a 3% increase in like-for-like sales<sup>1</sup>, with an improved margin of 15.4% (2013 14.0%). The business achieved important contract wins in defence markets and, in the high-growth commercial aircraft electronics market, Electronic Systems strengthened its positions across major aircraft platforms, with wins on Boeing contracts, including the 777X programme.</p>	 P28
<p><b>6. CYBER &amp; INTELLIGENCE</b></p> <p>Enhance and grow our positions in cyber, intelligence and security</p>	<p>Whilst the Intelligence &amp; Security business continued to face challenging market conditions, with budget pressures impacting its US government customers, order backlog<sup>1,2</sup> increased by 7%. In September, Intelligence &amp; Security acquired Signal Innovations Group, a leading provider of imaging technologies and analytics to the US intelligence community. Applied Intelligence delivered organic sales growth of 10% and order book grew by a further 37% following a 60% increase in 2013. A UK government customer selected the business as one of four strategic suppliers on a technology framework and multi-year framework contracts were awarded for Service Integration and Applications Management services. In December, Applied Intelligence acquired SilverSky, a commercial cyber service provider, to enhance its commercial cyber growth strategy.</p>	 P31
<p><b>7. PLATFORMS &amp; SERVICES (US)</b></p> <p>Drive value from our land portfolio and deliver sustainable, profitable growth in the services sector</p>	<p>In Land &amp; Armaments, there was continued focus on cost reduction and margin increased to 10.3% (2013 8.8%). Efforts to sustain and grow vehicle programmes resulted in significant awards, including the US Army's Armored Multi-Purpose Vehicle programme, Bradley and M88 vehicles, and the Low-Rate Initial Production of the M109A7 self-propelled howitzer. In Support Solutions, whilst performance was impacted by charges taken on commercial shipbuilding programmes, the US-based ship repair business continued to perform well, receiving orders totalling \$1.5bn (£1.0bn) on various US Navy vessels, and operational challenges on the Radford Army Ammunition Plant contract were mitigated significantly. Whilst successfully executing phase one of the Korean F-16 upgrade programme, the contract was terminated for convenience by the customer in November.</p>	 P34
<p><b>8. PLATFORMS &amp; SERVICES (UK)</b></p> <p>Deliver sustainably profitable through-life businesses in the air, maritime, combat vehicles and munitions sectors</p>	<p>Strong programme performance delivered a return on sales of 11.7%. Development of the Typhoon platform continued and a £365m contract was received for the integration of the E-Scan radar onto the aircraft. Potential management redundancies were announced to align the organisational operating model of the air business with its strategy and to improve competitiveness. The consolidation of UK shipbuilding operations in Glasgow progressed to plan, with shipbuilding operations in Portsmouth ceasing during the year. Over £1bn of contracts were awarded by the Royal Navy, including for the construction of three Offshore Patrol Vessels, support to the surface fleet and Spearfish torpedo upgrade.</p>	 P37
<p><b>9. PLATFORMS &amp; SERVICES (INTERNATIONAL)</b></p> <p>Grow our Platforms &amp; Services (International) business</p>	<p>Sales<sup>1</sup> reduced by £0.5bn to £3.6bn, including £143m for exchange translation. In Saudi Arabia, the Group continued to support the operational capabilities of the Royal Saudi Air Force and Royal Saudi Naval Forces, and to develop the industrial base. A reorganisation of industrial partner companies in Saudi Arabia to support their future growth commenced. In Australia, whilst activity on the Landing Helicopter Dock programme ramped down, a four-year contract was awarded to support the two vessels in service and BAE Systems continues to engage with the Australian government regarding the sustainment of shipbuilding capability following delivery of the second ship in 2015. Additional blocks were contracted on the Air Warfare Destroyer programme. MBDA received a number of significant contracts and is pursuing actively a number of export opportunities.</p>	 P40

1. Including share of equity accounted investments.

2. Comprises funded and unfunded unexecuted customer orders.

# FINANCIAL REVIEW

## FINANCIAL HIGHLIGHTS

£925m returned to shareholders in 2014, including £283m on the share repurchase programme and £642m in dividends

Sales<sup>1</sup> decreased by £1.5bn to £16.6bn. Around £0.6bn of that reduction was due to exchange translation. The volume reductions in Land & Armaments of £0.4bn were as expected. Last year's sales<sup>1</sup> included the retrospective benefit of £0.3bn from the price escalation settlement on the Salam programme

Underlying EBITA<sup>2</sup> decreased by £223m, to £1,702m, giving a return on sales of 10.2%. Of that reduction, £49m was due to exchange translation and £183m for the retrospective benefit traded in 2013 from the Salam price escalation

Excluding the prior year 4.4p benefit from the Salam price escalation settlement, underlying earnings<sup>3</sup> per share increased to 38.0p

Large order backlog<sup>1,4</sup> of £40.5bn after exchange translation benefit of £0.3bn

Total dividend increased by 2% to 20.5p per share

Peter Lynas, Group Finance Director

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.
3. Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items and, in 2014, a credit in respect of the re-assessment of existing tax provisions (see note 8 to the Group accounts).
4. Comprises funded and unfunded unexecuted customer orders, and is stated after the elimination of intra-group orders.





### Income statement

Sales<sup>1</sup> reduced by £1.5bn to £16.6bn (2013 £18.2bn). The prior year included the £0.3bn retrospective benefit from the trading of the price escalation on the Salam Typhoon programme. The volume reductions of £0.4bn in the Land & Armaments business were as expected. Approximately £0.6bn of the reduction in sales<sup>1</sup> was due to exchange translation.

Underlying EBITA<sup>2</sup> reduced by £223m to £1,702m (2013 £1,925m), giving a return on sales of 10.2% (2013 10.6%). The prior year included a £183m retrospective benefit from the Salam price escalation settlement. Charges totalling £74m were taken in 2014 on US commercial shipbuilding programmes in the Support Solutions business. Adverse exchange translation amounted to £49m.

Non-recurring items in 2014 includes a £47m accounting gain on the Group's existing 40% shareholding in Saudi Development and Training Company following the acquisition of an additional 59% shareholding in the company offset by a £47m charge on classification of the Saudi Aircraft Accessories and Components Company (AACC) as held for sale.

Amortisation of intangible assets was £184m (2013 £189m).

Impairment of intangible assets includes goodwill impairment charges of £87m against the carrying value of Support Solutions reflecting the performance issues in the US commercial shipbuilding business and £74m against the carrying value of the South African business expected to be sold in 2015.

Finance costs<sup>4</sup> were £448m (2013 £392m). The underlying interest charge, excluding pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements, increased to £204m (2013 £179m), primarily from a higher level of net present value charges. Net interest expense on the Group's pension deficit was lower at £155m (2013 £195m) mainly reflecting the reduction in the deficit during 2013.

Taxation expense<sup>5</sup> reflects the Group's underlying effective tax rate for the period of 19% (2013 22%), partially offset by a £51m credit in respect of the re-assessment of existing tax provisions. The calculation of the underlying effective tax rate is shown in note 6 to the Group accounts on page 115. The effective tax rate for 2015 is expected to be around 20%, with the final rate dependent on the geographical mix of profits.

### Earnings per share

Underlying earnings<sup>3</sup> per share for the year was 38.0p (2013 42.0p). The prior year included a 4.4p retrospective benefit from the Salam price escalation settlement.

Basic earnings per share, in accordance with International Accounting Standard 33, Earnings per Share, was 23.4p (2013 5.2p). The increase on the prior year mainly reflects the £887m of impairment charges taken in 2013 which are excluded from underlying earnings<sup>3</sup> per share.

INCOME STATEMENT			
		2014 £m	2013 £m
Sales <sup>1</sup>	KPI	16,637	18,180
Underlying EBITA <sup>2</sup>	KPI	1,702	1,925
Return on sales		10.2%	10.6%
Non-recurring items		-	6
EBITA		1,702	1,931
Amortisation of intangible assets		(184)	(189)
Impairment of intangible assets		(170)	(887)
Finance costs <sup>1</sup>		(448)	(392)
Taxation expense <sup>1</sup>		(148)	(287)
Profit for the year		752	176

SALES <sup>1</sup> BRIDGE (£BN)		KPI
2013		18.2
Salam price escalation		(0.3)
Land & Armaments volumes		(0.4)
Foreign exchange translation		(0.6)
Other		(0.3)
2014		16.6

P108 Note 1 to the Group accounts

EARNINGS PER SHARE			
		2014	2013
Underlying earnings <sup>3</sup> per share	KPI	38.0p	42.0p
Basic earnings per share		23.4p	5.2p

UNDERLYING EARNINGS <sup>3</sup> PER SHARE BRIDGE (PENCE)		KPI
2013		42.0
Salam price escalation		(4.4)
Land & Armaments volumes		(0.9)
Commercial shipbuilding charges		(1.9)
Foreign exchange translation		(1.2)
Finance costs		(0.6)
Reduced share base		0.9
Tax rate		1.6
Other performance improvements		2.5
2014		38.0

P117 Note 8 to the Group accounts

EXCHANGE RATES - AVERAGE			
		2014	2013
£/\$		1.647	1.564
£/€		1.241	1.178
£/A\$		1.827	1.623

EXCHANGE RATES - SENSITIVITY ANALYSIS		
Estimated impact on sales <sup>1</sup> of a ten cent movement in the average exchange rate		£m
\$		350
€		60
A\$		40



P18 Performance against our 2014 objectives



P27 Segmental performance

# FINANCIAL REVIEW CONTINUED

## Cash flow

Cash inflow from operating activities was £913m (2013 £205m), which includes cash contributions in respect of pension deficit funding, over and above service costs, for the UK and US schemes totalling £391m (2013 £389m).

As anticipated, advances received in prior years continue to be consumed on the Omani Typhoon and Hawk, Saudi training aircraft, European Typhoon Tranche 2 and Indian Hawk programmes. Costs incurred are also being charged against provisions created in previous years on the Oman Offshore Patrol Vessel contract, rationalisation and settlement of a US contract pricing dispute. The first of two payments in respect of the Salam price escalation settlement was received as expected.

The net cash proceeds from capital expenditure and financial investment of £215m (2013 £153m outflow) includes the sale and leaseback of two properties in Saudi Arabia, for which £418m was received in the year.

Dividends received from equity accounted investments reduced by £32m to £63m (2013 £95m) reflecting a dividend received from the Group's 50% shareholding in Gripen International in 2013.

Interest payments were £21m lower at £145m (2013 £166m) primarily reflecting the timing of interest payments on US dollar bonds and lower facility fees.

Taxation payments reduced to £92m (2013 £138m) mainly due to settlement of a US contract pricing dispute and other US issues.

There was a cash outflow in respect of acquisitions and disposals reflecting the acquisition of SilverSky (£147m) and Signal Innovations Group (£12m) and an additional 59% shareholding in Saudi Development and Training Company (£71m).

The cash outflow in respect of the share repurchase programme of £283m (2013 £212m) represents shares purchased and cancelled under the programme announced in February 2013.

Equity dividends paid in 2014 include payments in respect of the 2013 final (£383m) and 2014 interim (£259m) dividends.

As a consequence of movements in US dollar and Euro exchange rates during the year, there has been a cash inflow from matured derivative financial instruments of £8m (2013 £47m outflow) from rolling hedges on balances with the Group's subsidiaries and equity accounted investments.

Foreign exchange translation, primarily in respect of the Group's US dollar-denominated borrowing, increased reported net debt by £146m.

## Net debt (as defined by the Group)

The Group's net debt at 31 December 2014 is £1,032m, a net outflow of £333m from the net debt position of £699m at the start of the year.

A \$500m (£298m) 4.95% bond and a £100m, 10<sup>3</sup>/<sub>4</sub>% bond were repaid at maturity in June and December,

RECONCILIATION OF CASH INFLOW FROM OPERATING ACTIVITIES TO NET DEBT (AS DEFINED BY THE GROUP)		
	2014 £m	2013 £m
<b>Cash inflow from operating activities</b>	<b>913</b>	205
Capital proceeds/(expenditure) (net) and financial investment	215	(153)
Dividends received from equity accounted investments	63	95
<b>Operating business cash flow<sup>5</sup></b> <b>KPI</b>	<b>1,191</b>	147
Interest	(145)	(166)
Taxation	(92)	(138)
<b>Free cash flow</b>	<b>954</b>	(157)
Acquisitions and disposals	(230)	4
Cash classified as held for sale	(6)	-
Share repurchase programme	(283)	(212)
Other net sale of own shares	2	-
Equity dividends paid	(642)	(638)
Dividends paid to non-controlling interests	(14)	(11)
Cash flow from matured derivative financial instruments	8	(47)
Movement in cash collateral	10	(10)
Movement in cash received on customers' account <sup>6</sup>	1	1
Foreign exchange translation	(146)	3
Other non-cash movements	13	(19)
<b>Total cash outflow</b>	<b>(333)</b>	(1,086)
Opening net (debt)/cash (as defined by the Group)	(699)	387
<b>Closing net debt (as defined by the Group)</b> <b>KPI</b>	<b>(1,032)</b>	(699)

COMPONENTS OF NET DEBT (AS DEFINED BY THE GROUP)		
	2014 £m	2013 £m
Debt-related derivative financial instrument assets	10	6
Cash and cash equivalents	2,314	2,222
Less: Cash classified as held for sale	(6)	-
	<b>2,318</b>	2,228
Loans – non-current	(2,868)	(2,524)
Loans and overdrafts – current	(482)	(402)
Less: Cash received on customers' account <sup>6</sup>	-	(1)
	<b>(3,350)</b>	(2,927)
<b>Net debt (as defined by the Group)</b> <b>KPI</b>	<b>(1,032)</b>	(699)

5. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.  
6. 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.

respectively. These repayments had been largely pre-financed by the £0.4bn raised in the UK bond market in 2012.

In October, the Group issued \$800m (£495m) 3.8% and \$300m (£184m) 4.75% bonds maturing in 2024 and 2044, respectively, intended for general corporate purposes, including the repayment of debt securities at maturity in 2015 and 2016.

**Cash and cash equivalents** of £2,314m (2013 £2,222m) are held primarily for the repayment of £0.7bn of debt securities maturing in 2015 and 2016, the share repurchase programme, pension deficit funding, payment of the 2014 final dividend and management of working capital.

#### Balance sheet

The £248m increase in **intangible assets** to £10.0bn (2013 £9.7bn) arises from business acquisitions made in the year (£289m) and exchange translation (£258m), partly offset by the impairment of goodwill relating to the US commercial shipbuilding and South African businesses (£161m), and the year's amortisation charge (£179m).

**Property, plant and equipment, and investment property** reduced to £1.7bn (2013 £2.1bn) reflecting the disposal of a residential and office facility in Saudi Arabia.

**Equity accounted investments and other investments** reduced to £236m (2013 £286m) mainly reflecting the dividends of £63m received in the year. Note 12 to the Group accounts on page 125 identifies the Group's

principal joint ventures, Eurofighter, MBDA and Air Astana, and, this year, provides additional information in respect of the Group's interests in those companies.

The £1.9bn increase in the Group's share of the pre-tax **pension deficit** mainly reflects an increase in liabilities due to a 0.7 percentage point decrease in the real discount rate to 0.4% in the UK and a 0.8 percentage point decrease in the nominal discount rate to 4.1% in the US. Details of the Group's pension schemes are provided in note 21 to the Group accounts on page 134.

The triennial funding valuations of all of the Group's UK pension schemes were performed in 2014 and showed an aggregate funding deficit of £2.7bn. New funding arrangements, including deficit recovery plans which run until 2026, have been concluded with the trustees of those schemes.

A net deferred tax asset of £1.2bn (2013 £0.7bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

There was a £0.5bn increase in **working capital** mainly reflecting a net reduction in advance contract funding and utilisation of provisions.

At 31 December 2014, the South African land vehicles business (£41m) and AACC (£12m), both expected to be sold in 2015, are classified as **held for sale**. The disposal of the residential and office facility in Saudi Arabia classified as held for sale at 31 December 2013 (£140m) was completed on 9 January 2014.

MATURITY OF THE GROUP'S BORROWINGS (£BN)	
2014	3.4
2015	2.9
2016	2.6
2017	2.6
2018	2.6
2019	2.0
2020	2.0
2021	1.7
2022	1.3
2023	1.3
2024	0.8
2025	0.8
2026	0.8
2027*	0.4

P132 Note 19 to the Group accounts

\* Repayable in 2041 (£254m) and 2044 (£190m).

BALANCE SHEET		
	2014 £m	2013 £m
Intangible assets	9,983	9,735
Property, plant and equipment, and investment property	1,718	2,071
Equity accounted investments and other investments	236	286
Other financial assets and liabilities (net)	(112)	(23)
Pension deficit (net)	(5,368)	(3,509)
Tax assets and liabilities (net)	865	405
Working capital	(4,466)	(4,988)
Net assets held for sale	53	140
Net debt (as defined by the Group) <b>KPI</b>	(1,032)	(699)
<b>Net assets</b>	<b>1,877</b>	<b>3,418</b>

EXCHANGE RATES – YEAR END		
	2014	2013
£/\$	1.559	1.656
£/€	1.287	1.202
£/A\$	1.908	1.851

MOVEMENT IN THE GROUP'S PENSION DEFICIT (£BN)	
2013	3.5
Real discount rate	3.0
Return on assets	(1.2)
Deficit funding	(0.4)
Other	0.5
<b>2014</b>	<b>5.4</b>

P134 Note 21 to the Group accounts

# FINANCIAL REVIEW CONTINUED

## CRITICAL ACCOUNTING POLICIES

Certain of the Group's principal 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:

### Revenue and profit recognition

Sales	£16.6bn (year ended 31 December 2014) See note 1 to the Group accounts
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### Carrying value of intangible assets

Intangible assets	£10.0bn (at 31 December 2014) See note 9 to the Group accounts
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### Valuation of retirement benefit obligations

Group's share of IAS 19 deficit, net	£5.4bn (at 31 December 2014) See note 21 to the Group accounts
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**P102** For more information

## 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.

### Objectives/policies

#### Net debt

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 and funds raised are lent onward to operating subsidiaries as required.

#### Interest rates

Manage the exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, including interest rate and cross-currency swaps.

- A minimum of 50% and a maximum of 90% of gross debt is maintained at fixed interest rates.

#### Liquidity

Maintain adequate undrawn committed borrowing facilities.

- An undrawn committed Revolving Credit Facility of £2bn contracted to December 2018 and £1.8bn contracted from December 2018 to December 2019 is available to meet expected general corporate funding requirements.

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.

#### Currency

Reduce the Group's exposure to transactional volatility in earnings and cash flows from movements in foreign currency exchange rates.

- All material firm transactional exposures are hedged.
- The Group does not hedge the translation effect of exchange rate movements on the income statements or balance sheets of foreign subsidiaries and equity accounted investments it regards as long-term investments.



**P150** Note 28 to the Group accounts

## TAX

### Objectives

The Group's tax strategy is to:

- ensure compliance with all applicable tax laws and regulations; and
- manage the Group's tax expense in a way that is consistent with its values and its legal obligations in all relevant jurisdictions.

### Policies

The Group seeks to build constructive working relationships with tax authorities, following a policy of open disclosure in order to achieve early agreement and certainty in relation to its tax affairs. 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 and actively considers the implications of any planning for the Group's wider corporate reputation. Arm's length principles are applied in the pricing of all intra-group transactions of goods and services in accordance with Organisation for Economic Co-operation and Development guidelines. Where appropriate, the Group engages with governments to help shape proposed legislation and tax policy. The Group endorses the statement of tax principles issued by the Confederation of British Industry in May 2013 ([www.cbi.org.uk/media/2051390/statement\\_of\\_principles.pdf](http://www.cbi.org.uk/media/2051390/statement_of_principles.pdf)).

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 interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The assessment and management of tax risks are regularly reviewed by the Group's Audit Committee.



**P114** Note 6 to the Group accounts

## CAPITAL

### Objectives

Maintain the Group's investment grade credit rating and ensure operating flexibility, whilst: meeting its pension obligations; pursuing organic investment opportunities; paying dividends in line with the Group's policy of long-term sustainable cover of around two times underlying earnings; 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.

### Policies

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. Three credit rating agencies publish credit ratings for the Group:

Agency	Rating	Outlook	Category
Moody's Investors Service	Baa2	Stable	Investment grade
Standard & Poor's Ratings Services	BBB+	Stable	Investment grade
Fitch Ratings	BBB+	Stable	Investment grade



**P143** Note 23 to the Group accounts

# SEGMENTAL PERFORMANCE

	KPI	KPI	KPI	KPI	KPI	KPI	
	Number of employees <sup>1</sup>	Sales <sup>2</sup> £m	Underlying EBITA <sup>2</sup> £m	Return on sales %	Cash flow <sup>3</sup> £m	Order intake <sup>4</sup> £m	Order backlog <sup>1,4</sup> £bn
<b>ELECTRONIC SYSTEMS</b>	<b>12,500</b>	<b>2,415</b>	<b>373</b>	<b>15.4</b>	<b>246</b>	<b>2,341</b>	<b>3.9</b>
 <b>P28</b>	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.						
<b>CYBER &amp; INTELLIGENCE</b>	<b>7,900</b>	<b>1,085</b>	<b>123</b>	<b>11.3</b>	<b>71</b>	<b>1,163</b>	<b>0.9</b>
 <b>P31</b>	Cyber & Intelligence comprises the US-based Intelligence & Security business and UK-headquartered Applied Intelligence business, and covers the Group's cyber, secure government, and commercial and financial security activities.						
<b>PLATFORMS &amp; SERVICES (US)</b>	<b>16,900</b>	<b>3,266</b>	<b>147</b>	<b>4.5</b>	<b>201</b>	<b>3,191</b>	<b>5.8</b>
 <b>P34</b>	Platforms & Services (US) comprises the US-headquartered Land & Armaments business, with operations in the US, UK, Sweden and South Africa, and the US-based services and sustainment activities, including ship repair and munitions services.						
<b>PLATFORMS &amp; SERVICES (UK)</b>	<b>29,600</b>	<b>6,623</b>	<b>772</b>	<b>11.7</b>	<b>173</b>	<b>5,386</b>	<b>20.1</b>
 <b>P37</b>	Platforms & Services (UK) comprises the Group's UK-based air, maritime, combat vehicle, munitions and shared services activities.						
<b>PLATFORMS &amp; SERVICES (INTERNATIONAL)</b>	<b>14,000</b>	<b>3,572</b>	<b>366</b>	<b>10.2</b>	<b>881</b>	<b>3,398</b>	<b>11.6</b>
 <b>P40</b>	Platforms & Services (International) comprises the Group's businesses in Saudi Arabia, Australia and Oman, together with its 37.5% interest in the pan-European MBDA joint venture.						
<b>HQ</b>	<b>2,500</b>	<b>279</b>	<b>(79)</b>		<b>(381)</b>	<b>277</b>	<b>-</b>
	HQ comprises the Group's business in India and head office activities, together with a 49% interest in Air Astana.						
<b>LESS: INTRA-GROUP</b>		<b>(603)</b>				<b>(634)</b>	<b>(1.8)</b>
<b>TOTAL</b>	<b>83,400</b>	<b>16,637</b>	<b>1,702</b>	<b>10.2</b>	<b>1,191</b>	<b>15,122</b>	<b>40.5</b>

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 23).

3. Net cash inflow/(outflow) from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.

4. Comprises funded and unfunded unexecuted customer orders.


**P22** Financial review

# ELECTRONIC SYSTEMS



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.



## ADVANCED PRECISION KILL WEAPON SYSTEM (APKWS™)

APKWS is a laser-guided rocket that provides a low-cost surgical strike capability. At 31 December 2014, Electronic Systems has delivered more than 3,500 systems under its Full-Rate Production Lot 3 contract with the US Navy. The US Army is working closely with the US Navy to acquire APKWS for initial fielding in 2015. Jordan and the US Navy have signed a Letter of Offer and Acceptance to progress the first international sale of the APKWS system and other international opportunities are being progressed.

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

**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 threat warning and infrared countermeasures systems for aircraft, handheld targeting and thermal devices, precision guidance systems, electro-optic sensor products and enhanced situational awareness systems.

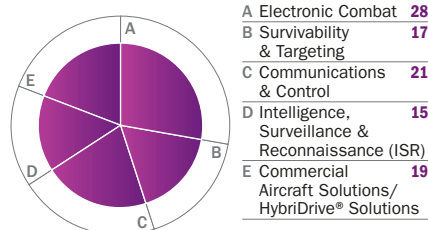
**Communications & Control** contains radio frequency communication and datalinks, and provides military aircraft controls and displays, together with platform integration capabilities.

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

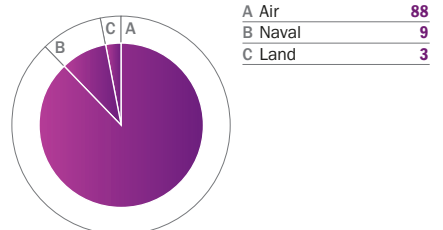
**Commercial Aircraft Solutions** addresses the commercial aircraft electronics market, including fly-by-wire flight controls, full authority digital engine controls, cockpit controls, head-up displays, cabin management systems and power management systems.

**HybriDrive® Solutions** delivers electric propulsion and power management performance, with products and solutions that advance vehicle efficiency in the transit, marine and defence markets.

SALES<sup>1</sup> BY LINE OF BUSINESS (%)



SALES<sup>1</sup> BY DOMAIN (%)



SALES<sup>1</sup> ANALYSIS: DEFENCE AND COMMERCIAL



1. Including share of equity accounted investments.

**OPERATIONAL AND STRATEGIC HIGHLIGHTS**

Maintained a leadership position in the US electronic warfare market

Received a three-year contract from the US Army for third-generation Common Missile Warning Systems

Next-generation Striker® II helmet-mounted display unveiled

Two-year contract awarded to provide Tactical Signals Intelligence Payloads and associated equipment for the US Army's Gray Eagle unmanned aircraft

Strengthened position in the high-growth commercial aircraft electronics market, with wins on several Boeing aircraft, including 777X, and other aircraft

Research and development expenditure<sup>2</sup> at 7% of sales<sup>1</sup> in 2014

**US COMMERCIAL AIRCRAFT ELECTRONICS**

BAE Systems is a major supplier to Boeing for flight controls, and cabin and flight deck systems. In July, Boeing selected BAE Systems to provide the integrated flight control electronics on its next-generation 777X programme which is projected to be worth over \$1bn (£0.6bn) over the life of the aircraft. The system will control the flight surfaces of the aircraft and integrate additional functionality unique to the 777X.

**Operational performance****Electronic Combat**

Electronic Systems maintains its leadership position in the US electronic warfare market. Initial design verification testing of the electronic warfare suite on the F-35 Lightning II programme was completed during the year. Low-Rate Initial Production (LRIP) Lots 7 and 8 deliveries continue, and the business has received initial funding on Lots 9 and 10, with anticipated negotiations in 2015.

The business is under contracts, from Boeing and Warner Robins Air Logistics Complex, totalling over \$0.9bn (£0.6bn) to install the Digital Electronic Warfare System (DEWS) on 84 new F-15 aircraft and upgrade the DEWS on 70 existing F-15 aircraft for the Royal Saudi Air Force. System verification and flight testing continues on schedule in advance of initial fielding in the second half of 2015.

The US Air Force has defined its requirements for the next-generation electronic warfare system, Eagle Passive Active Warning Survivability System, for more than 400 existing F-15 aircraft. The programme will consist of the design, development, integration and delivery of a passive and active electronic warfare suite. The business has submitted a proposal to Boeing and, in competition, an award decision is expected in the third quarter of 2015.

Following successful US Defense Advanced Research Projects Agency flight demonstrations, Electronic Systems has received an \$86m (£55m) contract to design, develop and deliver initial electronic sensors for the Long-Range Anti-Ship Missile in support of its initial fielding in 2018 on board B-1B aircraft.

In 2014, BAE Systems was not awarded the technology development contract for the Next-Generation Jammer.

**Survivability & Targeting**

Electronic Systems completed its \$38m (£24m) Common Infrared Countermeasures technology development contract on a US Army helicopter programme. A proposal for the engineering and manufacturing development phase, together with options for two LRIP phases, was submitted in November and, in competition, an award decision is expected in 2015.

A three-year Indefinite Delivery, Indefinite Quantity (IDIQ) contract with the US Army, with a potential value of approximately \$496m (£318m), was agreed in May for third-generation Common Missile Warning Systems. The US Army has determined that this will be the baseline for export to international customers.

Electronic Systems continues to execute its \$37m (£24m) Advanced Precision Kill Weapon System (APKWS™) Full-Rate Production Lot 3 contract with the US Navy, with more than 3,500 systems delivered to 31 December 2014. The APKWS laser-guided rocket achieved an Air Worthiness Release and successfully completed initial live testing on the US Army Apache D/E aircraft in 2014. The \$45m (£29m) Full-Rate Production Lot 4 contract was finalised in December. The US Army is working closely with the US Navy to acquire APKWS for initial fielding in 2015.

Jordan and the US Navy have signed a Letter of Offer and Acceptance to progress the first international sale of the APKWS system. Other international opportunities were progressed, with the successful completion of a ground trial in Australia and, in November, the US Defense Security Cooperation Agency began the Congressional Notification process on a potential Foreign Military Sale to Iraq for up to 2,000 systems.

The business continues to perform on the Terminal High-Altitude Area Defence orders for 307 infrared missile seekers supporting both the US government and Foreign Military Sales worth \$340m (£218m).

In May, Electronic Systems was awarded a five-year IDIQ contract with a potential value of approximately \$445m (£285m) to support the US Army's Enhanced Night Vision Goggle III and Family of Weapon Sights – Individual programme. Following a protest by a competitor and re-competition, BAE Systems was awarded the contract in December. However, this new award has been further protested, with the next decision expected in March 2015.

**Communications & Control**

Electronic Systems continues to deliver on programmes in Korea, providing flight control systems, head-up displays, mission computers and automatic test equipment systems.

On the F-35 Lightning II programme, BAE Systems successfully completed Lot 7 deliveries of the vehicle management computer in support of Lockheed Martin's production programme. Lots 8 and 9 are under contract.

The next-generation Striker® II helmet-mounted display was unveiled at the Farnborough Airshow in July. The system is a digital upgrade of the current product, in service on Typhoon and Gripen aircraft, providing seamless day and night capability through an integrated digital night vision camera.

2. Includes Group-funded and customer-funded expenditure.

# ELECTRONIC SYSTEMS CONTINUED

## Intelligence, Surveillance & Reconnaissance

Electronic Systems continues to provide Airborne Surveillance capability for the US Air Force and US Army based on two wide-area, high-resolution imaging sensor systems – the Airborne Wide Area Persistent Surveillance System, which has been operational for more than 23,000 hours in theatre, and the Autonomous Real-time Ground Ubiquitous Surveillance – Imaging System.

The business provides state-of-the-art processing capabilities for the US Navy's P-8A Poseidon programme, which has entered Full-Rate Production and delivered 28 mission computer and display systems. Eight additional systems have been delivered to Boeing for its first international customer and four systems were procured by Australia.

Electronic Systems continues to provide Signals Intelligence capability for the US Army and other US Department of Defense customers. In June, BAE Systems was awarded a two-year Indefinite Delivery, Indefinite Quantity contract worth up to \$70m (£45m) to provide Tactical Signals Intelligence Payloads and associated equipment for the US Army's Gray Eagle unmanned aircraft.

In December, BAE Systems entered into an agreement with Esterline Corporation for the proposed acquisition of Eclipse Electronic Systems, Inc. for cash consideration of approximately \$28m (£18m), subject to closing adjustments. The Texas-based business provides highly-advanced Intelligence, Surveillance and Reconnaissance products and services to the US defence and intelligence community. The proposed acquisition has not yet completed.

## Commercial Aircraft Solutions

BAE Systems is a major supplier to Boeing for flight controls, and cabin and flight deck systems. In July, Boeing selected BAE Systems to provide the integrated flight control electronics on its next-generation 777X programme, which is projected to be worth over \$1bn (£0.6bn) over the life of the aircraft. Development of subsystems for the 737 MAX aircraft has also continued on schedule, with the fly-by-wire spoiler units delivered to Boeing for system integration.

FADEC Alliance, a joint venture between FADEC International (the Group's joint venture with Sagem) and GE Aviation, completed first flight of the full authority digital engine controls on the Leap engine which will power the Boeing 737 MAX and Airbus A320neo aircraft.

The business completed development of the flight control system for the Embraer Legacy 500 business jet and is currently developing active side-sticks for Gulfstream G500 and G600 business jets, as well as Embraer's KC-390 cargo aircraft for the Brazilian Air Force.

Several airlines and original equipment manufacturers have expressed interest in the IntelliCabin™ product, a next-generation cabin system that provides in-seat power, LED lighting and tablet-based, wireless in-flight entertainment systems. Development activities are on schedule for system availability in 2015.

## HybriDrive® Solutions

BAE Systems has 4,500 propulsion systems in service in transit buses around the world and is delivering its HybriDrive Series-E system into major cities, including Hong Kong, Quebec, Paris, Seattle and Baltimore. The business continues to deliver systems to Washington, D.C., in the US and London in the UK, and will begin deliveries in 2015 to Boston and Honolulu.

FINANCIAL PERFORMANCE			
		2014	2013
Sales <sup>1</sup>	KPI	£2,415m	£2,466m
Underlying EBITA <sup>2</sup>	KPI	£373m	£346m
Return on sales		15.4%	14.0%
Cash inflow <sup>3</sup>	KPI	£246m	£235m
Order intake <sup>1</sup>	KPI	£2,341m	£2,697m
Order backlog <sup>1,4</sup>		£3.9bn	£3.7bn

Sales<sup>1</sup> compared to 2013 increased by 3% to just under \$4bn (£2.4bn). The commercial areas of the business now amount to 21%, having seen sales<sup>1</sup> growth in the year of 7%. On the defence side, sales<sup>1</sup> increased by 2% in the year, largely from the F-35 Lightning II programme in the Electronic Warfare area.

The return on sales achieved was 15.4% (2013 14.0%) largely reflecting continued strong programme execution and risk retirement. There was a 0.5 percentage point non-recurring gain from a contract pricing settlement.

Cash<sup>3</sup> conversion of underlying EBITA<sup>2</sup> for the year was 66% but, excluding pension deficit funding, that conversion rate was 80%.

Despite the US budget pressures, order backlog<sup>1,4</sup> was sustained at \$6.1bn (£3.9bn). The contract award for the Enhanced Night Vision Goggle programme has been protested again and is, therefore, not included within the reported order backlog<sup>1,4</sup>.

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 23).
3. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.
4. Comprises funded and unfunded unexecuted customer orders.

## LOOKING FORWARD

Whilst the longer-term outlook remains uncertain, the 2015 fiscal year omnibus appropriations legislation passed in December 2014 included stable Department of Defense funding and support for major programmes, including F-35 Lightning II aircraft.

Whilst further funding reductions and the resultant slowdown or cancellation of ongoing and new programmes could impact the business, Electronic Systems remains well-positioned to address changing US Department of Defense priorities. Its focus remains on maintaining a diverse portfolio of defence and commercial products and capabilities, with both US and international customers, and sustained emphasis on cost reduction and research and development.

The business expects to benefit from its incumbent positions, particularly on the F-35 Lightning II programme, increased activity on international defence programmes and continued commercial aviation market growth.



# CYBER & INTELLIGENCE



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

**Intelligence & Security** delivers a broad range of services to enable the US military and government to recognise, manage and defeat threats.

**GEOINT-ISR** develops and supports mission software and systems for intelligence and defence customers, leveraging domain expertise in geospatial, Intelligence, Surveillance and Reconnaissance (ISR) and mission management.

**Global Analysis and Operations** provides innovative, mission-enabling analytic solutions and support to operations to US federal, state and local agencies across the homeland security, law enforcement, defence, intelligence and counter-intelligence communities.

**IT Solutions** delivers operational secure solutions that enable national security and critical

infrastructure customers to perform operations and protect their data and networks.

**Applied Intelligence** collects, manages and exploits information to enable government and commercial clients to reveal intelligence, maintain security, manage risk and optimise performance.

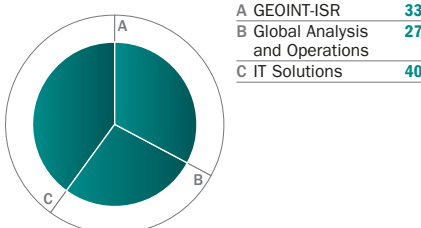
Alongside its secure government-focused activities, the business is a supplier of solutions that combine large-scale data exploitation, intelligence-grade security and complex services and solutions integration to commercial customers, with a focus on financial services, telecommunications, and energy and utility companies.

Primary operations are in the UK, Denmark, Ireland, Australia, Malaysia and the US.

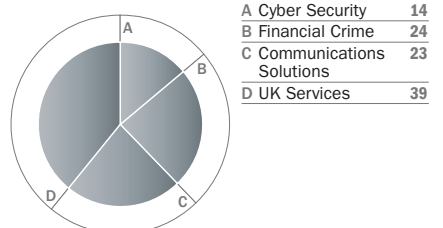
### SALES<sup>1</sup> BY BUSINESS



### SALES<sup>1</sup>: INTELLIGENCE & SECURITY (%)



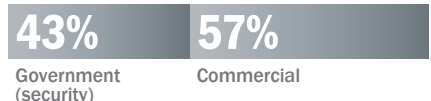
### SALES<sup>1</sup>: APPLIED INTELLIGENCE (%)



### SALES<sup>1</sup> ANALYSIS: INTELLIGENCE & SECURITY



### SALES<sup>1</sup> ANALYSIS: APPLIED INTELLIGENCE



### SILVERSKY ACQUISITION

In December, BAE Systems acquired SilverSky, a provider of cloud-based hosting, protection and monitoring of information that operates in the fast-growing cyber security market largely focused on the US. Its customer base includes approximately 5,500 customers in the financial services, retail, healthcare, energy, critical infrastructure and manufacturing sectors.

1. Including share of equity accounted investments.

# CYBER & INTELLIGENCE CONTINUED

## OPERATIONAL AND STRATEGIC HIGHLIGHTS

### INTELLIGENCE & SECURITY

US business impacted by US budget pressures and reductions in overseas operations

First task order awards under the Geospatial Data Services contract

Awarded a five-year contract for counter-terrorism analysis services

Awarded a five-year purchase agreement to support IT applications for the Bureau of Labor Statistics

Acquisition of Signal Innovations Group, a leading-edge technology company with activity-based intelligence expertise

### APPLIED INTELLIGENCE

Selected by a UK government customer as one of four strategic suppliers on a technology framework

Important multi-year customer wins for NetReveal® OnDemand managed services

Awarded multi-year framework contracts for Service Integration and Applications Management services

Acquisition of SilverSky, a commercial cyber service provider, to enhance commercial cyber growth strategy

### GEOSPATIAL INTELLIGENCE CAPABILITIES



The National Geospatial-Intelligence Agency (NGA) has awarded BAE Systems a five-year contract with an estimated total value of \$335m (£215m). The award supports NGA's dynamic Map of the World project, which is giving US military leaders clearer on-the-ground intelligence pictures to enhance situational awareness and mission planning.

## Operational performance

### Intelligence & Security

Whilst the US services market continued to experience challenges due to budget uncertainties, unpredictable and delayed acquisition and funding cycles, and the US withdrawal from Afghanistan, the Intelligence & Security business continues to focus on leveraging its core capabilities and domain expertise to pursue opportunities in intelligence analysis, special operations support, and Intelligence, Surveillance and Reconnaissance programmes, which remain priority activities in the US.

### GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance)

BAE Systems continues to mature its capabilities in activity-based intelligence which provides the intelligence and defence communities with increasingly automated, efficient and reliable data processing and management tools to transform big data into actionable intelligence. The business received authorisation to proceed on a \$32m (£21m) Engineering Change Proposal for activity-based intelligence services.

In 2014, the business delivered the first two software releases for testing of the Mobility Air Force Automated Flight Planning Service programme and passed final quality test on the Aero Advisory Notification Tool capability in support of the US Air Force's transition to a consolidated mission planning architecture. Development continues on the third release of the software.

The National Geospatial-Intelligence Agency awarded the business the first six task orders, totalling \$56m (£36m), under the five-year Geospatial Data Services contract to assist in transforming the collection, maintenance and utilisation of geospatial intelligence data and products. The contract has an estimated total value of \$335m (£215m).

In September, BAE Systems acquired Signal Innovations Group, a leading provider of imaging technologies and analytics to the US intelligence community.

### Global Analysis and Operations

In the market for Full Motion Video and Intelligence, Surveillance and Reconnaissance analysis, the business has ongoing contracts worth over \$400m (£257m), which includes the services of over 400 analysts supporting mission critical activities.

The business continues to provide security-cleared intelligence analyst support.

In August, BAE Systems won a five-year contract worth up to \$145m (£93m) to provide an intelligence community customer with counter-terrorism analysis services.

### IT Solutions

On the Solutions for the Information Technology Enterprise Indefinite Delivery, Indefinite Quantity contract, with task orders worth \$476m (£305m), the business has transitioned the customer from a costly regional support model to a less costly and more efficient enterprise support model.

In May, BAE Systems was awarded a position on the US Department of Homeland Security's Enterprise Acquisition Gateway for Leading Edge Solutions II multiple-award contract as one of 15 down-selected prime contractors to provide a broad range of IT solutions and services.

In August, BAE Systems was awarded a five-year purchase agreement valued at up to \$126m (£81m) to operate, maintain and develop IT applications for the Bureau of Labor Statistics.

### Applied Intelligence

Applied Intelligence continues to operate in competitive markets with fast-moving customer requirements. The business continues to grow through the provision of solutions which protect and enhance the operations of governments and commercial organisations in the areas of cyber security, financial crime prevention, communications intelligence and digital transformation, and is demonstrating its ability to win large, multi-year contracts.

Applied Intelligence continues to invest in building its skills base, with over 100 graduates joining the business in 2014, representing over one-third of BAE Systems' UK graduate intake. A Global Delivery Centre in Malaysia now supports product development and customer project delivery.

In December, BAE Systems acquired SilverSky, a provider of cloud-based hosting, protection and monitoring of information that operates in the fast-growing cyber security market largely focused on the US.

### Cyber Security

The business continues to grow, building on its strong relationship with the UK government, with orders including a £7m multi-year contract to address the UK Ministry of Defence's complex information assurance challenges.

The IndustrialProtect™ solution to protect industrial control systems was launched in the US and Middle East and received a £3m order from a major global energy supplier.

New orders for the CyberReveal™ cyber threat monitoring solution have been received in the US and Europe.

Market interest in MobileProtect™, launched in 2013 alongside a five-year strategic partnership with Vodafone, continues to grow with multiple large enterprises currently trialling the service. In 2015, the business is targeting to achieve an additional 150,000 subscribers to the MobileProtect™ service.

### Financial Crime

Applied Intelligence provides enterprise risk, fraud and compliance solutions internationally.

Applied Intelligence has won additional work with existing customers, including HSBC, which has procured NetReveal® Discovery, a suite of solutions that enable global financial crime investigations across borders. Demand for multi-year managed service solutions has increased, with NetReveal® OnDemand being selected by RSA in Canada to provide insurance fraud solutions under a five-year contract. Growth in the US continues with an order from a large US-based global personal and business payment provider.

Expansion is being achieved in other sectors, including healthcare with a £4m contract to provide Medicaid fraud prevention in Rhode Island and capital markets in the UK, Europe and Australia through a solution, launched in 2013, to protect against unauthorised trading, providing risk management controls to investment bank trading floors.

### Communications Solutions

The business is a provider of end-to-end communications intelligence solutions to government and communications service providers and is addressing opportunities in Europe, the Middle East and Asia-Pacific regions. It continues to win new clients, most recently in Asia-Pacific, and is developing follow-on business with existing clients as a result of new products from continued product investment.

### UK Services

Applied Intelligence provides consulting and systems integration services, with a particular focus on enabling digital transformation. The business continues to support UK government agencies in their intelligence missions and has been selected by a UK government customer as one of four strategic suppliers on a long-term framework that covers application development, systems integration and managed services.

Further success in the Service Integration and Applications Management market was achieved, with new and additional multi-year contracts worth £45m awarded, including new contracts with the Highways Agency and Skills Funding Agency.

### FINANCIAL PERFORMANCE

		2014	2013
Sales <sup>1</sup>	KPI	£1,085m	£1,243m
Underlying EBITA <sup>2</sup>	KPI	£123m	£115m
Return on sales		11.3%	9.3%
Cash inflow <sup>3</sup>	KPI	£71m	£118m
Order intake <sup>1</sup>	KPI	£1,163m	£1,247m
Order backlog <sup>1,4</sup>		£0.9bn	£0.7bn

In aggregate, sales<sup>1</sup> in the year reduced by 8%. The US business saw a 17% decrease driven largely by reduced budgets at the sector's two largest customers, along with further reductions in intelligence analyst support. Organic growth in the Applied Intelligence business was at 10%, almost all of which was from commercial customers. Completion of the SilverSky transaction occurred in mid-December and, therefore, only \$4m (£3m) of sales trading has been recognised from that business.

Despite the top line performance, the margin achieved was 11.3% (2013 9.3%), with profitability in the Applied Intelligence business increasing ahead of plan.

Cash<sup>3</sup> conversion of underlying EBITA<sup>2</sup> for the year was at 58% due to the capital costs of the replacement Enterprise Resource Planning system and set-up of the Malaysian Global Delivery Centre in the Applied Intelligence business.

In aggregate, order backlog<sup>1,4</sup> increased to \$1.4bn (£0.9bn). Despite the top line pressures, order backlog<sup>1,4</sup> in the US business grew by 7% largely on imagery analysis and cyber support awards. In the Applied Intelligence business, order book increased by 37% over the year, 22% organically and 15% from the SilverSky acquisition.

### LOOKING FORWARD

In the US, whilst the longer-term outlook remains uncertain, the 2015 fiscal year omnibus appropriations legislation passed in December 2014 included stable Department of Defense funding.

Intelligence & Security has reduced costs to address government budgets, whilst pursuing growth opportunities, particularly in critical, mission-focused areas.

Recognising the continued challenges in the US market, a restructuring was announced in 2014 that realigned the Support Solutions business across the remaining US operating sectors. A Support Solutions business area which develops and maintains systems supporting critical missions for the US military was integrated with Intelligence & Security. This integrated portfolio provides critical mass and economies of scale over a full spectrum of services and capabilities to the US military and other government agencies.

Applied Intelligence has a growing order backlog and pipeline of opportunities, underpinning expected growth from both government and commercial customers. In order to most effectively deliver against these opportunities, the business restructured into three divisions with effect from 1 January 2015: UK Services; International Services and Solutions; and Commercial Solutions. In 2015, the acquired SilverSky business will be integrated into the Commercial Solutions division, accelerating the growth strategy.

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 23).
3. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.
4. Comprises funded and unfunded unexecuted customer orders.

# PLATFORMS & SERVICES (US)



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

#### Land & Armaments

The Land & Armaments business includes a range of funded development activity, and fixed-price production and services contracts. Land & Armaments is engaged in the design, development, production, support and upgrade of armoured combat vehicles, artillery systems, naval guns, missile launchers and munitions.

*US Combat Vehicles* focuses on the tracked and amphibious vehicles markets, servicing both US and international customers.

*Weapon Systems* focuses on naval weapons, munitions and artillery markets, servicing US, UK and international customers. Products include naval gun systems, artillery systems, munitions and missile launchers.

*BAE Systems Hägglunds* focuses on the tracked vehicle market for Swedish and international customers.

*FNSS*, BAE Systems' Turkish joint venture, produces and upgrades tracked and wheeled military vehicles for international customers.

#### Support Solutions

The Support Solutions business includes services, sustainment and systems integration activities, which may be contracted over multi-year arrangements.

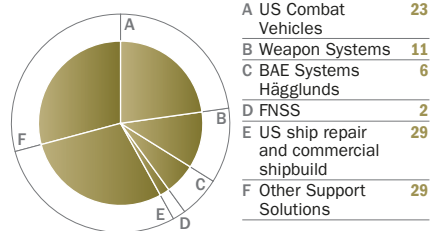
Support Solutions is a major supplier of ship repair services to the US Navy and complex munitions facilities management for the Holston and Radford facilities. Other activities in the US include fixed and rotary wing aircraft support services.



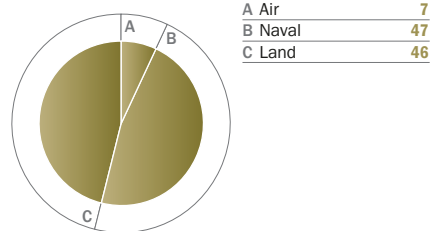
#### ARMORED MULTI-PURPOSE VEHICLE

In December, the US Army awarded BAE Systems a contract worth up to \$1.2bn (£0.8bn) for the engineering and manufacturing development and Low-Rate Initial Production of the Armored Multi-Purpose Vehicle. The initial award, valued at \$383m (£246m), is for a 52-month base term during which the business will produce 29 vehicles, with an option to produce an additional 289. The programme addresses a critical need to replace Vietnam-era M113 vehicles and the award confirms BAE Systems' role as a leading provider of combat vehicles.

#### SALES<sup>1</sup> BY LINE OF BUSINESS (%)



#### SALES<sup>1</sup> BY DOMAIN (%)



#### SALES<sup>1</sup> ANALYSIS: PLATFORMS AND SERVICES



1. Including share of equity accounted investments.

## OPERATIONAL AND STRATEGIC HIGHLIGHTS

## LAND &amp; ARMAMENTS

In-year awards sustain vehicle programme positions

Engineering and manufacturing development contract award worth up to \$1.2bn (£0.8bn) on the US Army's Armored Multi-Purpose Vehicle programme

Option worth \$142m (£91m) exercised to continue Low-Rate Initial Production of M109A7 self-propelled howitzers

Continued focus on cost reduction

Sale of 75% interest in Land Systems South Africa business announced, with completion expected in 2015

## SUPPORT SOLUTIONS

\$1.5bn (£1.0bn) of US Navy ship repair contracts awarded

Performance impacted by \$122m (£74m) of charges taken on commercial shipbuilding programmes

Improved performance on the Radford Army Ammunition Plant contract, with operational challenges mitigated significantly during the year

Korean F-16 upgrade contract terminated for convenience by the customer

Restructuring announced in 2014 realigned Support Solutions across the remaining US operating sectors

## US NAVY SHIP REPAIR



In 2014, the business was selected to continue five-year Multi-Ship, Multi-Option (MSMO) contracts supporting various US Navy ships at its Hawaii and San Diego shipyards. The new contracts, together with similar MSMO contracts in Norfolk, Virginia, and Mayport, Florida, reinforce the Group's trusted partnership with the US Navy. BAE Systems has successfully completed more than 300 cruiser and destroyer availabilities over the last 20 years.

## Operational performance

## Land &amp; Armaments

As the defence market stabilises, BAE Systems retains its focus on maintaining key programmes and building a strong domestic and international pipeline, whilst shaping the business portfolio and scaling operational resources for optimised competitiveness.

## US Combat Vehicles

The business has focused on maintaining and enhancing its positions on vehicle programmes, with a number of significant contracts received during the year.

In December, the US Army awarded BAE Systems a contract worth up to \$1.2bn (£0.8bn) for the engineering and manufacturing development and Low-Rate Initial Production of the Armored Multi-Purpose Vehicle. The initial award, valued at \$383m (£246m), is for a 52-month base term during which the business will produce 29 vehicles, with an option to produce an additional 289.

In December, the business received a \$34m (£22m) contract to convert 49 M3A3 Cavalry Bradley Fighting Vehicles to the M2A3 Infantry configuration, extending the Bradley production line through the first half of 2016.

The business received a \$154m (£99m) follow-on contract for the upgrade of an additional 53 vehicles to the M88A2 HERCULES configuration, which will maintain the M88 production line to the end of 2016.

In November, the US Army exercised an option, valued at \$142m (£91m), to continue Low-Rate Initial Production of the M109A7 self-propelled howitzer, with the first deliveries expected in the second quarter of 2015.

BAE Systems' significant experience with amphibious vehicle platforms has resulted in its selection as one of two contractors competing for the US Marine Corps Assault Amphibious Vehicle survivability upgrade programme. The business is also competing for the engineering and manufacturing development phase of the Amphibious Combat Vehicle 1.1 contract. Down-selects for both programmes are expected in 2015.

Work on the Joint Light Tactical Vehicle (JLTV) programme was transitioned successfully from the Sealy, Texas, plant, which closed in June. BAE Systems, as a strategic partner to Lockheed Martin on the JLTV programme, completed limited user testing of the engineering and manufacturing development vehicles in the fourth quarter of 2014 in support of the competitive pursuit of a Low-Rate Initial Production award.

Following the US Army's decision to discontinue the Ground Combat Vehicle programme, BAE Systems was awarded a follow-on bridge contract in June to continue related technology development efforts and maintain critical engineering talent.

## Weapon Systems

The business was awarded a contract for four 57mm Mk3 naval guns for an international customer.

The business did not secure an order from India for M777 ultra-lightweight howitzers, but continues to pursue this prospect.

BAE Systems continues to develop its position in the advanced weapons market through its Electromagnetic Railgun programme, having competitively won contracts in excess of \$100m (£64m) for land and sea-based demonstrators, pulse power modules and the next development phase of the hyper velocity projectile programme.

Following the Norwegian government's decision to withdraw from the Archer artillery system programme, the business signed a contract amendment with Sweden establishing a new technical and schedule baseline for the contract, which has initial deliveries planned for the second half of 2015.

## BAE Systems Hägglunds

Work on the \$865m (£555m) CV90 vehicles contract for the Norwegian Army remains on schedule, with series production of the 144 vehicles continuing until 2017.

BAE Systems has offered the CV90 Armadillo concept for the Danish Armoured Personnel Carrier programme. Four manufacturers submitted bids in December and an award decision is expected in the first half of 2015.

## FNSS

FNSS, BAE Systems' Turkish joint venture, has continued production under the \$559m (£359m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army.

Production continued under a \$360m (£231m) contract to upgrade 32 M113 tracked armoured personnel carriers for the Royal Saudi Land Forces. The business is pursuing other armoured vehicle prospects elsewhere in the Middle East region.

## Business disposal

BAE Systems expects to complete the disposal of its Land Systems South Africa business in 2015 following the agreement of a proposed sale of the company in 2014.

## Support Solutions

Under Multi-Ship, Multi-Option (MSMO) contract vehicles with the US Navy, the US-based ship repair business received orders totalling \$1.5bn (£1.0bn) for the repair, maintenance and modernisation of various vessels during the year. The business was awarded a new five-year MSMO contract at its Hawaii shipyard to support the maintenance and modernisation of a range of US Navy ships.

## PLATFORMS & SERVICES (US) CONTINUED

The commercial shipbuilding business continued to experience challenges, taking \$122m (£74m) of charges against ongoing contracts in 2014.

BAE Systems manages the operations of the Holston and Radford Army Ammunition Plants, receiving in excess of \$400m (£257m) of contracts in 2014 for explosives, propellant and facility modernisation. Following the operational challenges at the Radford plant identified during 2013, performance has improved reflecting the award of new contracts, pricing adjustments on existing contracts and operational efficiencies.

In 2012, BAE Systems was selected to upgrade the Republic of Korea's fleet of F-16 aircraft. The US government approved the selection in 2013 and, whilst the business was successfully executing phase one of the programme, in November, Korea requested the termination for convenience of the US Air Force's contract with BAE Systems. BAE Systems expects to recover all of its programme costs under normal terms of a termination for convenience. In response to the Korean government's claim for approximately \$43m (£28m) under a bid guarantee on the programme, the Group has asked a US federal court to rule that it does not owe any monies to Korea.

Under the eight-year, \$534m (£343m) US Air Force contract, received in 2013, to maintain the readiness of Minuteman III intercontinental ballistic missiles in the US, the business completed the nine-month transition period from the incumbent on schedule in June and performed a successful test launch in September, a major milestone for the programme.

In February 2014, the US Air Force Space Command awarded BAE Systems a further three-year contract extension to maintain

its Solid State Phased Array Radar System, space radars used for missile warning and space surveillance operations, raising the cumulative value of the contract to approximately \$540m (£346m). This contract is expected to complete in 2018.

In April, BAE Systems was informed that it had not been awarded the Automated Installation Entry III contract, which would have extended its current work in support of US Army installation security. BAE Systems' protest of the award was upheld and the contract is being re-solicited.

In August, BAE Systems was one of five companies awarded the ability to compete for task orders under an Indefinite Delivery, Indefinite Quantity contract to build-to-print a secure afloat network for the US Navy.

In September, the US Navy's Strategic Systems Programmes Office awarded BAE Systems a four-year, \$72m (£46m) contract to continue the provision of logistics and supply systems support for the Trident II D-5 submarine-launched ballistic missile.

In December, the US Navy's Naval Air Systems Command awarded BAE Systems a five-year contract to provide full lifecycle engineering and technical support for communication and combat systems on land and at sea. The initial award is valued at \$28m (£18m), with the total value of the five-year contract estimated at \$147m (£94m).

Also in December, the US Navy awarded BAE Systems the nine-year DDG VI Radio Communications Systems contract to support radio and communications systems design and integration for 13 guided missile destroyers. The initial award is valued at \$28m (£18m), with the total value of the nine-year contract estimated at \$187m (£120m).

FINANCIAL PERFORMANCE			
		2014	2013 <sup>1</sup>
Sales <sup>2</sup>	KPI	£3,266m	£3,912m
Underlying EBITA <sup>3</sup>	KPI	£147m	£229m
Return on sales		4.5%	5.9%
Cash inflow <sup>4</sup>	KPI	£201m	£191m
Order intake <sup>2</sup>	KPI	£3,191m	£3,315m
Order backlog <sup>2,5</sup>		£5.8bn	£6.1bn

### Land & Armaments

Sales<sup>2</sup> in the year declined to \$2.3bn (£1.4bn). Bradley reset activity has more than halved, the Medium Mine Protected Vehicle (MMPV) production contract has completed and deliveries under US M777 lightweight howitzer contracts have largely traded out.

Despite the expected top line reductions, the business has delivered an improved margin of 10.3% (2013 8.8%) through good programme execution and cost reduction.

Cash flow<sup>4</sup> generation was again strong, with good cash conversion of working capital.

Order backlog<sup>2,5</sup> reduced from \$5.0bn (£3.0bn) to \$4.4bn (£2.8bn) largely from the trading out of deliveries on MMPV and M777. We have not recognised within order backlog the \$0.8bn (£0.5bn) of Low-Rate Initial Production options under December's Armored Multi-Purpose Vehicle programme award.

### Support Solutions

Sales<sup>2</sup> of \$3.1bn (£1.9bn) were 1% lower than in 2013.

The year's margin has been materially impacted by cost overruns on the commercial shipbuild contracts. Charges taken in the first and second half year totalled \$122m (£74m). The Radford munitions contract has now been stabilised, with no additional provisioning necessary.

Order backlog<sup>2,5</sup> decreased from \$5.1bn (£3.1bn) to \$4.6bn (£3.0bn) on the sales trading out under the five-year US Navy ship repair contracts. The re-competes for the Hawaiian and San Diego contracts were both successfully secured in the year.

1. Re-presented for the transfer of the UK Munitions business to Platforms & Services (UK) from 1 January 2014.
2. Including share of equity accounted investments.
3. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 23).
4. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.
5. Comprises funded and unfunded unexecuted customer orders.

### LOOKING FORWARD

Whilst the longer-term outlook remains uncertain, the 2015 fiscal year omnibus appropriations legislation passed in December 2014 included stable Department of Defense funding and support for major programmes, including the Group's Bradley and M88 HERCULES vehicles, as well as requested funding for US Navy ship maintenance and the Armored Multi-Purpose Vehicle (AMPV) programme.

The business is investing to protect existing combat vehicle programmes and to establish new domestic and international programmes, such as the US Army's AMPV, amphibious vehicles and international combat vehicle opportunities to sustain the Group's US combat vehicle manufacturing base. The services and sustainment activities provide continuing opportunities for multi-year contracts on existing platforms.

Recognising the continued challenges in the US market, a restructuring was announced in 2014 that realigned the Support Solutions business across the remaining US operating sectors. A business area which develops and maintains systems supporting critical missions for the US military will be reported in Intelligence & Security in 2015. As a result of the realignment of Support Solutions, the reporting segment retains all of the Land & Armaments businesses, as well as Ship Repair, Ordnance Systems and Protection Systems from Support Solutions. This change will allow the business to deliver more comprehensive, integrated and cost-effective product and service offerings across a full range of naval, land and individual warfighter platforms.

# PLATFORMS & SERVICES (UK)



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

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.

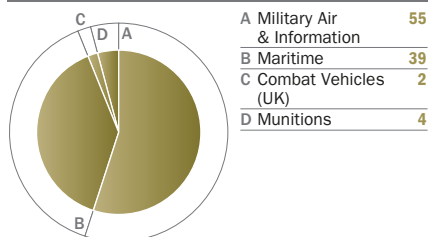
**Military Air & Information** includes programmes for the production of Typhoon combat and Hawk trainer aircraft, F-35 Lightning II sub-assembly manufacture, support and upgrades for Typhoon, Tornado and Hawk aircraft, and development of next-generation Unmanned Air Systems and defence information systems.

**Maritime** programmes include the manufacture of two Queen Elizabeth Class aircraft carriers, three River Class Offshore Patrol Vessels and seven Astute Class submarines for the Royal Navy, the design of the Successor submarine and Type 26 frigate, and in-service support, including the Portsmouth Naval Base contract.

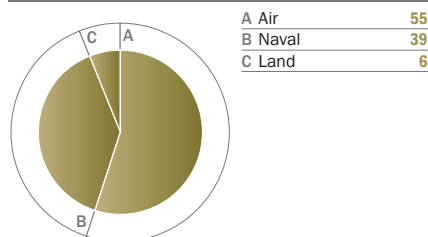
**Combat Vehicles (UK)** provides upgrades and support to the British Army and international customers.

**Munitions** focuses on the design, development and manufacture of a comprehensive range of products, servicing its main customer, the UK Ministry of Defence, as well as international customers. The business is a principal supplier of general munitions to the British armed forces.

SALES<sup>1</sup> BY LINE OF BUSINESS (%)



SALES<sup>1</sup> BY DOMAIN (%)



## QUEEN ELIZABETH CLASS AIRCRAFT CARRIER

In July, 13 days after the vessel was named by Her Majesty The Queen, the UK's largest ever warship, HMS Queen Elizabeth, was successfully floated out of the dock in which she was assembled.

SALES<sup>1</sup> ANALYSIS: PLATFORMS AND SERVICES



1. Including share of equity accounted investments.

# PLATFORMS & SERVICES (UK) CONTINUED

## OPERATIONAL AND STRATEGIC HIGHLIGHTS

Eurofighter partner nation commitment to the full integration of the Captor E-Scan radar onto Typhoon aircraft

Major milestone achieved with floating of the aircraft carrier, HMS Queen Elizabeth

£348m contract awarded to construct three new River Class Offshore Patrol Vessels for the Royal Navy

First two Khareef Class corvettes for Oman achieved final acceptance and third achieved interim acceptance

Awarded the five-year, £600m Maritime Support Delivery Framework contract for support to the Royal Navy

£270m order received for the upgrade of Spearfish torpedoes

Third Astute Class submarine, Artful, launched in May

Announced potential management redundancies in the Military Air & Information business to align with its strategy and to improve competitiveness

## E-SCAN RADAR FOR TYPHOON AIRCRAFT



In November, BAE Systems welcomed the news that the four Eurofighter partner nations had placed a contract for the full integration of the Captor E-Scan radar onto Typhoon aircraft. The E-Scan radar will give the aircraft one of the most advanced radar systems in the world providing a wider field of regard than any other combat aircraft. Other benefits include increased detection and tracking ranges, advanced air-to-surface capability and enhanced electronic protection measures.

## Operational performance

### Military Air & Information

In the year, deliveries of Typhoon Tranche 2 aircraft to the four Eurofighter partner nations totalled 16, bringing the cumulative number of Tranche 2 aircraft delivered to 219 of the contracted 236. Eighteen Tranche 3 front fuselage sub-assemblies were manufactured in the year. During 2014, there have been certain issues regarding acceptance of Typhoon Tranche 3 aircraft. Whilst the UK customer has continued to accept the aircraft, acceptances by Germany, Italy and Spain are held pending the completion of further technical and safety reviews by the NATO Eurofighter and Tornado Management Agency, which are planned to be concluded during the first quarter of 2015.

Work on the Omani Typhoon and Hawk aircraft contract continues, with sub-assembly manufacture for both aircraft types commencing and first deliveries on schedule for 2017.

In July, BAE Systems was awarded a three-year, £72m contract by the UK Ministry of Defence to de-risk E-Scan radar development for the Royal Air Force's Typhoon aircraft fleet. In November, the four partner nations placed a contract with Eurofighter for the full integration of the Captor E-Scan radar onto Typhoon aircraft and, as the system integrator, this award is worth £365m.

BAE Systems continues to support its UK and European customers' Typhoon and Tornado aircraft and their operational commitments. The business supports its UK customer through availability-based service contracts. A £125m contract extension was received in the year to provide support to the Royal Air Force's Tornado GR4 fleet until the aircraft's planned retirement in 2019. In December, BAE Systems was awarded a £112m contract to extend the Typhoon Availability Service for the in-service support of the Royal Air Force's Typhoon fleet by 15 months.

On the F-35 Lightning II programme, BAE Systems has continued to deliver aircraft fuselages for the sixth and seventh Low-Rate Initial Production (LRIP) contracts, with a total of 45 assemblies delivered to Lockheed Martin in 2014. Contract award for LRIP 8 for 43 assemblies was received in the year and manufacturing commenced. Proposals for LRIP 9 and 10 have been submitted with negotiations to commence in 2015.

Support continues to be provided to users of Hawk trainer aircraft around the world. In 2014, the Indian Navy and Air Force received four and 15 Hawk aircraft, respectively, built under the Batch 2 licence for 57 aircraft by Hindustan Aeronautics Limited. A response to a proposal for an additional 20 Hawk aircraft for the Indian Air Force's aerobatic display team has been submitted.

Working jointly with Dassault Aviation, progress is being made in maturing and demonstrating critical technology and operational aspects for an Unmanned Combat Air System. In November, the signature of a two-year feasibility study, worth a total of £120m to the six participating companies, was announced by the UK and French governments to continue joint Future Combat Air System technology development. The contract value to BAE Systems is £34m.

Taranis, the stealthy unmanned combat air vehicle demonstrator designed and built by BAE Systems with UK industry partners and the Ministry of Defence, has successfully completed a second phase of flight testing. During these latest tests, Taranis flew in a fully stealthy configuration.

The business undertook a review to ensure that its organisational operating model was aligned with its strategy and to improve competitiveness, which resulted in the announcement of 440 potential management redundancies in October.

### Maritime

The consolidation of BAE Systems' UK shipbuilding operations in Glasgow is progressing to plan, with shipbuilding operations at Portsmouth ceasing in the second half of 2014. The restructuring programme concludes in 2016.

BAE Systems has continued to negotiate contracts with the Ministry of Defence to enact the restructuring of its naval ships business. During the year, contracts were signed for the recovery of associated rationalisation costs and the revised target cost arrangements for the delivery of the Queen Elizabeth Class aircraft carriers. In August, BAE Systems was awarded a £348m contract to construct three new River Class Offshore Patrol Vessels for the Royal Navy, sustaining shipbuilding skills between the Carrier programme and the start of manufacture for the anticipated Type 26 frigate programme.



On the aircraft carrier programme, HMS Queen Elizabeth was officially named by Her Majesty The Queen and floated for the first time at Rosyth in July. The second ship block build programme is now 80% complete and assembly at Rosyth has commenced. Under the revised target cost arrangements, the industrial participants' fee includes a 50:50 risk share arrangement providing greater cost performance incentives.

The assessment phase contract for the Type 26 frigate continues, with over 700 employees now working on the programme. A contract for the demonstration phase of the programme, including procurement of long lead items, is expected to be placed in the first half of 2015, with a full manufacture contract anticipated in 2016.

The third Khareef Class corvette for the Royal Navy of Oman achieved interim acceptance in May, with final acceptance planned for 2015. The first two ships completed their final acceptance trials in Oman during the second half of the year.

The five-year, £600m Maritime Support Delivery Framework contract for the delivery of services at Portsmouth Naval Base and support to half of the Royal Navy's surface fleet was secured in the year.

In June, the Ministry of Defence awarded BAE Systems a £70m contract extension to manage the support, maintenance and upgrade of the Type 45 destroyers at Portsmouth Naval Base and on all their operations in the UK and globally through July 2014 to November 2016.

A £270m contract for upgrade of the Spearfish torpedo was secured in December.

Artful, the third of class attack submarine for the Royal Navy, was launched in May. Progress continues on the remaining four boats, with further funding of £207m received in the year.

Progress continues on the design and development phase of the Successor submarine programme, the potential replacement to the Vanguard Class fleet, with more than 1,400 people now employed on the programme. Initial long lead orders were placed during 2014. The Ministry of Defence has agreed to fund £389m of capital investment in preparation for the Successor manufacturing programme.

#### Combat Vehicles (UK)

Following delivery of all 60 Terrier combat engineering vehicles to the customer, 55 of these were completed to the final accepted build standard in the year, with the final five due for completion at the Telford site in 2015. The Newcastle facility closed at the end of 2014 following delivery of the Terrier vehicles.

Orders totalling £106m for ongoing support activity were received in the year.

#### Munitions

Following submission of the next five-year pricing proposal for its 15-year Munitions Acquisition Supply Solution partnering agreement with the Ministry of Defence, negotiations continue with a contract amendment expected in 2015.

Transformation of the Munitions facilities under the original £200m capital programme was completed during the year.

### FINANCIAL PERFORMANCE

		2014	2013 <sup>1</sup>
Sales <sup>2</sup>	KPI	£6,623m	£7,174m
Underlying EBITA <sup>3</sup>	KPI	£772m	£915m
Return on sales		11.7%	12.8%
Cash inflow <sup>4</sup>	KPI	£173m	£60m
Order intake <sup>2</sup>	KPI	£5,386m	£6,085m
Order backlog <sup>2</sup>		£20.1bn	£21.6bn

The year's sales<sup>2</sup> of £6.6bn were 8% lower than 2013, or 4% excluding last year's retrospective trading of price escalation on the Salam Typhoon programme. This reduction is largely due to a lower level of intra-group trading in 2014 and, therefore, has no impact to the total Group numbers.

Return on sales was at 11.7% (2013 12.8%).

Cash performance was better than expected with a cash inflow<sup>4</sup> of £173m (2013 £60m). Consumption of customer advances was at a lower level in the year than anticipated. Provisions were utilised against costs incurred on rationalisation and on the Oman Offshore Patrol Vessel programme.

Order backlog<sup>2</sup> reduced to £20.1bn (2013 £21.6bn) primarily from trading on the Typhoon aircraft, Indian Hawk and aircraft carrier programmes.

### 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 aircraft production on Typhoon and F-35 Lightning II, and in-service support for existing and legacy combat and Hawk trainer aircraft. There are a number of opportunities to secure future Typhoon export sales.

In Maritime, sales are underpinned by the design and subsequent build of the Successor submarine and Type 26 frigates, and the build of the Queen Elizabeth Class aircraft carriers and Astute Class submarines. The through-life support of these platforms, plus the Type 45 destroyer, together with their associated command and combat systems, provides a sustainable business in technical services and mid-life upgrades.

Combat Vehicles (UK) continues to provide engineering support to a large installed base of vehicles across UK and export markets. The business is pursuing obsolescence and upgrade programmes for the Challenger 2 main battle tank and land bridging systems.

The Munitions business is underpinned by the 15-year Munitions Acquisition Supply Solution partnering agreement with the Ministry of Defence secured in 2008.

1. Re-presented for the transfer of the UK Munitions business from Land & Armaments from 1 January 2014.
2. Including share of equity accounted investments.
3. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 23).
4. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.

# PLATFORMS & SERVICES (INTERNATIONAL)



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

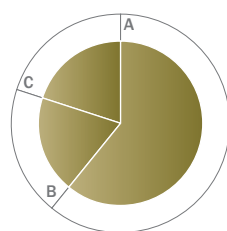
In Saudi Arabia, the business provides operational capability support to the country's air and naval forces on UK/Saudi government-to-government contracts. Contracts include multi-year agreements, such as the Saudi British Defence Co-operation Programme and Salam Typhoon programme.

In Australia, the business delivers production, upgrade and support programmes for customers in the defence and commercial sectors across the air, naval and land domains. Services contracts include the provision of sustainment, training solutions and upgrades. Platforms contracts include naval ships, such as the Landing Helicopter Dock programme for the Australian Navy. Contracts are often multi-year and fixed price.

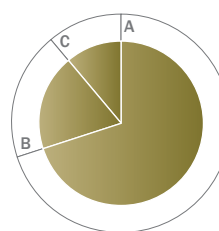
In Oman, the business is developing its position building on a long history of relationships with the Omani armed forces, through the provision, support and upgrade of defence platforms and cyber security services. Resulting orders are placed with the relevant reporting segments.

MBDA is a leading global prime contractor of missiles and missile systems across the air, naval and land domains.

SALES<sup>1</sup> BY LINE OF BUSINESS (%)



SALES<sup>1</sup> BY DOMAIN (%)



## SALAM TYPHOON AIRCRAFT

Through the build-up of the Typhoon aircraft fleet 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 Typhoon programme, UK final assembly of the 72 aircraft continues. At 31 December 2014, 45 aircraft have been delivered to the customer.

SALES<sup>1</sup> ANALYSIS: PLATFORMS AND SERVICES



1. Including share of equity accounted investments.

**OPERATIONAL AND STRATEGIC HIGHLIGHTS**

11 Typhoon aircraft delivered to Saudi Arabia under the Salam programme

Continued support to the operational capabilities of the Royal Saudi Air Force and Royal Saudi Naval Forces under the Saudi British Defence Co-operation Programme

Reorganisation of portfolio interests in industrial companies in the Kingdom of Saudi Arabia and enhanced relationship with Riyadh Wings

Customer acceptance of the first of two Landing Helicopter Dock ships in Australia

Four-year, A\$190m (£100m) contract awarded to provide in-service support for the two Landing Helicopter Docks

MBDA secured a UK/French government order worth €600m (£466m) for the joint development and production of the Future Anti-Ship Guided Weapon

€301m (£234m) contract secured by MBDA for the Advanced Short Range Air-to-Air Missile (ASRAAM) for India's Jaguar aircraft fleet

**AUSTRALIAN LANDING HELICOPTER DOCK SHIPS**



The Australian customer has formally accepted and taken delivery of the first of two Landing Helicopter Dock ships, HMAS Canberra. The BAE Systems team at the Williamstown shipyard, along with key subcontractors, has consolidated the Australian-built superstructure and masts, installed and integrated platform, combat and communication systems, and conducted a comprehensive series of harbour and sea trials.

**Operational performance**

**Saudi Arabia**

On the Salam Typhoon programme, UK final assembly of the 72 aircraft continues. At 31 December 2014, 45 aircraft have been delivered to the customer. Work on enhancing Typhoon's capability is progressing to schedule.

The five-year Typhoon support contract received in 2013 is operating well with all contractual Key Performance Indicators met during the year. The first of 30 aircraft completed its scheduled maintenance and upgrade under a contract also received in 2013.

Through the Saudi British Defence Co-operation Programme (SBDCP), the business continues to support the operational capabilities of the Royal Saudi Air Force (RSAF) and Royal Saudi Naval Forces (RSNF). The modernisation of the RSAF's training aircraft fleet continues to programme, with the first deliveries of Pilatus PC-21 aircraft made in 2014 and Hawk aircraft progressing through manufacturing. Training delivery and support under five-year contracts awarded in 2012 continue.

The orders received in 2013 for the upgrade of Tornado aircraft and equipment procurement are proceeding to plan. During the year, the business received a contract for Typhoon role equipment.

Under the minehunter mid-life update programme, the second ship is scheduled for acceptance back into the RSNF fleet in 2015.

A planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia was announced during the year, enhancing its existing relationship with Riyadh Wings Aviation Academy LLC. As part of the reorganisation, BAE Systems acquired an additional 59% shareholding in Saudi Development and Training Company. This reorganisation is being undertaken in support of BAE Systems' strategy to expand further its In-Kingdom Industrial Participation programme, and to promote training, development and employment opportunities for Saudi national personnel.

In 2014, the Group's In-Kingdom industrial partner, Advanced Electronics Company, was accredited as an approved maintenance and repair agent for Typhoon avionics equipment.

**Australia**

The customer has formally accepted and taken delivery of the first Landing Helicopter Dock warship, HMAS Canberra. The hull for the second ship arrived at the Williamstown shipyard in February 2014 and work is progressing towards delivery in the second half of 2015.

After delivery of the second Landing Helicopter Dock, there is then no contracted shipbuilding programme for the Williamstown shipyard. BAE Systems continues to engage with the Australian government with a view to sustaining appropriate shipbuilding capability.

In September, the business was awarded a four-year, A\$190m (£100m) contract to provide in-service support for the two Landing Helicopter Docks. The majority of the work will be undertaken in Sydney, the home port of these warships, creating over 40 new jobs.

The customer has accepted the second and third ANZAC Class frigates to be modernised under the Anti-Ship Missile Defence programme. The fourth and fifth frigates continue to undergo refurbishment.

In October, the business was awarded a A\$25m (£13m) contract to produce an additional three blocks for the Air Warfare Destroyer programme at its Williamstown shipyard. The additional blocks will bring the total number constructed by BAE Systems to 21, of which 11 have already been delivered.

In October, the Flight Training Centre at Tamworth, New South Wales, where BAE Systems trains Australian Defence Force pilots, achieved a significant milestone, reaching 250,000 flying hours. Since 1992, the centre has helped to train more than 5,000 students from the Australian Defence Force and other military and commercial operations throughout the Asia-Pacific region.

BAE Systems remains in negotiations with the Commonwealth to agree a revised schedule for the delayed delivery of the JP 2008 Phase 3F programme for enhanced satellite communications services to the Australian Defence Force. The business expects these negotiations to conclude in the first half of 2015.

# PLATFORMS & SERVICES (INTERNATIONAL) CONTINUED

## Oman

The two major contracts in Oman, Typhoon and Hawk aircraft and Khareef Class corvettes, are being undertaken by Platforms & Services (UK).

On the Typhoon and Hawk aircraft programme, sub-assembly manufacture has commenced.

On the Khareef Class corvette programme, the first two ships achieved final acceptance and the third ship achieved interim acceptance.

See pages 38 and 39 for further information on the operational performance of these contracts.

BAE Systems has provided a substantial proportion of Oman's in-service military equipment and works closely with the Omani armed forces in supporting this equipment.

The business is making good progress in addressing its industrial participation obligations in Oman through delivery of an agreed training and knowledge transfer programme, which covers over 80% of the Group's total obligations. BAE Systems continues to work with the Omani government to develop plans to discharge its remaining commitments.

## MBDA

In January 2014, the UK and French governments signed an agreement worth €600m (£466m) for the joint development and production of the MBDA Future Anti-Ship Guided Weapon – Anti-Navire Léger missile for their armed forces.

On the Meteor development programme, an updated certificate of design, recording the final design standard of the missiles, was submitted to the customer at the end of 2014. Deliveries, against almost 1,100 production-standard missiles ordered by the six partner nation customers, have now commenced.

In December, MBDA received a €301m (£234m) contract to supply the Advanced Short Range Air-to-Air Missile (ASRAAM) for India's Jaguar aircraft fleet.

Work continues towards securing German government commitment to a German/Italian collaborative programme (TLVS) to replace the current trilateral arrangement with the US which expired at the end of 2014. The programme will provide a new generation of air and missile defence with improved inter-operability, mobility and full 360-degree defence capability.

FINANCIAL PERFORMANCE			
		2014	2013
Sales <sup>1</sup>	KPI	£3,572m	£4,063m
Underlying EBITA <sup>2</sup>	KPI	£366m	£429m
Return on sales		10.2%	10.6%
Cash inflow/(outflow) <sup>3</sup>	KPI	£881m	£(189)m
Order intake <sup>1</sup>	KPI	£3,398m	£7,221m
Order backlog <sup>1</sup>		£11.6bn	£12.3bn

Sales<sup>1</sup> were £0.5bn lower at £3.6bn. The reduction against 2013 includes £143m in respect of exchange translation arising on the Australian dollar and Euro. The trading reductions were in the Australian business, as the Landing Helicopter Dock programme ramps down, last year's sales trading arising from the Salam price escalation and the higher Saudi equipment deliveries in 2013.

Underlying EBITA<sup>2</sup> of £366m (2013 £429m) generated a return on sales of 10.2% (2013 10.6%).

There was an operating cash inflow<sup>3</sup> of £881m (2013 £189m outflow), which includes a net £349m from the sale and leaseback, and initial rentals, of the two Saudi residential compounds. Some £200m of receivables were collected in December, earlier than expected, and there were down-payments received on Saudi equipment awards.

Order backlog<sup>1</sup> has reduced from last year end's high following the awards in 2013 of the five-year support contracts and equipment packages in Saudi Arabia.

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 23).

3. Net cash inflow/(outflow) from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.

## LOOKING FORWARD

In the Kingdom of Saudi Arabia, the Group expects to sustain its long-term presence through delivering current programmes and industrialisation, and developing new business in support of the Saudi military forces. The planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia is intended to increase growth prospects and reinforce an ongoing commitment to support the national objectives of local skills and technology development, increasing employment and developing an indigenous defence industry.

In Australia, the government has increased the defence budget by 8% for the 2014–15 fiscal year and remains on track to increase annual defence expenditure to 2% of Gross Domestic Product within a decade. Following delivery of the second Landing Helicopter Dock in 2015, the Williamstown shipyard needs a follow-on shipbuilding programme to sustain capability. In the longer term, there are significant opportunities in the naval domain as Australia modernises its submarine and surface fleets to strengthen its ability to secure access to sea lines of communication across the Indo-Pacific region.

In Oman, the business continues to provide support to its products in service to position for future requirements.

MBDA continues to build on the effective partnerships it has established with its domestic customers and is pursuing actively a significant number of export opportunities, including substantial air defence requirements and weapons packages linked to prospective aircraft and naval procurements.

# RESPONSIBLE BUSINESS



We are a business that operates responsibly and with integrity, delivering on customer requirements by being a trusted partner.

## RESPONSIBLE BUSINESS PRIORITIES

2014 priorities	2014 progress	2015 priorities
<p><b>Trust and integrity</b> Continue to improve and evolve the Group's business conduct programme. Undertake external assessment of ethical culture and environment.</p>	<p>Code of Conduct refresher training rolled out to employees across the Group. Developed a refreshed Code of Conduct which will be rolled out across the Group in 2015. Ethical Leadership Group (NAVEX Global) conducted an external assessment of the Group's business conduct programme and concluded that BAE Systems has all the elements of a best practice programme in place and should continue to evolve the programme.</p>	<p>Roll out refreshed Code of Conduct. Implement Ethical Leadership Group (NAVEX Global) recommendations to ensure continued improvement. Continue to drive alignment and integration of the business conduct programme with human resources, legal and audit activities.</p>
<p><b>Our employees</b> Continue the drive towards a world-class level of safety. Use benchmarking against leading companies to identify key areas for improvement and focus. Increase diversity and inclusion within the organisation in accordance with business goals. Diversity and inclusion plans to be aligned with business plans and Key Performance Indicators identified for monitoring and tracking against plans.</p>	<p>The Group achieved an 11% reduction in the Recordable Accident Rate<sup>1</sup>. The number of major (most serious) injuries<sup>1</sup> was reduced by 32%. Benchmarking against external companies showed that a number of our businesses are achieving a world-class level of safety management. All businesses set diversity and inclusion plans to address specific issues or strategic aims. These were supported at Group level by the Senior Women Mentoring Programme and extensive involvement in both national and regional education schemes to encourage more students from different backgrounds, at all stages, into science and engineering.</p>	<p>Continue drive towards a world-class level of safety performance. Achieve a 10% reduction (15% stretch target) in the Recordable Accident Rate. Maintain focus on, and management and reduction of, significant safety risk. Continue to drive a strong safety culture through communication, awareness and visible leadership. All businesses to continue to drive a diversity and inclusion agenda to address business needs and strategic aims.</p>
<p><b>Resource efficiency</b> Set environmental improvement targets to include energy, water and waste.</p>	<p>All businesses set and met improvement targets for energy, water and waste, except where additional work opportunities and extremes of climate impacted.</p>	<p>All businesses to continue to drive improvements in management of materials and resources.</p>

### IDENTIFYING TALENTED PEOPLE

To identify and train the next generation of talent, our UK business initiated a cross-business internship programme and partnered with universities and government on early employment programmes. From the 1,000+ applications received for the programme, just over 100 were accepted onto our paid 12-week summer programme.

In 2015, we plan to recruit nearly 300 graduates in the UK with a particular focus on cyber security. Around one-third of our total graduate intake will join the Applied Intelligence business. In the UK, we will also be taking on over 800 apprentices in 2015, two-thirds of whom will be employed in engineering-related roles.

1. See summary of Deloitte assurance on page 47.

# RESPONSIBLE BUSINESS CONTINUED

In order to support the delivery of the strategy, our responsible business activities focus on the wider impacts of our business which have the most potential to affect the long-term value of the Group. Specifically, we focus on ethics and governance, employee safety and wellbeing, diversity and inclusion, and operational environmental impacts.

Areas, such as ethics, are managed at Group level. Others, such as diversity and inclusion, are managed locally, where teams apply local knowledge to making a difference and drive change.

Achievement of objectives for employee safety is directly linked to the remuneration of executive directors and other members of the Executive Committee.

Priorities for diversity and inclusion were set within each member of the Executive Committee's personal development plan. An assessment of progress against these actions is determined by the Chief Executive as part of each Executive Committee member's annual performance review.

## Trust and integrity

To earn and retain our customers' trust, we need to manage our operations responsibly and conduct our business in an ethical way.

We continue to embed our ethics programme globally, driving the right behaviours by supporting employees in making ethical decisions and embedding responsible business practices.

We have reinforced our commitment to ethical behaviour, with our employees receiving ethics training during 2014. Additional compliance-based e-learning training was also targeted at employees throughout the year. A refreshed Code of Conduct will be rolled out to all employees during the first half of 2015.

If employees (or third parties) need help or guidance in addition to that provided by the Code of Conduct, or want to report a concern, they can call the Ethics Helpline, which is managed by a third party and is available 24 hours of every day using a freephone number from most countries. Employees can also get independent advice and support, or report concerns, via Ethics Officers, now in place across the business, or via the Ethics Helpline e-mail address, which is also made available to third parties via our website. During 2014, 1,037 enquiries were reported to Ethics Officers and through the Ethics Helpline<sup>1</sup>.

Our governance framework covers the products we make and export. Our Responsible Trading Principles, Product Trading Policy and Pursuit of Export Opportunities Policy help employees to make informed decisions about the business opportunities we pursue and to address any responsible trading risks.

We are committed to respecting human rights in our operations, within our sphere of influence.

## ETHICAL LEADERSHIP GROUP/NAVEX GLOBAL ASSESSMENT



During 2014, the Ethical Leadership Group, now called the Advisory Services Practice of NAVEX Global, conducted an assessment of our business conduct programme. During the assessment, NAVEX Global assessed documents, conducted interviews with senior leaders and held focus groups with our employees globally to assess perceptions of the programme.

NAVEX Global's report concludes that our business conduct programme continues to make progress and is now, in many respects, a best practice programme.

NAVEX Global's report findings focused on further embedding and maturing the Group's business conduct programme, including recommendations for continued improvements in socialising and embedding new and existing processes consistently across the Group; ongoing assessment and improvement of the programme elements; and training for line managers and supervisors.

## ETHICS DATA

### ENQUIRIES TO ETHICS HELPLINE<sup>1</sup>

2014	<b>1,037</b>
2013	<b>1,043</b>
2012	<b>1,024</b>
2011	<b>1,011</b>
2010	<b>734</b>

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.

### DISMISSALS FOR REASONS RELATING TO UNETHICAL BEHAVIOUR<sup>1</sup>

2014	<b>286</b>
2013	<b>265</b>
2012	<b>292</b>
2011	<b>298</b>
2010	<b>355</b>

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.

1. See summary of Deloitte assurance on page 47.

## Our employees

Our employees are integral to our success. We value the talents and skills that our global workforce of 83,400<sup>1</sup> people in 40 countries brings to our business.

Engaging and developing our workforce for current and future business is key to delivering our strategy successfully. We are, therefore, committed to attracting, selecting, developing and retaining the best people to deliver this.

Global training and development programmes support employees in making the most of their talents. Programmes are focused on continuous learning and development, using a blend of e-learning, classroom training and partnerships with academic institutions.

We work with the education sectors in each of our 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 (STEM).

During 2014, we recruited 275 graduates and 583 apprentices to support the talent pipeline in the UK.

The US business contributed in excess of \$2m (£1m) to support accredited institutions and organisations that develop teachers and our future workforce by encouraging students to pursue and thrive in STEM disciplines. BAE Systems, Inc. recruited approximately 2,400 employees within the STEM disciplines during 2014, representing approximately 40% of employees recruited.

We are committed to creating an inclusive work environment where a diverse range of talented people can work together to ensure business delivery. Diversity amongst our workforce is a significant force for innovation.

We focus on our goal of building a diverse workforce which reflects that of the populations we recruit from. A particular current focus is increasing female representation in the pipeline for senior roles.

Engaging our employees to help them make the fullest contribution to the business is important. Through a variety of media, we seek to listen to employees' views and opinions, and keep them informed about developments and prospects for the business. Regular internal communication, including e-enabled channels, leadership blogs, newsletters, management and team meetings, monthly team briefs and the intranet, keeps employees informed, involved and engaged.

The Group welcomes employees becoming shareholders in BAE Systems and offers a number of employee share plans to support this.

During 2014, employees had the opportunity to provide feedback via our engagement survey (see page 20).

Safety of our employees, and anybody who works on, or visits, our sites, is a key priority. We continue to embed a 'safety first' approach by providing training and tools that help employees to understand the importance of a safe workplace, and encouraging employees to take responsibility for their own safety and the safety of those around them. Senior leadership plays a key role in maintaining the focus on safety and leading through example.

## DIVERSITY IS KEY TO A SUCCESSFUL BUSINESS

In 2014, the Executive Committee progressed actions to grow the female talent pipeline at senior executive levels:

**Fostering a culture of inclusion** – further to the unconscious bias training for all leaders which was rolled out during 2013, there was a focus in 2014 on raising further awareness and understanding. This included a UK-wide 'Diversity and Inclusion Week', which was the first targeted awareness campaign for all employees in the UK. In the US, a month-long celebration of the UN's 'Do One Thing for Diversity and Inclusion' campaign and 'Going Global' engagement events were conducted at several sites.

**Accelerating the development of high-potential women** – an Executive Committee mentoring programme was launched in 2012 providing support and development to 46 participants in two cohorts. The programme has supported 90% of the first cohort and 50% of the second to promotions or moves into broader roles.

**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. During 2014, the percentage of external female candidates hired in the leadership population was 20%.

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

### GENDER DIVERSITY DATA AS AT 31 DECEMBER 2014

	Number of males	Number of females	Total number	Male %	Female %
Board	9	2	11	82	18
Executive Committee	9	2	11	82	18
Senior managers <sup>2</sup>					
Employees in senior executive positions <sup>3</sup>	235	38	273	86	14
Directors of subsidiary companies (excluding employees in senior executive positions)	84	12	96	88	12
Total senior managers <sup>3</sup>	319	50	369	86	14
Total employees <sup>4,5</sup>	61,000	15,000	76,000	80	20

1. Including share of equity accounted investments.

2. Senior managers are defined as employees who have responsibility for planning, directing or controlling the activities of the Group or a strategically significant part of the Group and/or who are directors of subsidiary companies.

3. Excludes executive directors.

4. Excluding share of equity accounted investments and rounded to the nearest thousand employees.

5. See summary of Deloitte assurance on page 47.

# RESPONSIBLE BUSINESS CONTINUED

The metric used to measure workplace injuries is the Recordable Accident Rate which, along with the number of major injuries, is used to determine an element of executive bonus. During 2014, the Recordable Accident Rate<sup>1</sup> decreased by 11%, consistent with the improvement target set. This progress represents a seventh consecutive year of improvement. The number of major injuries<sup>1</sup> was reduced by 32% to 44 (see page 20).

We recognise that a healthy workforce is a more engaged and productive one and, during 2014, we continued to promote an enterprise-wide campaign on employee wellbeing.

## Key relationships

Our employees are critical to the delivery of our strategy, but it is also how we work responsibly with others that supports our success.

We work with suppliers who embrace standards of ethical behaviour consistent with our own.

We require our suppliers to comply with local legislation. We expect and encourage all our suppliers to embrace ethical values of a comparable standard to our own. Our standards include issues such as ethical conduct, health and safety, environment and human rights. Compliance to required standards is evaluated during the supplier selection process and, for existing suppliers, as part of ongoing quality and approvals assurance.

Advisers can only work for us after they have been approved via our due diligence process and authorised by an external panel.

We continue to work with peers across the defence industry to improve ethical standards. During 2014, we participated in the International Forum on Business Ethical Conduct's industry working group on collective action.

We are committed to strengthening relationships and investing in the communities in which we operate. This is done via local recruitment and employment, contracting with local suppliers where possible, the taxes we pay and by supporting local charities and not-for-profit organisations.

Globally, we and our employees, through the Community Investment programme, contributed more than £1.1m<sup>1</sup> during 2014 to local, national and international charities and not-for-profit organisations.



**DEVELOPING OUR PEOPLE**

We have global leadership programmes to deliver executive development for high-potential individuals looking to accelerate their career and leadership capability. The diversity, career progression and retention of participants is monitored on a regular basis to measure the effectiveness of these development programmes.

In Australia, our Accelerated Development Programme is open to those who are identified as high-potential individuals, and who have the energy and focus to accelerate their development. The programme is designed to accelerate high-potential leaders through a two-year on-the-job development experience.

Employees are required to participate in a range of development activities, including: mentoring by a management board or senior lead team member; leading business projects that grow and stretch them professionally; building a targeted individual development plan that addresses areas for improvement; access to career development coaching; and the opportunity to push their career with up to one role change during the programme.



**EXTERNAL RECOGNITION FOR SAFETY PERFORMANCE**

Radway Green, the Group's centre of excellence for the design, manufacture, proofing and supply of small arms ammunition at the Munitions business in the UK, has won a prestigious Royal Society for the Prevention of Accidents (RoSPA) Gold Medal for reducing injuries and its commitment to continuous improvement in accident and ill-health prevention at work. The medal is awarded once a company has received five consecutive Gold awards in RoSPA's annual Occupational Health and Safety Awards.

Other Munitions sites, Bishopton Environmental Test Facility, Ridsdale Range and Washington, each received an individual 2014 RoSPA Gold award.



**ENVIRONMENTAL AWARDS FOR US SHIPYARD**

In April, our San Diego shipyard received two awards for its sustainability efforts.

The first award came from the Port of San Diego, which honoured environmentally-conscious port businesses that have shown exemplary environmental achievements. During a 12-month assessment period, the San Diego yard achieved a reduction in energy, water and waste. The shipyard currently uses oily water separators, which process large quantities of industrial waste water and remove the free-floating oil, grease and raw petroleum hydrocarbons from waste water, allowing for reduction of the amount of hazardous waste disposed.

The second award came from the County of San Diego on Earth Day. The sustainable business award was given, in part, for the shipyard's efforts to manage waste with an 80% diversion rate to landfills. Paper waste produced in offices is 100% recycled. Metals and abrasive blasting materials are recycled and diverted.

1. See summary of Deloitte assurance on page 47.



### Resource efficiency

Minimising the impact on the environment of our operations and products, and using resources more efficiently are focus areas.

Our primary operational impacts on the environment are through the use of energy used for heating and lighting work spaces. We have relatively few energy-intensive processes. Water use is typically linked to employee numbers, apart from in our Munitions business where water is used via steam and cooling. In the majority of businesses, waste is of high value and recycled wherever possible.

Our businesses have targets in place to reduce the environmental impact of their operations and products by reducing energy, water and waste at a local level. These targets address specific issues or strategic aims. At Group level, we monitor business performance against targets and review

global trend data. During 2014, at Group level, we decreased the amount of electricity and natural gas used, and hazardous waste generated. However, water used and non-hazardous waste generated increased reflecting throughput on programmes, particularly at shipyard, submarine and munitions sites.

Our reported greenhouse gas emissions have decreased by 4% between 2013 and 2014. The reduction in Scope 1 and 2 emissions has been mainly due to a decrease in purchased electricity across our business as a result of various energy management initiatives. Our Scope 3 emissions have reduced by 9% largely due to improvements in the environmental efficiency of commercial flights and a marginal decrease in business travel. We have maintained a per employee rate of 18 tonnes CO<sub>2</sub>e.

Businesses 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.

Environmental considerations are taken into account throughout a product's lifecycle from concept, design and manufacture through to use and disposal. This includes reducing the environmental impacts of our products during research and development, minimising waste materials during manufacturing, and helping to reduce the impact of our products when they are used, upgraded or disposed of.

GREENHOUSE GAS EMISSIONS DATA FOR THE PERIOD 1 NOVEMBER TO 31 OCTOBER	
<b>Total emissions</b>	<b>1,336,751 TONNES CO<sub>2</sub>E</b> <b>-4%</b>
2014 <sup>1</sup>	1,336,751
2013 <sup>2</sup>	1,393,646
<b>Combustion of fuel within BAE Systems facilities and vehicles (Scope 1)</b>	<b>585,233</b>
2014 <sup>1</sup>	585,233
2013 <sup>2</sup>	590,451
<b>Electricity and steam purchased for BAE Systems use (Scope 2)</b>	<b>594,866</b>
2014 <sup>1</sup>	594,866
2013 <sup>2</sup>	630,522
<b>Business travel in non-BAE Systems vehicles (Scope 3)</b>	<b>156,652</b>
2014 <sup>1</sup>	156,652
2013 <sup>2</sup>	172,673
<b>Total emissions per employee<sup>3</sup></b>	<b>18 TONNES CO<sub>2</sub>E</b> <b>0%</b>
2014 <sup>1</sup>	18
2013 <sup>2</sup>	18

**Methodology**  
The sources of greenhouse gas emissions fall within the Group's consolidated financial statements. Emissions from joint ventures and pension scheme properties not occupied by the Group are not included. The greenhouse gas emissions data is in line with the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised version) and emission factors for fuels and electricity from the UK government's Department for Environment Food & Rural Affairs (DEFRA), published at [www.ukconversionfactorscarbonsmart.co.uk/](http://www.ukconversionfactorscarbonsmart.co.uk/)  
The CO<sub>2</sub>e associated with carbon dioxide, methane and nitrous oxide is reported. Greenhouse gas emissions associated with hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride are estimated to be immaterial to total emissions.  
The principal record of the Group's worldwide facilities is its legal department's Global Property Database. Greenhouse gas emissions are primarily calculated from energy consumption records reported via the Group's global environmental database. Where actual usage data is not available for facilities and residences within the Global Property Database, an estimated consumption is used based on the type of building.  
Greenhouse gas emissions related to business travel include air travel data for the majority of the global business and rail data for business units operating in the UK and US. These data are taken from suppliers' procurement records.

### DELOITTE ASSURANCE

This year, Deloitte LLP has provided limited assurance on the following performance indicators at Group level:

- Ethics – employee and third-party enquiries to Ethics Helpline and dismissals for reasons relating to unethical behaviour;
- Diversity and inclusion – total employees split by gender;
- Safety – Recordable Accident Rate and the number of major injuries recorded;
- Community – total Community Investment programme donations; and
- Environment – greenhouse gas emissions.



**TO SEE DELOITTE LLP'S UNQUALIFIED ASSURANCE STATEMENT VISIT**  
[BAESYSTEMS.COM/DELOITTEASSURANCESTATEMENT](http://BAESYSTEMS.COM/DELOITTEASSURANCESTATEMENT)  
**TO SEE OUR BASIS OF REPORTING 2014 VISIT**  
[BAESYSTEMS.COM/2014CRDATA](http://BAESYSTEMS.COM/2014CRDATA)

1. See summary of Deloitte assurance above.  
2. Our published 2013 greenhouse gas emissions have been re-calculated as the conversion factors used in the calculations have changed.  
3. Excluding share of equity accounted investments.

# HOW WE MANAGE RISK

## Board

The Board has overall responsibility for determining the nature and extent of the risk it is willing to take within the strategy, 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 annual strategy review process. This provides 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 twice a year. 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, mitigating the effect of those risks before they occur and dealing with them effectively if they crystallise.

The Group is committed to the protection of its assets, which include human, intellectual and physical 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.

The Board has conducted a review of the effectiveness of the Group's systems of risk management and internal control processes, including financial, operational

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.

and compliance controls and risk management systems, in accordance with the UK Corporate Governance Code. The Company has developed a system of internal controls that was in place throughout 2014 and to the date of this report.

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 understood adequately and related to the financial statements.

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

## 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 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 metrics, which are reviewed regularly by the Executive Committee and Board (see page 20). 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 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 determined by the Executive Committee. 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.

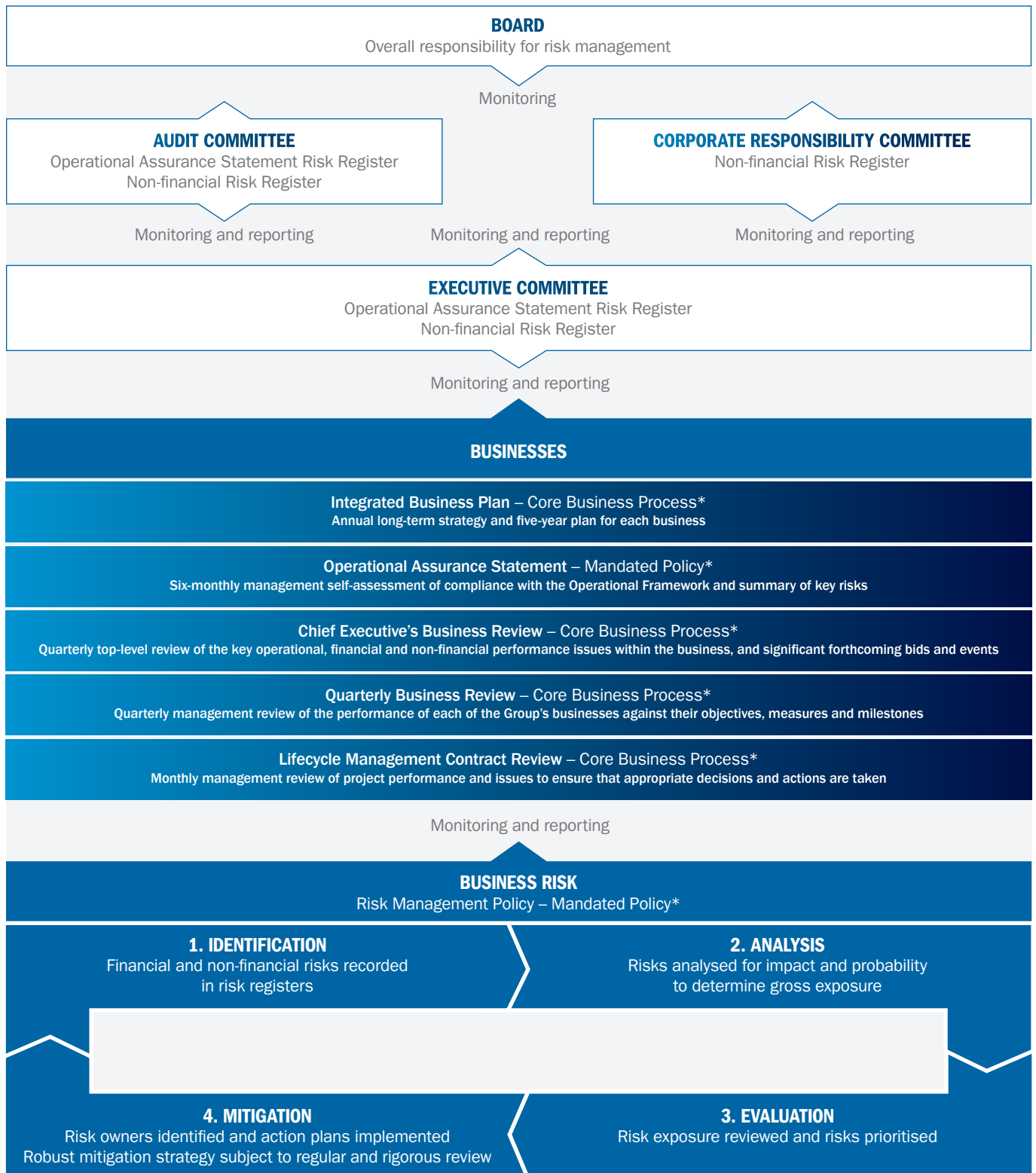
## Principal risks

The Board has carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency and liquidity. Such risks have been identified as principal based on the likelihood of occurrence and the potential impact on the Group, and have been identified through the application of the policies and processes outlined above. These risks, together with details of how they are being mitigated and managed, are detailed on pages 50 to 53.

As a result of its assessment of the Group's principal risks, the Board has determined that a number of risks identified as being principal risks in the 2013 Annual Report, while still risks for the Group, are no longer considered to be principal risks and has added an additional risk relating to the Group's employees (see page 53).



**P50** Principal risks



\* As defined in the Group's Operational Framework.



# PRINCIPAL RISKS

Risks are identified as principal based on the likelihood of occurrence and the potential impact on the Group. The Group's principal risks are identified below, together with a description of how we mitigate those risks.

## 1. DEFENCE SPENDING

The Group is dependent on defence spending.

### Description

- In 2014, 93% of the Group's sales were defence-related.
- Defence spending by governments can fluctuate depending on political considerations, budgetary constraints, specific threats and movements in the international oil price.
- There have been constraints on government expenditure in a number of the Group's principal markets, in particular in the US and UK, and there is a risk that there may be further reductions.
- With the Eurozone area experiencing financial difficulties, affordability continues to be a key focus for customers.

### Impact

- Lower 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 business is geographically spread across US, UK and international defence markets.
- The diverse product and services portfolio is marketed across a range of defence markets.
- BAE Systems has a growing portfolio of commercial businesses, including commercial avionics and the commercial areas of the Applied Intelligence business. Sales in commercial markets represented 7% of the Group's sales in 2014.
- In Saudi Arabia, regional tensions continue to dictate that defence remains a high priority.

## 2. GOVERNMENT CUSTOMERS

The Group's largest customers are governments.

### Description

- The Group has long-standing relationships and security arrangements with a number of its government customers, including its three largest customers, the governments of the UK, US and Saudi Arabia, and their agencies. It is important that these relationships and arrangements are maintained.
- In the defence and security industries, governments can typically modify contracts or terminate them at short notice. Long-term US government contracts, for example, are funded annually and are subject to cancellation if funding appropriations for subsequent periods are not made.
- The Group's performance on its contracts with some government customers is subject to financial audits and other reviews which can result in adjustments to prices and costs.

### Impact

- Deterioration in the Group's principal government relationships resulting in the failure to obtain contracts or expected funding appropriations, adverse changes in the terms of its arrangements with those customers or their agencies, or the termination of contracts could have a material adverse effect on the Group's future results and financial condition.

### Mitigation

- Government customers have sophisticated procurement and security organisations with which the Group can have long-standing relationships with well-established and understood terms of business.
- 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.

## 3. INTERNATIONAL MARKET

The Group operates in an international market.

### Description

- BAE Systems is an international company conducting business in a number of regions, including the US and Middle East.
- The risks of operating in some countries include: political changes impacting the business environment; economic downturns; political instability and civil disturbances; changes in government regulations and administrative policies; the imposition of restraints on the movement of capital; and the introduction of burdensome taxes or tariffs.
- The Group is exposed to volatility in currency exchange rates, particularly in respect of the US dollar, Euro and Saudi Riyal.

### 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 a number of markets internationally.
- The Group's policy is to hedge all material firm transactional exposures.

#### 4. COMPETITION IN INTERNATIONAL MARKETS

The Group's business is subject to significant competition in international markets.

##### Description

- The Group's business plan depends upon its ability to win and contract for high-quality new programmes, an increasing number of which are expected to be in non-UK/US markets.
- The Group is dependent upon UK and US government support in relation to a number of its business opportunities in export markets. In the UK, export contracts are often structured on a government-to-government basis and government support can also involve military training, ministerial support for promotional activities and financial support through UK Export Finance. In the US, most of the Group's defence export sales are delivered through the Foreign Military Sales process, under which the importing government contracts with the US government.

##### Impact

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

##### Mitigation

- The Group has an international, multi-market presence, a balanced portfolio of businesses, leading capabilities and a track record of delivery on its commitments to its customers.
- The Group continues to invest in research and development, and to reduce its cost base and improve efficiencies, to remain competitive.

#### 5. LAWS AND REGULATIONS

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

##### Description

- The Group operates in a highly-regulated environment across many jurisdictions and is subject, without limitation, to regulations relating to import-export controls, money laundering, false accounting, anti-bribery and anti-boycott provisions. It is important that the Group maintains a culture in which it focuses on embedding responsible business behaviours.
- Export restrictions could become more stringent and political factors or changing international circumstances could result in the Group being unable to obtain necessary export licences.

##### Impact

- Failure by the Group, or its sales representatives, marketing advisers or others acting on its behalf, to comply with these regulations could result in fines and penalties and/or the suspension or debarment of the Group from government contracts or the suspension of the Group's export privileges, which could have a material adverse effect on the Group.
- Reduced access to export markets could have a material adverse effect on the Group's future results and financial condition.

##### Mitigation

- BAE Systems has a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements and identifying any restrictions that could adversely impact the Group's activities. A programme is underway to enhance resources dedicated to regulatory compliance.
- Internal and external market risk assessments form an important element of ongoing corporate development and training processes.
- A uniform global policy and process for the appointment of advisers engaged in business development is in effect.
- The special compliance officer, appointed pursuant to commitments concerning ongoing regulatory compliance made in the course of the 2011 settlement with the US Department of State, concluded his monitorship in May 2014 and, at the invitation of BAE Systems, agreed to remain in a limited capacity for a limited further period of time.

# PRINCIPAL RISKS CONTINUED

## 6. CONTRACT RISK AND EXECUTION

The Group has many contracts, including a small number of large contracts and fixed-price contracts.

### Description

- In 2014, 43% of the Group's sales were generated by its 12 largest programmes. At 31 December 2014, the Group had seven programmes with order backlog in excess of £1bn.
- A significant portion of the Group's revenue is derived from fixed-price contracts. Actual costs may exceed the projected costs on which the fixed prices are agreed and, since these contracts can extend over many years, it can be difficult to predict the ultimate outturn costs.
- It is important that the Group maintains a culture in which it delivers on its projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner.

### Impact

- The inability of the Group to deliver on its contractual commitments, the loss, expiration, suspension, cancellation or termination of any one of its large contracts or its failure to anticipate technical problems or estimate accurately and control costs on fixed-price contracts could have a material adverse effect on the Group's future results and financial condition.

### Mitigation

- Contract-related risks and uncertainties are managed under the Group's mandated Lifecycle Management process.
- A significant proportion of the Group's largest contracts are with the UK Ministry of Defence. In the UK, development programmes are normally contracted with appropriate levels of risk being initially held by the customer and contract structures are used to mitigate risk on production programmes, including where 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 forward visibility.
- The Group has limited exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity.
- 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.

## 7. CONTRACT CASH PROFILES

The Group is dependent on the award timing and cash profile of its contracts.

### Description

- The Group's profits and cash flows are dependent, to a significant extent, on the timing of, or failure to receive, award of defence contracts and the profile of cash receipts on its contracts.

### Impact

- Amounts receivable under the Group's defence contracts can be substantial and, therefore, the timing of, or failure to receive, awards and associated cash advances and milestone payments could materially affect the Group's profits and cash flows for the periods affected, thereby reducing cash available to meet the Group's cash allocation priorities, potentially resulting in the need to arrange external funding and impacting its investment grade credit rating.

### Mitigation

- The Group's balance sheet continues to be managed conservatively in line with its policy to retain an investment grade credit rating and to ensure operating flexibility.
- The Group monitors a rolling forecast of its liquidity requirements to ensure that there is sufficient cash to meet its operational needs and maintain adequate headroom.

## 8. PENSION FUNDING

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

### Description

- In aggregate, there is an actuarial deficit between the value of the projected liabilities of the Group's defined benefit pension schemes and the assets they hold.
- 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.

### Impact

- 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 cash allocation priorities.

### Mitigation

- Following triennial funding valuations of the Group's UK pension schemes during 2014, where appropriate, revised deficit recovery plans have been agreed which run until 2026.
- Growth of the defined benefit pension liabilities is expected to be curtailed as, in the UK, new employees have been offered defined contribution benefits since April 2012 and, in the US, with effect from January 2013, employees no longer accrue salary-related benefits in defined benefit schemes.
- In 2013, the trustees of a number of UK pension schemes entered into arrangements to insure against longevity risk for current pensioners, covering £4.4bn of liabilities, and, in 2014, 38% of BAE Systems Pension Scheme pensioners opted to exchange future increases on part of their pensions for higher non-increasing pensions.

## 9. INFORMATION TECHNOLOGY SECURITY

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

### Description

– 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.

## 10. PEOPLE

The Group's strategy is dependent on its ability to recruit and retain people with appropriate talent and skills. All employees are required to act in accordance with the Group's policies.

### Description

– Delivery of the Group's strategy and business plan is dependent on its ability to compete to recruit and retain people with appropriate talent and skills, including those with innovative technological capabilities.

– With constraints on defence spending in its UK and US markets, the Group's business plan is targeting an increasing level of business in international export markets. It is important that the Group recruits and retains management with the necessary international skills and experience in the relevant jurisdictions.

– It is important that all employees act in accordance with the requirements of the Group's policies, including the Code of Conduct, at all times.

### Impact

– The loss of key employees or inability to attract the appropriate people on a timely basis, in particular to deliver the Group's strategy in international markets, could adversely impact its ability to meet the business plan and, accordingly, have a negative impact on the Group's future results and financial condition.

### Mitigation

– The Group recognises that its employees are key to delivering its strategy and business plan, and focuses on developing the existing workforce and hiring talented people to meet current and future requirements.

– The Group has well-established graduate recruitment and apprenticeship programmes and, in order to maximise the contribution that its workforce can make to the performance of the business, has an effective through-career capability development programme.

– In order to seek to maximise its talent pool, the Group is committed to creating a diverse and inclusive environment for its employees.

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

## Changes in principal risks

As a result of its assessment of the Group's principal risks referred to on page 48, the Board has determined that the following risks, identified as principal risks in the 2013 Annual Report, while still risks for the Group, are no longer considered to be principal risks:

### 1. THE GROUP IS DEPENDENT UPON COMPONENT AVAILABILITY, SUBCONTRACTOR PERFORMANCE AND KEY SUPPLIERS

In the improving global economic environment, the Group has not identified any specific, material risks in relation to its strategically important subcontractors or suppliers.

### 2. THE ANTICIPATED BENEFITS OF ACQUISITIONS MAY NOT BE ACHIEVED

The Group has not engaged in acquisitions other than bolt-on acquisitions in the last three years.

### 3. THE GROUP IS INVOLVED IN CONSORTIA, JOINT VENTURES AND EQUITY HOLDINGS WHERE IT DOES NOT HAVE CONTROL

Whilst the Group has such joint ventures, the principal ones being Eurofighter, MBDA and Air Astana (as referred to on page 125), its relationships with the joint venture partners are such that the risk of disagreement leading to failure to meet the strategic objectives of those joint ventures is not currently regarded as a principal risk to the Group.

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

# GOVERNANCE SUMMARY



**‘Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.’**

**UK Corporate Governance Code**

The Company seeks to maintain the highest standards of governance to ensure that it is performance-driven, but value-led. The Board is focused not simply on how much money the Company makes for its shareholders, but how it makes money.

To achieve this objective, the Board comprises both a strong executive and a majority of independent non-executive directors who have been selected to deliver an appropriate mix of diversity, skills and experience.

The Board is led by an independent Chairman, who in turn is well-supported by a Senior Independent Director.

Board members populate a range of formal committees to oversee financial and cultural behaviour in the areas of audit, remuneration and corporate responsibility. Each committee is chaired by an independent non-executive director.

Membership and make-up of the Board, both for executive and non-executive roles, is carefully considered on a regular basis. The Nominations Committee is led by the Chairman and includes all non-executive directors. The Committee considers all Board appointments. In addition, the Committee reviews the bench strength of the senior executive team in conjunction with the Group Human Resources Director to assess development needs, resourcing and succession planning to meet the strategy of the Company.

As part of the succession planning process, external search firms are engaged to identify suitable candidates for both Board executive and non-executive roles when appropriate. All appointments are made on ability and merit, but the Committee recognises and values the benefit of diversity in Board composition and executive management roles.

As a governing body, the Board focuses on the principles of openness and transparency to ensure the atmospherics and dynamics within the boardroom remain constructive and healthy. To review progress, the Board commissions an external independent evaluation every two years. In the intervening years, the Board undertakes an internal review comprising a questionnaire completed by all Board members supplemented by individual discussion when required. Following collective Board discussion on the findings of the review, a plan for performance improvement is developed, implemented and monitored at six-monthly intervals as a Board agenda item.

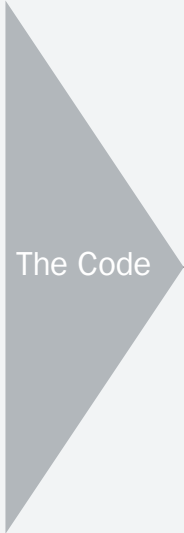
Details of governance processes and procedures are listed opposite.

**Sir Roger Carr, Chairman**



The Company was compliant with the provisions of the UK Corporate Governance Code as published in September 2012 throughout 2014 and the Board has applied its principles in its governance structure and operations.

**HOW THE COMPANY HAS APPLIED THE PRINCIPLES OF THE UK CORPORATE GOVERNANCE CODE AS PUBLISHED IN SEPTEMBER 2012 (THE CODE)**

 <p>The Code</p>	<b>LEADERSHIP</b>		
	An effective board collectively responsible for the long-term success of the company	Board of directors Board effectiveness	<b>P56</b> <b>P59</b>
	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 Board and its responsibilities	<b>P58</b>
	The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role	The Board and its responsibilities	<b>P58</b>
	Non-executive directors should constructively challenge and help develop proposals on strategy	How we manage risk The Board and its responsibilities	<b>P48</b> <b>P58</b>
	<b>REMUNERATION</b>		
	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	Remuneration Committee Report	<b>P67</b>
	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	Remuneration Committee Report	<b>P67</b>
	<b>ACCOUNTABILITY</b>		
	The board should present a fair, balanced and understandable assessment of the company's position and prospects	Strategic Report Going concern	<b>P01</b> <b>P60</b>
	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	How we manage risk	<b>P48</b>
	The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting, risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditors	Audit Committee Report	<b>P61</b>
	<b>EFFECTIVENESS</b>		
	The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively	Nominations Committee Board of directors	<b>P66</b> <b>P56</b>
	There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board	Nominations Committee Chairman's governance letter	<b>P66</b> <b>P54</b>
	All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively	Board attendance table Board effectiveness	<b>P58</b> <b>P59</b>
	All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge	Board effectiveness	<b>P59</b>
	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	Board effectiveness	<b>P59</b>
	The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors	Board effectiveness	<b>P59</b>
	All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance	Board effectiveness	<b>P59</b>
	<b>RELATIONS WITH SHAREHOLDERS</b>		
	There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole is responsible for ensuring that a satisfactory dialogue with shareholders takes place	Shareholder engagement	<b>P60</b>
	The board should use the AGM to communicate with investors and to encourage their participation	Shareholder engagement	<b>P60</b>

# BOARD OF DIRECTORS



	<b>CHAIRMAN</b>	<b>EXECUTIVE DIRECTORS</b>			<b>NON-EXECUTIVE DIRECTORS</b>
	<b>Sir Roger Carr</b> Chairman	<b>Ian King</b> Chief Executive	<b>Jerry DeMuro</b> President and Chief Executive Officer of BAE Systems, Inc.	<b>Peter Lynas</b> Group Finance Director	<b>Harriet Green OBE</b> Non-executive director
Nationality					
Appointed to the Board	2013	2007	2014	2011	2010
Skills and experience	Appointed to the Board on 1 October 2013 as Chairman designate, Sir Roger succeeded Sir Richard Olver as Chairman on 1 February 2014. He was chairman of the board of Centrica plc from 2004 until 31 December 2013. Previous senior appointments include chairman of Cadbury plc, President of the Confederation of British Industry and senior independent director of the Court of the Bank of England. Throughout his career, he has served on a number of external committees, including the Higgs Committee on Corporate Governance and Business for New Europe.	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.	Appointed to the Board on 1 February 2014 as President and Chief Executive Officer of BAE Systems, Inc., Jerry DeMuro is an experienced US executive who has worked in the national security, technology and aerospace industry for over 30 years. Most recently, he served as executive vice president and corporate vice president of General Dynamics' Information Systems and Technology Group. Earlier in his career, he spent almost a decade as an acquisition official at the US Department of Defense.	Peter Lynas, a qualified accountant, was appointed to the Board as Group Finance Director in 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.	Until recently, Harriet Green served as Chief Executive Officer and executive director of Thomas Cook Group plc. She was previously Chief Executive Officer and executive director of Premier Farnell plc. She is a member of the UK Prime Minister's Business Advisory Group and the British Chambers of Commerce's International Advisory Council.
Other appointments	Member of the UK Prime Minister's Business Advisory Group and a senior adviser to Kohlberg Kravis Roberts. Fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce, an honorary fellow of the Institute of Chartered Secretaries and Administrators, and a visiting fellow to the Saïd Business School, Oxford		Non-executive director of Aero Communications, Inc.	Non-executive director of SSE plc and chairman of its audit committee	Non-executive director of Emerson Electric Co.
Other past appointments	Chairman of Thames Water plc and Mitchells & Butlers plc	Non-executive director and senior independent director of Rotork p.l.c.			Senior vice president of Arrow Electronics, Inc.
Committee membership	Chairman of the Nominations Committee and the Non-Executive Directors' Fees Committee	Non-Executive Directors' Fees Committee	Non-Executive Directors' Fees Committee		Corporate Responsibility Committee and Nominations Committee



**Chris Grigg**  
Non-executive director

**Paula Rosput Reynolds**  
Non-executive director

**Nick Rose**  
Non-executive director and  
Senior Independent Director

**Carl Symon**  
Non-executive director

**Ian Tyler**  
Non-executive director



2013

2011

2010

2008

2013

Chris Grigg is Chief Executive of The British Land Company PLC and has more than 30 years' experience in the financial and real estate industries in a range of leadership roles. Prior to joining British Land as its Chief Executive in 2009, he was an executive with Barclays Bank and previously spent over 20 years at Goldman Sachs where he rose to the position of partner.

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, 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. She was then appointed as Vice Chairman and Chief Restructuring Officer of American International Group, Inc. (AIG) from October 2008 to September 2009.

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 at Diageo, including group treasurer and group controller, having spent his earlier career with Ford Finance.

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.

Ian Tyler served as Chief Executive of Balfour Beatty plc for a period of eight years, stepping down from that position in 2013. A Chartered Accountant, he joined Balfour Beatty as Finance Director in 1996 having spent his earlier career in a variety of finance roles.

Non-executive director of Delta Air Lines, Inc., Anadarko Petroleum Corporation and TransCanada Corporation

Chairman of Williams Grand Prix Holdings PLC. Non-executive director and senior independent director of BT Group plc. Adviser to CCMP Capital Advisors, LLC

Non-executive director and senior independent director of Thomas Cook Group plc

Chairman of Cairn Energy PLC, Bovis Homes Group PLC and Al Noor Hospitals Group plc, and a non-executive director of Cable & Wireless Communications Plc

Non-executive director of Coca-Cola Enterprises, Inc. and Air Products and Chemicals, Inc.

Non-executive director of Edwards Group Limited, Moët Hennessy SNC and Scottish Power plc

Non-executive director of BT Group plc, Rexam PLC and Rolls-Royce Group plc, and Chairman of HMV Group plc

Non-executive director of VT Group plc

Remuneration Committee and Nominations Committee

Audit Committee and Nominations Committee

Chairman of the Audit Committee, and member of the Nominations Committee and Remuneration Committee

Chairman of the Remuneration Committee and member of the Nominations Committee

Chairman of the Corporate Responsibility Committee, and member of the Audit Committee and Nominations Committee

# CORPORATE GOVERNANCE REPORT

## The Board and its responsibilities

The Board has adopted a governance structure based on the principles of the UK Corporate Governance Code as published in September 2012 (the Code), which includes the following governance principles:

**Strategy** – reviewing and agreeing strategy for the Company;

**Performance** – overseeing 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** – monitoring the effectiveness of the Company’s risk management and internal control systems; and

**People** – ensuring the Group is managed by individuals with the necessary skills and experience, and that appointments to the Board are managed effectively.

Pursuant to these principles, the Board has put in place a detailed governance framework, the Operational Framework, which includes the Company’s Code of Conduct. It sets out how we do business across BAE Systems and encapsulates the Company’s values, policies and processes, together with clear levels of delegated authority aimed at ensuring that all of its employees and businesses act in a clear, accountable and consistent manner.

## ATTENDANCE BY INDIVIDUAL DIRECTORS AT MEETINGS OF THE BOARD AND ITS COMMITTEES IN 2014

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Paul Anderson	11/11	–	2/2	2/2	–
Sir Roger Carr	11/11	–	–	2/2	–
Jerry DeMuro	11/11	–	–	–	–
Harriet Green	8/11	–	4/4	1/1	–
Chris Grigg	11/11	–	–	1/1	6/6
Ian King	11/11	–	–	–	–
Peter Lynas	11/11	–	–	–	–
Paula Rosput Reynolds	10/11	7/7	–	1/1	–
Nick Rose	11/11	7/7	–	2/2	6/6
Carl Symon	11/11	–	–	1/1	6/6
Ian Tyler	11/11	7/7	4/4	1/1	–

There is a clear division of responsibility at the head of the Company and these are detailed in the Operational Framework. The Chairman leads the Board and is responsible for ensuring that it discharges its duties effectively. The Chief Executive is responsible for the implementation and delivery of the strategy agreed by the Board.

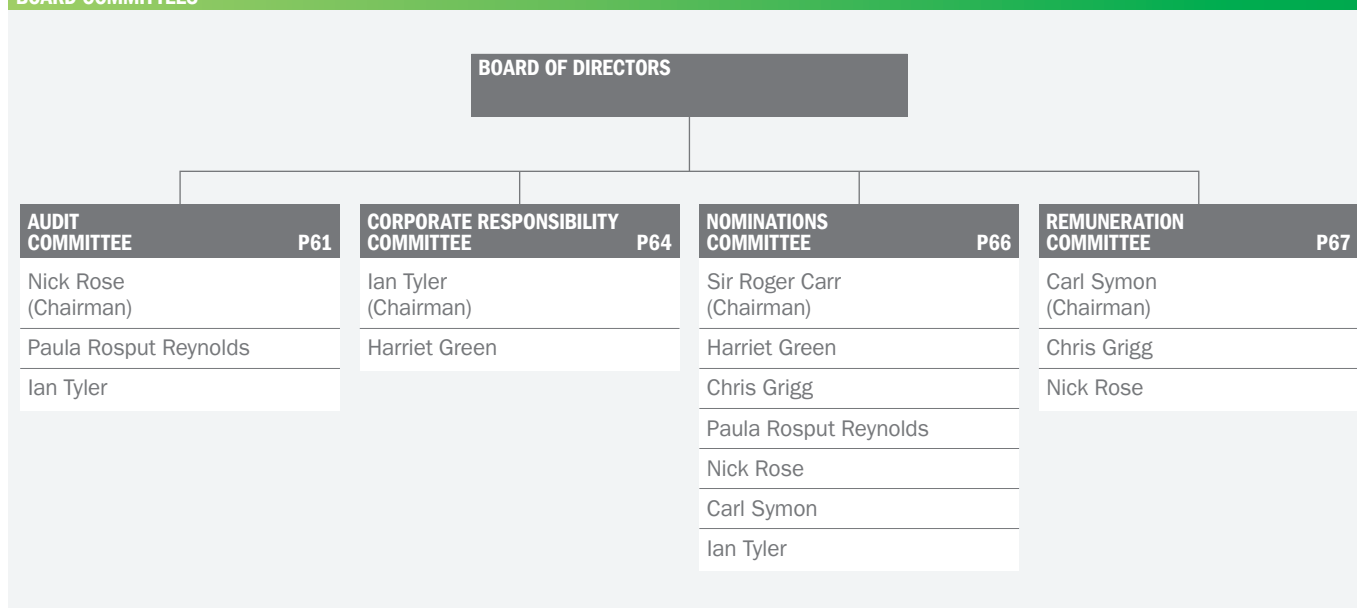
The Senior Independent Director acts as a sounding board for the Chairman and acts as an intermediary for the other directors when necessary. He is also available to shareholders if they have concerns which cannot be addressed through the normal channels. The Company Secretary is responsible to the Board for ensuring that board procedures are complied with.

In general, non-executive directors help develop the Company’s strategy, scrutinise the performance of management in meeting agreed goals and objectives, and monitor the reporting of performance. The Board considers all of the non-executive directors, with the exception of the Chairman, to be independent for the purposes of the Code.

All directors seek election on an annual basis at the Annual General Meeting.

Attendance by individual directors at meetings of the Board and its committees in 2014 is shown above.

## BOARD COMMITTEES



## Board effectiveness

This section considers the effectiveness of the board of directors and the way in which the provisions of the Code have been addressed.

### Annual evaluation

The Board's evaluation in respect of performance in 2014 was facilitated internally by way of a questionnaire produced by the Company Secretary and completed by all directors. This included questions on the quality of the decisions made, the process used to reach those decisions and the contribution of individual members of the Board. The completed questionnaires were analysed by the Chairman and also by the Senior Independent Director. The results of the survey as they applied to the Board were discussed collectively and objectives for 2015 agreed. The Chairman will meet with each director to provide feedback on individual performance. Feedback on the Chairman's own performance will be provided by the Senior Independent Director, Nick Rose.

Having reviewed the analysis of the feedback provided by directors, the Board has agreed objectives for 2015, which will be monitored and progressed at the board meetings

scheduled for the year. These include objectives concerning Board succession planning and how the Company identifies and develops future leaders. Objectives have also been agreed that will build on the strategy work the Board undertook last year, and ensure that directors continue to develop the depth of their understanding of both strategic and key operational matters. Finally, the Board will continue to refine its processes to ensure that the use of modern technology improves the efficiency and effectiveness of reporting.

The Board evaluation also included an assessment of performance against the objectives agreed for last year. The table below summarises this assessment.

### Board induction

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, where necessary, part of the directors' annual evaluation process overseen by the Chairman.

An induction programme is agreed for all new directors aimed at ensuring 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.

### Information for the Board

The Chairman, with the assistance of the 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.

BOARD OBJECTIVES AND ACHIEVEMENTS	
2014 OBJECTIVES	2014 ACHIEVEMENTS
<p><b>Strategy</b> Focus on developing a more detailed strategic understanding of the Company's businesses and markets.</p> <p>Ensure that the strategy for the Company's Applied Intelligence business is optimised to access fully the growth potential of the cyber security market.</p>	<p>During 2014, the Board undertook a comprehensive review of the business, which has provided a deeper understanding of current activity and has established a platform for longer-term strategic planning.</p> <p>The strategy for Applied Intelligence continued to develop during the year, with the SilverSky acquisition accelerating the Group's strategy to grow its commercial cyber business.</p>
<p><b>Succession planning</b> Engage with all directors on executive development and succession planning.</p> <p>Increase the levels of diversity and bench strength in key roles and make progress against the Company's diversity objectives.</p>	<p>The membership of the Nominations Committee was expanded to include all non-executive directors during the year. This has helped facilitate wider board-level engagement on executive development and succession planning.</p> <p>During the year, the Board initiated additional work on diversity and succession planning for key roles, but it is recognised that there is more to do in these areas and this is reflected in the Board's 2015 objectives.</p>
<p><b>Risk and risk management</b> The Board to continue reviewing the level of risk it is willing to take in achieving its strategic objectives.</p>	<p>A review of principal risks was incorporated into the Board's strategy review process.</p>
<p><b>Board development</b> Develop a wider understanding by all directors of the use and management of commercial offset arrangements.</p> <p>Use site visits by individual non-executive directors to help develop a deeper understanding of the Company.</p>	<p>Facilitated by the Group Finance Director and Group Business Development executives, non-executive directors participated in a training session aimed at developing a deeper understanding of the management of commercial offset.</p> <p>Whilst some site visits were undertaken by directors during the year, additional emphasis will be placed on this in 2015.</p>

# CORPORATE GOVERNANCE REPORT CONTINUED

## Business planning and going concern

The Company has developed an annual Integrated Business Planning (IBP) process, which comprises a strategic plan, a financial forecast for the current year and financial projections for the next five years. The IBP represents a common process with standard outputs and requirements that produces consolidated plans at both the Group level and at a number of levels within the Company. The plan is reviewed each year by the Board as part of its strategy review process. Once approved by the Board, the IBP is cascaded down across all the Company's businesses and provides the basis for setting all detailed financial budgets and strategic actions that are subsequently used by the Board to monitor performance.

In undertaking its review of the IBP in 2014, the Board considered the prospects of the Company over the one and five-year periods covered by the process. The one-year planning period has a greater level of certainty and is, therefore, used to set detailed budgetary targets at all levels across the Group – it is also used by the Remuneration Committee to set targets for the annual incentive. The five-year period provides less certainty of outcome, but provides a robust planning tool against which strategic decisions can be made. On the basis of this and other matters considered and reviewed by the Board during the year, the Board has reasonable expectations that the Company will be able

to continue in operation and meet its liabilities as they fall due over the periods used for the assessment. In doing so, it is recognised that such future assessments are subject to a level of uncertainty that increases with time and, therefore, future outcomes cannot be guaranteed or predicted with certainty. Also, this assessment was made recognising the principal risks that could have an impact on the future performance of the Company (see pages 50 to 53).

Accounting standards require that directors satisfy themselves that it is reasonable for them to conclude whether it is appropriate to prepare financial statements on a going concern basis. The Group's business activities, together with factors that are likely to affect its future development and position, are set out in the segmental performance section on pages 27 to 42. The financial position of the Group, including information on cash flow, can be found in the financial review section on pages 22 to 26. Principal risks are detailed on pages 50 to 53. In addition, the financial statements include, amongst other things, notes on finance costs (page 113) and financial risk management, including treasury policies on interest rate, liquidity, currency and credit risk (pages 150 and 151). After making due enquiry, 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.

## Shareholder engagement

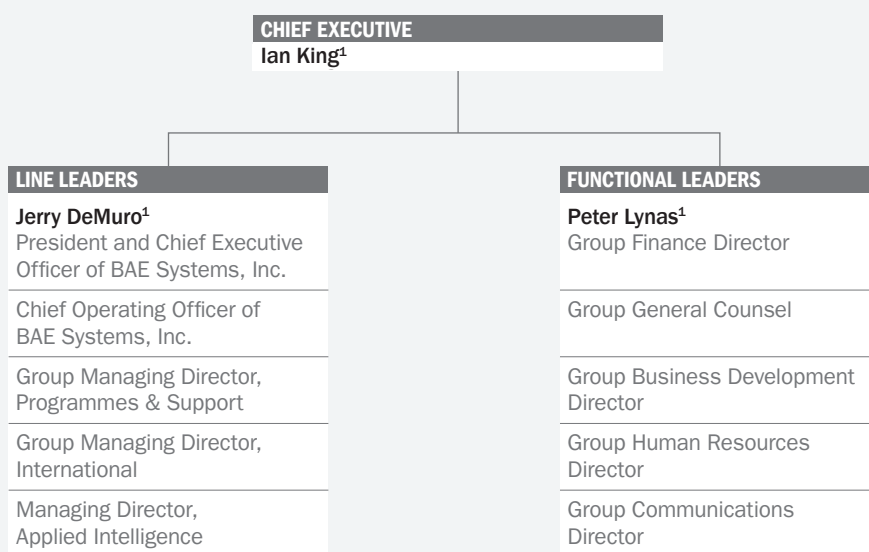
The Company has a well-developed investor relations programme managed by the Chief Executive, Group Finance Director and Investor Relations Director. In addition, the Chairman is available to meet with major shareholders and is in regular contact with them so as to keep them informed of progress on corporate 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's Annual General Meeting 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 results of the voting on all resolutions are published on the Company's website.

## EXECUTIVE COMMITTEE MEMBERS

The Chief Executive has established the Executive Committee as the executive forum in which the most senior Line and Functional Leaders come together to communicate, review and agree on issues and actions of Company-wide significance.



1. Board member.

# AUDIT COMMITTEE REPORT



**NICK ROSE**  
CHAIRMAN OF THE AUDIT COMMITTEE

**Members**

Nick Rose (Chairman)

Paula Rosput Reynolds

Ian Tyler

**Governance**

The Audit Committee was in place throughout 2014 and held seven 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 and reviewing the output

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

The Committee's full Terms of Reference, which are reviewed each year by the Board, are available on the Company's website.

**Attendance at meetings**

The Committee invites the following to its regular meetings:

Chairman; Chief Executive; Group Finance Director; and Director, Financial Control and Reporting;

Internal Audit Director, together with other senior members of the Internal Audit function, as appropriate;

Other representatives from businesses and functions, as appropriate; and

The senior KPMG partner responsible for the BAE Systems audit, together with other senior audit partners, as appropriate.

The Committee holds private sessions with the Auditors and Internal Audit Director without management present, and the Committee Chairman meets privately with both internal and external audit.

**Reporting to the Board**

The Committee Chairman provides regular updates to the Board on the key issues discussed at the Committee's meetings.

**Dear Shareholders,**

Business risk continues to be a much discussed topic in boardrooms and governance circles, placing continual emphasis on the importance of boards understanding the principal risks in their businesses and how they are being managed effectively. As reported on page 48, the Board as a whole has been reviewing risk with the Audit Committee supporting this activity and also considering the Group's risk disclosures and reporting.

During the year, Ian Tyler assumed chairmanship of the Corporate Responsibility Committee which provides a helpful crossover for us in terms of his wider understanding of non-financial and reputational risk. I also sit on the Remuneration Committee where I contribute to discussion on risk and reward.

**Internal control and 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 requirement of good corporate governance.

As set out on page 48, the Board has overall responsibility for determining the nature and extent of the risk it is willing to take, and ensuring that risks are managed effectively across the Group. At the Board's request, the Committee has reviewed the Company's principal risks in the light of new provisions in the 2014 UK Corporate Governance Code covering the assessment of principal risks, as well as the Financial Reporting Council's (FRC) associated Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. Whilst the 2014 UK Corporate Governance Code does not apply to the Company until the next financial year, the Board has elected to report on certain of the risk management and internal control principles in the new code on a best practice basis.

The way in which the Company manages risk is set out on pages 48 and 49, with the principal risks facing the Group set out on pages 50 to 53.

We have reviewed the ongoing effectiveness of the Company's risk management processes as part of our wider review of the effectiveness of internal controls.

Our review of internal controls has also encompassed a review of the reports relating to the six-monthly Operational Assurance Statements, which are submitted by each business or function as a mandated policy under the Group-wide Operational Framework, and controls reports and audit reports from both internal and external auditors.

# AUDIT COMMITTEE REPORT CONTINUED

A key controls focus for the Committee is the controls environment surrounding Lifecycle Management (LCM). LCM is integral to the successful execution of the Group's projects and programmes, and of particular importance in the early identification of programme risk and the determination of profit recognition or provisioning. We have discussed the outputs of general financial and LCM controls testing, and any required improvement actions, with management, and internal and external audit, with a view to ensuring the ongoing robustness of programme execution and risk mitigation.

During the year, we met with local senior management of the US Support Solutions business with regard to performance issues identified on commercial shipbuilding contracts as well as operational challenges identified on the Radford ammunition facility maintenance contract. We reviewed and discussed with management the wider control environment and risk management processes surrounding these businesses, including programme management controls and lessons learned, and the steps being taken to address the issues.

We have also received and discussed a report from the Group General Counsel on compliance with the Company's Export Control Policy.

## Financial reporting

The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2014 financial statements were:

- **Recognition of profit and provisioning:** We reviewed key estimates and judgements prior to publication of the financial statements. Our review included the key estimates and assumptions applied in determining the financial status of the more significant programmes, including US commercial shipbuilding contracts.
- **Goodwill:** We considered the level of goodwill held on the Group's balance sheet in respect of a number of past major transactions and whether, given the future prospects of these businesses, the value of goodwill held on the balance sheet remains appropriate. The methodology for impairment testing used by the Group is set out in note 9 to the Group accounts on page 118.
- **Impairments:** the Group has incurred a goodwill impairment of £161m, of which £87m relates to performance issues in the US commercial shipbuilding business and £74m relates to the proposed disposal of the Group's interest in BAE Systems Land Systems South Africa (Pty) Limited.
- **Acquisitions:** we considered the acquisition accounting for acquisitions made in 2014 as set out in note 26 on page 147, these being SilverSky, Saudi Development and Training Company, and Signal Innovations Group, Inc.
- **Pensions:** Recognising the scale of the Group's pension obligation, we reviewed the key assumptions supporting the valuation of the retirement benefit obligation. This included a comparison of the discount and inflation rates used against externally derived data. We reviewed the methodology used to allocate a proportion of the retirement benefit obligation to equity accounted investments and other participating employers, and concluded that this was appropriate with reference to agreements between the Company and those companies. We also considered the adequacy of disclosures in respect of the sensitivity of the deficit to changes in these key assumptions.  
  
We noted that the Company and the trustees of the UK pension schemes have agreed recovery plans (where necessary) to address the funding positions resulting from the actuarial valuations carried out on the Group's UK defined benefit schemes in 2014. The Board as a whole has been kept apprised of progress in this regard.
- **Taxation:** Whilst tax policy is ultimately a matter for the Board's determination, we reviewed the Group's tax strategy as set out on page 26. On a twice-yearly basis, we reviewed the Group's tax charge and tax provisions.  
  
Taking into account the revised FRC guidance referred to above, the Committee agreed the parameters of, and reviewed the supporting report for, the going concern statement and the statement on the Board's assessment of the prospects of the Company on the one and five-year periods used in the Integrated Business Plan.  
  
An intrinsic requirement 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 is an extensive exercise performed within an exacting time frame which runs alongside the formal audit process undertaken by the Auditors.  
  
The process to ensure that the Committee, and then the Board, are satisfied with the overall fairness, balance and clarity of the document has been underpinned by:
  - comprehensive guidance issued to all the 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 directors and the senior team.

## External audit

The Company's Auditors are KPMG LLP. The Committee has been kept up-to-date with the development of new EU-wide regulations concerning audit tenure and the longevity of audit firm relationships with the companies they audit. Under current EU transitional arrangements, the Company would be required to rotate its auditor by June 2020.

Continuity and consistency of audit quality are important, however the Committee is also mindful of the fact that KPMG LLP, and their legacy predecessors, have been in place as the Company's Auditors since 1981 without re-tender and it remains our present intention to initiate an audit re-tendering process not later than 2017 (for the 2018 accounts) prior to the rotation of the current audit engagement partner. This is in line with best practice provisions on audit rotation in the Code. The Committee will keep this re-tendering time frame under review and will use our regular reviews of auditor effectiveness to assess whether an earlier date for a re-tender would be desirable. There are no contractual obligations that would restrict the selection of a different auditor.

It is the Committee's view that, given the complexity of the audit process at BAE Systems, a significant transition period will be required. Plans are being formulated to address this and the Committee's Terms of Reference have been amended to enable it to oversee the tender process.

The Committee maintains oversight over the effectiveness of the Company's Auditors principally by way of an annual review of audit effectiveness at the conclusion of each year-end audit and to supplement this with an in-depth review of audit effectiveness on a triennial basis. We undertook our triennial review midway through 2014 which enabled us to take a deeper look at the service provided by our Auditors. This included the enhancements made by our lead engagement partner after he had completed one full annual audit cycle, for example:

- audit resource skilling, including familiarity with our business processes and the transfer of knowledge;
- the planned rotation of lead partners to ensure continuity; and
- enhanced reporting and communications.

KPMG's plans to support us through our future audit transition were outlined and discussed. We also looked at fees from a value-for-money perspective.



We have since assessed the output of the annual review undertaken at the close of the 2014 year-end audit. This review was based on a Group-wide evaluation at management and functional level, and covered areas such as:

- understanding of the Group's risks and opportunities to facilitate the development of an appropriate audit plan;
- the robustness of audit processes;
- objectivity;
- quality of communications; and
- ability to provide a seamless service across differing jurisdictions.

We provided feedback to the Auditors from the evaluation and will assess how the related actions have been incorporated into the 2015 audit plan when the latter has been formulated.

On the basis of the reviews undertaken in 2014, and the review following the 2014 year-end audit, the Committee proposed to the Board that it recommend that shareholders support the re-appointment of KPMG LLP at the 2015 Annual General Meeting.

**Internal Audit**

Internal Audit plays an important role in assessing the effectiveness of internal controls by a programme of reviews based on a continuing assessment of business risk across the Group.

The annual internal audit programme 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, as well as financial risk. The Committee considered the output from the 2014 annual internal audit programme of assurance work on a six-monthly basis.

Over the past year, the Committee has benefited from interactive sessions with the respective heads of Internal Audit for the UK businesses, the US businesses and the international businesses. This has complemented the regular reporting we receive from, and private meetings we have with, the Internal Audit Director. As part of the annual evaluation of the Internal Audit function that the Committee oversees each year, we have discussed with the Internal Audit Director the level of skilling and resourcing required to deliver the 2015 internal audit programme.

**Nick Rose**  
Chairman of the Audit Committee

**AUDITOR INDEPENDENCE – NON-AUDIT SERVICES POLICY**

The Committee has a formal policy governing the engagement of the Auditors to provide non-audit services which we review on an annual basis. The Policy prohibits certain activities from being undertaken by the Auditors such as 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; internal auditing; and any work where a mutuality of interest is created that could compromise the independence of the Auditors. The Policy also places restrictions on the employment of former employees of the Auditors.

Recognising that the Auditors are best placed to undertake certain work of a non-audit nature, the Policy permits the provision of Audit-Related Services and Permitted Non-Audit Services up to limits that are pre-approved by the Committee, with specific approvals required beyond such limits by the Committee. A copy of the policy is available on the Company's website.

Details of fees payable to the Auditors are set out on page 111. In 2014, non-audit fees represented 30% of the audit fee. The principal non-audit services provided by the Auditors related to tax compliance and advisory services, the interim review and equity advisory services.

**OTHER KEY AREAS OF WORK UNDERTAKEN BY THE COMMITTEE IN 2014**

During the year, the Committee has:

reviewed and challenged the external audit plan to gauge whether it was appropriately focused;

considered the accounting, financial control and audit issues reported by the Auditors that flowed from the audit work;

reviewed the confirmation and information received from KPMG on the arrangements that it has in place to safeguard its independence and objectivity;

reviewed and agreed the audit fee;

reviewed and discussed on a quarterly basis the nature and level of non-audit fees, and undertaken an annual review of the Non-Audit Services Policy which we concluded was still appropriate (see above);

reviewed the effectiveness of the Company's helpline procedures in respect of the reporting of possible accounting, financial control or other financial irregularities, which form part of our wider Ethics Helpline procedures, and concluded that the procedures continue to work effectively;

reviewed on a twice-yearly basis the procedures for the identification, assessment and reporting of risk; and

considered corporate governance and accounting developments.

# CORPORATE RESPONSIBILITY COMMITTEE REPORT



**IAN TYLER**  
**CHAIRMAN OF THE CORPORATE RESPONSIBILITY COMMITTEE**

**Members**

- Ian Tyler (Chairman)
- Harriet Green

**Governance**

The Corporate Responsibility Committee was in place throughout 2014 and held four meetings. 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 includes an examination of ethical business conduct within the Company

**Attendance at meetings**

The Committee invites the following to its regular meetings:

- Chairman; Chief Executive; Managing Director Corporate Responsibility; Group General Counsel; and Internal Audit Director

**Reporting to the Board**

The Committee Chairman provides regular updates to the Board on the key issues discussed at the Committee's meetings.

**Dear Shareholders,**

This is the first Corporate Responsibility Committee Report since I succeeded Paul Anderson as chairman of the Committee in September last year. During Paul's chairmanship, the Committee placed a strong focus on ethical conduct, safety, and diversity and inclusion. These areas will continue to be our priorities.

Last year, the Committee reported that, five years on from the Woolf Committee Report on business conduct in BAE Systems, it had agreed a number of actions aimed at maintaining the impetus and energy we have seen in this area. One of the key recommendations was that we engaged an independent third party to undertake a survey of ethical business culture to follow up on a similar survey undertaken in 2011.

This survey was undertaken by Ethical Leadership Group (NAVEX Global). It was completed during 2014 and the Committee reviewed the findings. The survey concluded that BAE Systems has all the elements of a best practice programme in place and should continue to review and mature this. However, one of the key messages that we took from the report was the need to continually reinforce the key messages regarding responsible behaviour so as to ensure that these are understood across the Company at all levels. It emphasised also the importance of continuing to communicate the standards of behaviour we expect of employees and, in particular, to provide training and support to those with supervisory responsibilities to ensure they have the necessary skills to provide leadership at all levels across the Company.

The Committee will continue to monitor the implementation of the recommendations in the report.

As part of the Company's planned activities, responsible behaviour training has been undertaken across the Group in 2014 and the refresh of the Code of Conduct has been completed. This will be issued to all employees in 2015.

It is essential that the Company has an effective means by which all employees have a means of raising matters of concern in confidence. BAE Systems has both an Ethics Helpline through which such matters can be raised and also a network of Ethics Officers to whom employees can raise matters in confidence. The Company continues to

expand its network of Ethics Officers who are able to provide confidential support and advice to employees on business conduct matters and also act as ambassadors for the Code of Conduct. The Committee oversees the effectiveness of these means of raising matters in confidence and, twice a year, we review the number and nature of the issues raised, and monitor how they are resolved.

The Committee's overall safety goal for the Company remains one of achieving world-class levels of safety management. Whilst some parts of the Company are now achieving these levels, we continue to drive for further improvement, and see a focus on reducing significant risks and the promotion of a strong safety culture as key to achieving continual improvement in safety performance. Benchmarking is important and, as a Committee, we look at a range of performance indicators that provide us with comparable information on the Company's safety performance relative to other major companies. In addition, the leadership shown by senior management in driving the right behaviours and expectations is critical to achieving our safety objectives, and performance in this area is part of the executive annual incentive plan, for which the Committee sets performance targets and makes recommendations to the Remuneration Committee on levels of achievement.

The Committee continues to monitor corporate responsibility-related risks and it reviews the output from the Company's

Internal Audit function regularly so that we can be responsive to possible emerging issues and trends. Also, to help develop a better understanding of particular matters, our meetings have included deep dives into particular issues. By way of example, in 2014, we spent time looking at the anti-bribery and corruption compliance processes used by the Group Business Development function and how they are applied in practice in overseas markets.

The future agenda that we have set for the Committee aims to ensure that we maintain focus over the priority areas that we believe are most important for the Company in terms of corporate responsibility. During 2015, we will undertake a number of deep dives into key areas. These will include diversity and inclusion, which remains an important focus for the Committee and where we will be reviewing the progress being made against the actions the Company has in place to grow the female talent pipeline at senior levels. Also, our annual programme of meetings includes a whole day visit to one of the Company's sites. We have undertaken a number of such visits in the past and they have proved to be an excellent means of providing in-depth first-hand experience of corporate responsibility matters.

**Ian Tyler**  
**Chairman of the Corporate Responsibility Committee**

**OTHER KEY AREAS OF WORK UNDERTAKEN BY THE COMMITTEE IN 2014**

- During the year, the Committee has:

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- reviewed the Company's product trading policies;

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- reviewed and received regular updates on the development of the Company's US International Traffic in Arms Regulations (ITAR) export control compliance programme and associated assurance work;

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- received reports and presentations from the Internal Audit Director on audit work undertaken during the year, particularly with regards to corporate responsibility-related matters;

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- received a report on the management of offset commitments;

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- considered the output from the non-financial risk reviews undertaken by the Executive Committee and the status of associated mitigation activity;

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- agreed the scope of the work to be undertaken by Deloitte LLP pursuant to their assurance statement included in this report;

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- reviewed the Responsible Behaviour training package as rolled out across all parts of the Group in 2014; and

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- met with the heads of the Company's UK and US Government Relations departments and reviewed the Company's lobbying activities and associated controls.

# NOMINATIONS COMMITTEE

Members
Sir Roger Carr (Chairman)
Harriet Green
Chris Grigg
Paula Rosput Reynolds
Nick Rose
Carl Symon
Ian Tyler
Sir Richard Olver was chairman of the Committee prior to Sir Roger Carr succeeding him on 1 February 2014. During the year, the membership of the Committee was widened to comprise all the non-executive directors. Paul Anderson was a member of the Committee up to 31 December 2014.
<b>Governance</b>
The Nominations Committee was in place throughout 2014 and held two meetings during the year. It is chaired by the Chairman of the Company. Whilst he is not deemed to be independent, the other members of the Committee are independent non-executive directors in accordance with the provisions of the UK Corporate Governance Code.
<b>Summary of responsibilities</b>
Reviewing the balance of skills, experience, diversity (including gender), knowledge and independence, and recommending any changes to the Board's membership that it believes are necessary or desirable as a result of such review
Planning the orderly succession of new directors to the Board by reviewing on a regular basis the Company's senior management resource
Identifying and nominating for the Board's approval suitable candidates to fill any vacancies for non-executive or executive directors
Recommending to the Board the membership and chairmanship of the Audit, Corporate Responsibility and Remuneration committees
Nominating suitable candidates for the role of Senior Independent Director
Reviewing, and making recommendations to the Board on, the re-appointment of non-executive directors at the conclusion of their specific terms of office, having given due regard to their performance and ability to continue to contribute to the Board

## Diversity

The Board has adopted the following statement 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:

- The Board has 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 will only engage the services of search consultants who are signatories to the Voluntary Code of Conduct for Executive Search Firms.
- The Board will report progress against targets and actions taken in its Annual Reports.

There are currently two women on the Board (2014 two), 20% (2014 18%) of the total membership.

# REMUNERATION COMMITTEE REPORT



**CARL SYMON**  
CHAIRMAN OF THE REMUNERATION COMMITTEE

**Members**

- Carl Symon (Chairman)
- Chris Grigg
- Nick Rose

**Governance**

The Remuneration Committee was in place throughout 2014 and held six meetings. All its members are independent in accordance with the provisions of the Code.

The Chief Executive and the Company's Chairman attend Committee meetings by invitation only. They do not attend where their individual remuneration is discussed and no director is involved in deciding his own remuneration.

**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

The Committee's full Terms of Reference, which are reviewed each year by the Board, are available on the Company's website.

**Dear Shareholders,**

On behalf of the Board, I am delighted to present the Remuneration Committee's Report for 2014.

We were pleased by the level of shareholder support received for our 2013 Remuneration Committee Report in our first year of reporting under the new reporting regulations. In implementing the Directors' Remuneration Policy (the Policy), we stated that it would apply for three years with 2015 being the first year of operation. I am pleased to confirm that, for 2015, no revisions are proposed to our executive remuneration framework which would constitute a change to the Policy. However, we remain committed to continued transparency and engagement with our shareholders and have consulted with our major shareholders on proposed changes to our executive remuneration arrangements for 2015 which may be made at the discretion of the Remuneration Committee as follows:

**Earnings per Share (EPS) performance condition applicable to Long-Term Incentive (LTI) grants**

The current LTI performance metrics of 5% to 11% average annual EPS growth with nil vesting at threshold were developed during a period of high-growth expectations from our shareholders commensurate with the then market opportunities. The metrics are no longer deemed appropriate given the recent changes in the market for defence companies. It is proposed to set a performance range of 3% to 7% average annual EPS growth for 2015 awards of Performance Shares under the Long-Term Incentive Plan (LTIP) as this will provide executives with an appropriately challenging and meaningful incentive to drive performance which, at the same time, delivers a level of financial performance which supports capital market expectations. Achievement of performance at the threshold level represents significant challenge due to the dependency on winning several pivotal orders.

For this reason, it is proposed that there should be a level of reward equal to 25% of maximum for achievement of threshold. Average annual EPS growth of 5% will achieve 50% vesting with full vesting requiring 7% growth. Whilst not 'straight-line' vesting (as currently), this vesting profile will provide a potential reward for the executives which reflects the unique set of market challenges which are expected in the next several years. It is intended that the revised EPS performance condition is also subject to the same 'quality of earnings' performance hurdle as applies to the Total Shareholder Return (TSR) condition, such that awards will not vest unless the Board is satisfied that there has been a sustained

# REMUNERATION COMMITTEE REPORT CONTINUED

improvement in the underlying financial performance of the Company (taking account of items such as cash, order book, risk and project performance).

The Committee intends to review the performance condition again for 2016.

### Malus and clawback provisions

Reflecting the changes to the malus and clawback provisions in the 2014 UK Corporate Governance Code, the Committee has determined the following:

- A two-year clawback period will be added to the end of the three-year vesting period applicable to Share Options and Restricted Shares awarded under the LTIP. This will mean that shares delivered on vesting and exercise will, except in exceptional circumstances, be held on the participant's behalf until the fifth anniversary of vesting. This policy amendment will apply to all awards made from and including 2015 to the executive directors and to all members of the Executive Committee.
- The Committee has also extended the definition of circumstances and trigger events to cover the emergence of financial 'black holes' which emerge regardless of whether they affect the results for the year on which the incentive is based. At the same time, the Committee's ability to trigger malus or clawback on the grounds of misconduct has been extended to cover situations which give rise to disciplinary action short of termination. This policy amendment will apply to all awards made from and including 2015 to all participants.

We will also maintain our requirement for executive directors to build up a significant personal shareholding, which stands at 300% of salary for the Chief Executive, 350% for the President and Chief Executive Officer of BAE Systems, Inc. and at 200% for the Group Finance Director.

### Business performance in 2014

In 2014, BAE Systems delivered a solid overall performance. Pages 18 to 21 set out the performance against our 2014 annual objectives, which focus on deliverables in support of both short-term results and the overall long-term strategy. For the purpose of incentives applicable to the executive directors:

- order intake of £15.1bn was between target and stretch performance;
- excluding the prior year retrospective benefit from the Salam price escalation, underlying earnings per share increased to 38.0p, which was between target and stretch performance;
- net debt of £1,032m achieved stretch performance; and

- an 11% reduction was achieved in the Recordable Accident Rate and a reduction of over 30% in the number of major (most serious) injuries.

In relation to performance over the three-year period 2012 to 2014:

- threshold TSR was achieved;
- EPS performance was impacted by the challenges in US markets and performance issues identified previously. In addition, the base year, 2011, included a one-off benefit of 5.9p from an agreement with the UK tax authorities; and
- operating cash performance in the US business was impacted by the market challenges and performance issues referred to above.

### Decisions for 2014

- 2014 annual bonus pay-outs for the executive directors ranged from 56.5% to 74.5% of maximum.
- Performance Share Plan (PSP) awards granted in March 2012 to UK executive directors will partially vest in 2015 as performance exceeded the TSR threshold; EPS portion will lapse. PSP awards granted to the US executive director will lapse as the operating cash and EPS measures were not met.
- Share Matching Plan (SMP) matching award granted in March 2012 will lapse in 2015 as EPS condition not met.
- Share options granted in March 2012 to the executive directors will partially vest as performance exceeded the TSR threshold.
- Approval at the 2014 Annual General Meeting (AGM) by shareholders of a single umbrella LTI plan with flexibility to award Performance Shares, Share Options and Restricted Shares (to the US executive director only) within set award limits.
- In relation to the retirement of Linda Hudson as President and Chief Executive Officer of BAE Systems, Inc., the Committee confirmed all elements of remuneration to be actioned in line with policy and as disclosed in last year's Annual Report.
- In relation to the appointment of Jerry DeMuro as President and Chief Executive Officer of BAE Systems, Inc., the Committee confirmed all elements of remuneration to be actioned in line with policy and as disclosed in last year's Annual Report.

### Context to the Committee's decisions for 2015

Our remuneration strategy is to motivate our key talent to realise the Company's strategic objectives, deliver on customer commitments, lead and inspire employees, and drive value for our shareholders. It recognises the need to be competitive in those markets in which we operate and compete for talent. A core

design objective is an appropriate balance of short-term and long-term incentives, focused on Group performance, business segment performance and leadership behaviours that underpin a Total Performance culture.

The focus of changes to our reward framework in recent years has been to improve alignment with shareholder value creation and address the perceived complexity of our long-term incentive arrangements by simplifying our arrangements. We believe the approval of the single LTI plan at the 2014 AGM achieves simplification of our arrangements and have, therefore, focused this year on ensuring that our long-term incentives are appropriately rewarding our executive team only when their performance delivers tangible business results in line with the Group's strategy.

### Key changes for 2015

- The Chief Executive Officer has elected to not take any base salary increase for a third successive year.
- For the first time since 2012, the salary of the Group Finance Director is to be increased, by 2%, with effect from 1 January 2015.
- To recognise his performance in role, the salary of the President and Chief Executive Officer of BAE Systems, Inc. is to be increased, by 2%, with effect from 1 January 2015.
- First awards to be made under the approved single LTI plan in Spring 2015.
- Proposed performance range of 3% to 7% average annual EPS growth with 25% vesting at threshold to apply to 2015 LTI awards.
- Strengthening of malus and clawback provisions to reflect the changes in the 2014 UK Corporate Governance Code applicable to the executive directors and all members of the Executive Committee.

For the purposes of the Companies Act 2006, the legally binding restrictions under the Policy took legal effect from 1 January 2015. As stated in last year's Annual Report, the Policy has been operated in practice from the 2014 AGM.

On behalf of the Board

**Carl Symon**  
Chairman of the Remuneration Committee



**P70** Executive directors' remuneration



**P72** Annual bonus



**P73** Long-Term Incentive Plans

# ANNUAL REMUNERATION REPORT

## Remuneration for the year ended 31 December 2014

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2014 and will be proposed for an advisory vote by shareholders at the 2015 Annual General Meeting (AGM). It has been prepared on the basis prescribed in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

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## Directors' remuneration in the year ending 31 December 2015

As stated in the Remuneration Committee Chairman's letter on page 68, for the purposes of the Companies Act 2006, the Directors' Remuneration Policy (the Policy) took legal effect on 1 January 2015. The Policy has been operating in practice since the date of its approval on 7 May 2014 at the 2014 AGM. The remuneration for 2015 will be implemented as follows:

- The Chief Executive Officer has elected to not take any base salary increase for another year.
- The salaries of the Group Finance Director and President and Chief Executive Officer of BAE Systems, Inc. are being increased by 2% with effect from 1 January 2015.
- The performance measures and weightings for 2015 for the Annual Incentive and Long-Term Incentives are set out on page 83.
- The Committee is of the view that bonus targets for the Annual Incentive are commercially sensitive and that it would be detrimental to the Company to disclose them in advance. The targets will be disclosed retrospectively after the end of the relevant financial year.
- The fee structure for non-executive directors has been reviewed and remains unchanged for 2015.

# ANNUAL REMUNERATION REPORT CONTINUED

## Single total figure of remuneration

	Fees		Benefits		Other		Total	
	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000
<b>Chairman</b>								
Sir Roger Carr <sup>1</sup>	602	19	-	-	-	-	602	19
Sir Richard Olver <sup>2</sup>	60	725	1	15	-	-	61	740
<b>Non-executive directors</b>								
P M Anderson <sup>3</sup>	84	95	1	-	23	23	108	118
H Green	75	75	-	-	9	9	84	84
C M Grigg <sup>4</sup>	75	38	-	-	9	-	84	38
Sir Peter Mason <sup>5</sup>	n/a	28	n/a	-	n/a	5	n/a	33
L A McIntire <sup>5</sup>	n/a	47	n/a	-	n/a	18	n/a	65
P Rosput Reynolds	75	75	1	-	23	23	99	98
N C Rose	120	119	1	-	9	14	130	133
C G Symon	95	95	1	-	23	23	119	118
I P Tyler <sup>4</sup>	85	49	1	-	9	5	95	54

1. Appointed to the Board in 2013 and as Chairman on 1 February 2014.

2. Retired from the Board on 1 February 2014.

3. Retired from the Board on 31 December 2014.

4. Appointed in 2013.

5. Retired or resigned in 2013.

### Chairman

Sir Roger Carr was appointed to the Board as Chairman designate on 1 October 2013 at a fee of £75,000 per annum (pro-rata) until 1 February 2014 when he succeeded Sir Richard Olver as Chairman. His annual fee thereafter was £650,000 per annum (pro-rata). This fee will not be reviewed during his initial three-year term as Chairman.

To assist in completing handover activities and as agreed pursuant to the notice period under his letter of appointment, Sir Richard Olver's services were retained by the Company up to 16 May 2014. For these services, he was paid his then annual fee of £725,000 (pro-rata) and retained use of a chauffeur-driven car: the fee for these services was £211,458 and the car-related benefit totalled £5,380. His pro-rated fee and benefit figures for the period from 1 January to 1 February 2014 are given in the table above; the benefit figure relates to private use of a chauffeur-driven car.

### Non-executive directors

The fee structure for 2014 for the non-executive directors on a per annum basis was as follows: (i) Chairman, Audit Committee: £100,000; (ii) Chairman, Corporate Responsibility Committee: £95,000; (iii) Chairman, Remuneration Committee: £95,000; (iv) Other non-executive directors: £75,000; and (v) Additional fee for Senior Independent Director: £20,000. These amounts are shown in the 'Fees' column above. A travel allowance of £4,500 per meeting is also paid on each occasion that a non-executive director's travel necessitates air travel of more than five hours (one way) to the meeting location, subject to a maximum of six travel allowances per year. These amounts are shown in the 'Other' column. The amounts in the 'Benefits' column relate to travel expenses and subsistence.

The above table has been subject to audit.

	Base salary		Taxable benefits <sup>1</sup>		Bonus <sup>2</sup>		LTIP <sup>3,7</sup>		Pension <sup>4</sup>		Other <sup>5</sup>		Total	
	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000	2014 £'000	2013 £'000
I G King	963	963	45	41	1,610	1,156	690	-	210	338	1	1	3,519	2,499
P J Lynas	546	546	46	64	651	477	391	-	369	698	-	1	2,003	1,786
J DeMuro <sup>†6</sup>	529	n/a	22	n/a	671	n/a	-	n/a	9	n/a	575	n/a	1,806	n/a
L P Hudson <sup>††7</sup>	56	668	20	143	60	735	261	-	-	56	-	686	397	2,288

<sup>†</sup> Jerry DeMuro was appointed to the Board on 1 February 2014. His remuneration arrangements are set out in note 6 below.

<sup>††</sup> Linda Hudson retired from the Board on 1 February 2014. Further detail is provided below.

- The benefits received by Ian King include the provision of a car allowance and the private use of a chauffeur-driven car (2014 £45k; 2013 £41k). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2014 £18k; 2013 £17k). In addition, he received a second residence allowance of £28k (2013 £47k) as disclosed in previous years. Jerry DeMuro's benefits include private use of a chauffeur-driven car and parking (£2k); medical and dental benefits (£9k); insured life and disability benefits (£6k); and the private use of a company aircraft (£5k). Linda Hudson's benefits include the provision of a cash allowance for a car and parking and the private use of a chauffeur-driven car (2014 £5k; 2013 £48k); medical and dental benefits (2014 £288; 2013 £4k); insured life and disability benefits (2014 £1k; 2013 £8k); and the private use of a company aircraft (2014 £14k; 2013 £83k).



2. Further detail on bonus payments is provided on page 72. One-third of the bonus paid to Ian King, Peter Lynas and Jerry DeMuro will be deferred compulsorily into BAE Systems shares for a three-year period, without additional performance.
3. This column relates to the estimated or actual value of Long-Term Incentive Plans for which the performance period ended in the relevant financial year. The 2012 PSP<sup>EPS</sup> and 2012 SMP awards (for which the performance periods ended on 31 December 2014) did not meet their EPS performance condition and will lapse, as will the PSP<sup>OCF</sup>. The 2012 PSP<sup>TSR</sup> and ExSOP<sup>2012</sup> awards (for which the performance periods ended on 31 December 2014) exceeded the threshold TSR level and vest at 26.7%. Shares deriving from notional dividends during the performance period for the PSP<sup>TSR</sup> will also vest on a pro-rated basis. The 2011 PSP<sup>TSR</sup> (for which the performance period ended on 31 March 2014) did not meet its performance conditions and lapsed (see page 73 for more detail). As reported in the prior year, the 2011 PSP<sup>EPS</sup> and SMP awards (for which the performance periods ended on 31 December 2013) lapsed.
4. The figures in this column have been calculated in line with the method set out in Section 229 of the Finance Act 2004 using a capitalisation factor of 20 to assess the increase in the value of the pension promise over the year, net of inflation. Therefore, these figures are sensitive to salary increases and Consumer Prices Index (CPI) inflation as follows:
  - Salary increase: As pensionable salary is averaged over three years, the figures for Peter Lynas still show the effect of the promotional increase following his appointment as Group Finance Director.
  - CPI inflation: In a year with high CPI inflation, the increase in the value of the pension promise would be lower than in a year with lower CPI inflation.

Linda Hudson ceased to be an executive director on 1 February 2014 and a Group employee on 31 May 2014. There was no change in her accrued benefit between 31 December 2013 and 31 January 2014, based on pay and service to that date and calculated (i) using one-twelfth of the prescribed inflation figure to cover the month of January 2014; and (ii) taking one-fifth of the defined contributions over her period of employment from 1 January to 31 May 2014. She subsequently took her accrued pension entitlements as cash lump sums (see page 76) in accordance with the rules of the US pension arrangements; there are no further benefits due.

5. This column includes (i) for Ian King, the value of Free Share awards under the UK all-employee Share Incentive Plan (SIP) and Matching Shares under voluntary investment in the SIP (for Peter Lynas, the value of his Free Share awards under the SIP was £479); and (ii) for Jerry DeMuro, the value of the 2014 grant under the Restricted Share Plan (RSP). This award formed part of Jerry DeMuro's 2014 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached.
6. As reported last year, Jerry DeMuro was appointed to succeed Linda Hudson as President and Chief Executive Officer of BAE Systems, Inc. on 1 February 2014 and joined the Board as an executive director on the same date. His salary on appointment was \$950,000 per annum (pro-rata for 2014), with a maximum bonus opportunity of 225% of salary, of which one-third will be deferred in shares for a period of three years. He also receives LTIP awards at the levels contained within the executive directors' policy table. His pension arrangements are set out on page 75.
7. Linda Hudson retired from the Board on 1 February 2014. As previously announced, the following arrangements applied on her retirement from the Board:
  - For a period of 120 days from 1 February 2014, Linda Hudson was employed as Senior Vice President and Chief Executive Officer Emeritus for BAE Systems, Inc. on her then existing terms performing transition activities to the new President and Chief Executive Officer of BAE Systems, Inc. and supporting handover with customers and external relationships. At the end of this 120-day period, 31 May 2014 (the 'Termination Date'), Linda Hudson retired from BAE Systems, Inc. and ceased to be employed by BAE Systems, Inc. During this four-month period, her salary totalled \$341,754 and her benefits totalled \$13,392.
  - On ceasing to be employed by BAE Systems, Inc., in accordance with the terms of her employment agreement, Linda Hudson was entitled to receive:
    - one year's base salary of \$1,045,350 paid six months after the Termination Date;
    - a bonus payment for 2014 of \$490,008 (being a bonus payment calculated on a pro-rata basis up to the Termination Date determined on an 'on-target' basis) which was paid within 30 days of the Termination Date. One-fifth of this payment (£59,576) is shown in the 'Bonus' column (for service to 1 February 2014);
    - payment of \$51,896 for all accrued but unused vacation as at the Termination Date; and
    - a lump sum payment equivalent to 18 months' medical premiums paid six months after the Termination Date (payment made of \$22,984).
  - Outstanding awards made under the Company's Long-Term Incentive Plans (as disclosed on page 81) were subsequently time pro-rated and, where appropriate, will vest on the normal vesting dates subject to meeting the requirements of any applicable performance conditions. The value of Long-Term Incentive Plan awards vested or delivered to Linda Hudson in the period from 1 February 2014 to 31 December 2014 was £1,624,853. In addition, the value of Linda Hudson's (time pro-rated) 2012 ExSOP<sup>2012</sup> award (for which the performance period ended on 31 December 2014, as referred to in note 3 above) is shown in the 'LTIP' column on page 70.

After the Termination Date, Linda Hudson will serve as a non-executive director of BAE Systems, Inc. until April 2015. For the period from 1 June 2014 to 31 December 2014, the fee paid to her in this regard was \$73,667.

The above table has been subject to audit.

# ANNUAL REMUNERATION REPORT CONTINUED

## Annual bonus

Bonuses for the 2014 year are paid in March 2015. The breakdown of bonus measures, achievement and pay-out for each executive director is shown below. One-third of the bonus payment is subject to compulsory deferral into BAE Systems shares for a three-year period, for which there is no additional performance condition.

CHIEF EXECUTIVE									
Measures	Weight (as a percentage of target)	Actual performance against targets set				Target for 2014	Actual performance <sup>4</sup>	Percentage of maximum opportunity	
		Below	Threshold	Target	Stretch				
Financial	Group EPS	40.0					38.5p	39.1p	58.6%
	Group cash	25.0					£(1,916)m	£(743)m	100.0%
	Group order intake	15.0					£13.5bn	£14.8bn	63.8%
Personal	Safety	5.0					See note 1 below		60.0%
	Key strategic objectives	15.0					See note 2 below		88.8%
<b>Total bonus (as a percentage of maximum)</b>								<b>74.3%</b>	

GROUP FINANCE DIRECTOR									
Measures	Weight (as a percentage of target)	Actual performance against targets set				Target for 2014	Actual performance <sup>4</sup>	Percentage of maximum opportunity	
		Below	Threshold	Target	Stretch				
Financial	Group EPS	40.0					38.5p	39.1p	58.6%
	Group cash	25.0					£(1,916)m	£(743)m	100.0%
	Group order intake	15.0					£13.5bn	£14.8bn	63.8%
Personal	Safety	5.0					See note 1 below		60.0%
	Key strategic objectives	15.0					See note 2 below		90.0%
<b>Total bonus (as a percentage of maximum)</b>								<b>74.5%</b>	

PRESIDENT AND CHIEF EXECUTIVE OFFICER OF BAE SYSTEMS, INC.									
Measures	Weight (as a percentage of target)	Actual performance against targets set				Target for 2014	Actual performance <sup>4</sup>	Percentage of maximum opportunity	
		Below	Threshold	Target	Stretch				
Financial	Group EPS	13.3					38.5p	39.1p	58.6%
	Group cash	8.3					£(1,916)m	£(743)m	100.0%
	Group order intake	5.0					£13.5bn	£14.8bn	63.8%
	BAE Systems, Inc. profit	26.7					\$1,030m	\$959m	0.0%
	BAE Systems, Inc. cash	16.7					\$(3,903)m	\$(3,430)m	100.0%
	BAE Systems, Inc. order intake	10.0					\$10.5bn	\$10.5bn	50.0%
Personal	Safety	5.0					See note 3 below		37.5%
	Key strategic objectives	15.0					See note 2 below		90.0%
<b>Total bonus (as a percentage of maximum)</b>								<b>56.5%</b>	

1. The Group achieved the 11% target for reduction in the Recordable Accident Rate (see page 20). The other elements of the objective relating to reduction in significant risk rating and driving improvements in behavioural safety were also met.
2. Outcome determined by the Committee based on performance against a combination of base and premier objectives relating to the delivery of the Group's strategic objectives and demonstration of leadership behaviours.
3. The US business did not meet the 11% target for reduction in the Recordable Accident Rate. The other elements of the objective relating to reduction in significant risk rating and driving improvements in behavioural safety were met.
4. Adjusted to be on a like-for-like basis with the targets.

The above table has been subject to audit.

## Long-Term Incentive Plan (LTIP) performance

ANNUAL AVERAGE EPS GROWTH				
Outperformance of performance conditions ending on 31 December 2014	Target	Maximum	Actual	Percentage of maximum achieved
2014 EPS requirement	56.3p	60.4p	37.9p	
Annual average EPS growth	5%	11%	<5%	0%

RELATIVE TSR AGAINST COMPARATOR GROUP				
Outperformance of performance conditions ending on 31 December 2014	Target	Maximum	Actual	Percentage of maximum achieved
TSR against comparator group	95.4%	157.1%	96.9%	26.7%

The following awards had performance periods that ended on 31 December 2014:

### 2012 Performance Share Plan (PSP)

– Performance conditions: half on relative TSR against comparator group, half on EPS growth of 5% to 11% per annum. The TSR performance condition ended on 31 December 2014 and resulted in 26.7% vesting of the TSR portion. The Committee is satisfied that there has been a sustained improvement in the Company's underlying financial performance and that it is appropriate for vesting at 26.7% of the TSR portion. The EPS growth was not achieved and, accordingly, this portion will lapse. For the US executive director, 50% of the performance condition was based on EPS and 50% on long-term operating cash performance at the level of the US businesses. The long-term operating cash target was not met and, therefore, that portion also lapsed.

### 2012 Executive Share Option Plan (ExSOP<sup>2012</sup>)

– Performance condition: relative TSR against comparator group. The TSR performance condition ended on 31 December 2014 and resulted in 26.7% vesting.

### 2012 Share Matching Plan (SMP)

– 2:1 match on shares deferred from 2011 annual incentive based on a performance condition of EPS growth of 5% to 11% per annum. The EPS growth was not achieved and, accordingly, this portion will lapse.

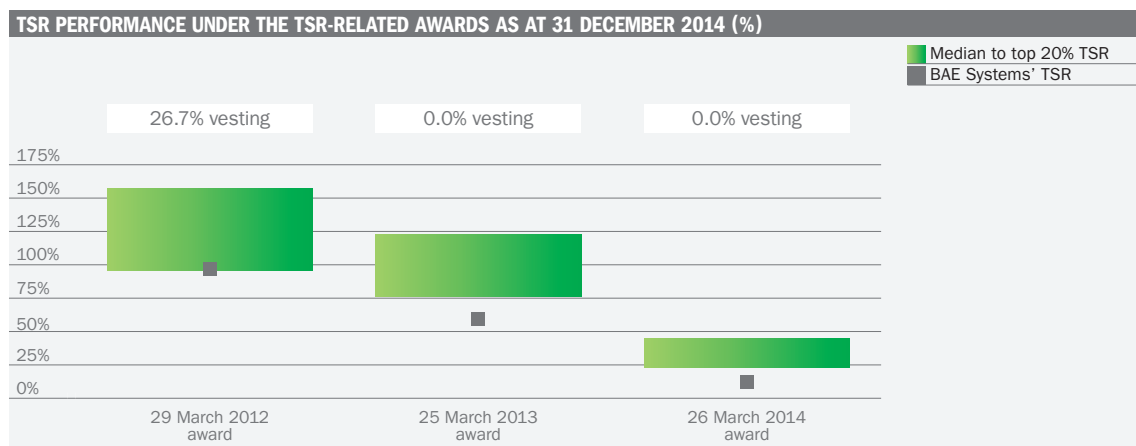
The following award had a performance period that ended on 31 March 2014:

### 2011 Performance Share Plan (PSP)

– Performance conditions: half on relative TSR against comparator group, half on EPS growth of 5% to 11% per annum. The Company's TSR for the 50% of awards of shares granted in May 2011 under the TSR portion of the PSP was below the median position when compared against the comparator group of other defence and aerospace companies, and the award accordingly lapsed. The EPS performance period for the EPS portion of the award ended on 31 December 2013 and was reported on last year.

A summary of TSR performance to 31 December 2014 on outstanding TSR-related LTIP awards is illustrated in the chart below.

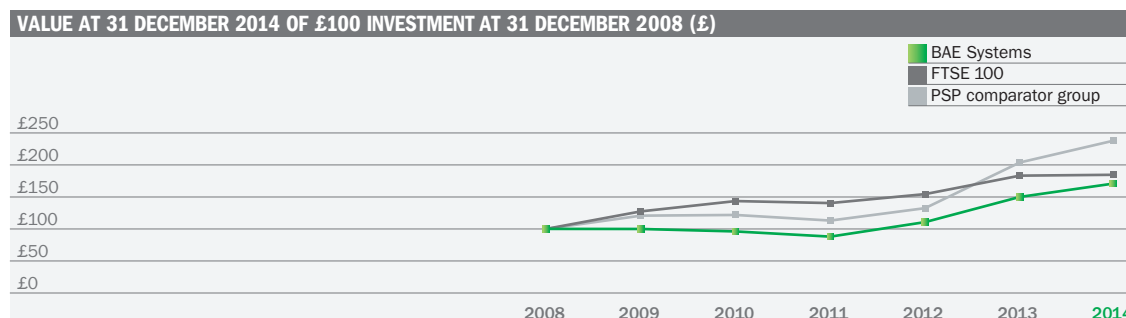
The coloured boxes show the range of TSR required for 25% vesting to full vesting and the grey boxes show BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.



# ANNUAL REMUNERATION REPORT CONTINUED

## TSR performance and Chief Executive pay

The graph below shows the value by 31 December 2014, on a Total Shareholder Return basis, of £100 invested in BAE Systems on 31 December 2008 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 of which BAE Systems is a constituent member. The equivalent data is shown for the PSP comparator group.



**CHANGE IN CHIEF EXECUTIVE'S REMUNERATION OVER SIX YEARS**

	2008	2009	2010	2011	2012	2013	2014
Chief Executive's single figure (£'000)	4,030	4,810	4,613	4,613	2,574	2,499	<b>3,519</b>
Bonus paid as a percentage of maximum	83.0%	71.0%	68.6%	68.6%	55.6%	53.4%	<b>74.3%</b>
LTI as a percentage of maximum vesting	65.5%	57.6%	44.3%	44.3%	nil	nil	<b>16.8%</b>

Note: Total remuneration includes the value of share plans vesting that were granted prior to appointment as Chief Executive.

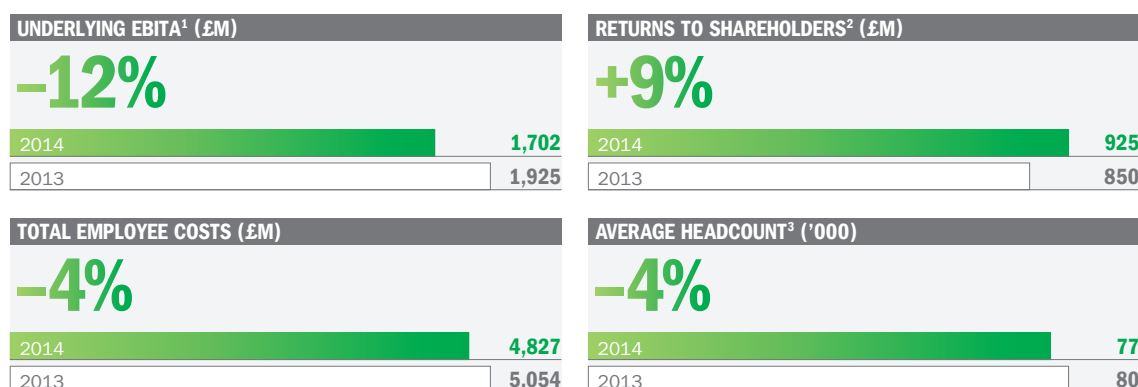
The percentage change from 2013 to 2014 in remuneration of the Chief Executive and average UK employee was as follows:

	Change in Chief Executive's remuneration %	Change in average UK employee <sup>1</sup> remuneration %
Salary	0	+1
Benefits	+9	+1
Bonus	+39	+33

1. The UK population has been chosen as this employee comparator group reflects the local employment conditions of the Chief Executive for the purpose of this comparison.

## Relative importance of spend on pay

The following charts set out underlying EBITA<sup>1</sup>, amounts paid in returns to shareholders, total employee costs and average headcount for the years ended 31 December 2013 and 2014.



1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 23).

2. Includes share buyback of £283m (2013 £212m).

3. Excluding share of equity accounted investments.

## Pension entitlements

TOTAL PENSION ENTITLEMENTS							Figures in the remuneration table on page 70		
Director	Age	Normal retirement age	Accrued benefit at 1 January 2014 <sup>1,2</sup> £ per annum	Accrued benefit at 31 December 2014 <sup>1,2,3</sup> £ per annum	Added pension value received in the year from defined benefit scheme <sup>2</sup> £	Added pension value received in the year from defined contribution scheme £	Total	£	
Ian King	58	62	759,728	794,973	209,908	–	209,908		
Peter Lynas	56	62	378,285	409,350	368,987	–	368,987		
Jerry DeMuro	59	65	–	8,601	–	8,601	8,601		

1. Accrued benefits are reduced if they are taken before the normal retirement date of the scheme. In addition, a longevity adjustment factor applies to UK pension accrued after 5 April 2006.

2. The defined benefit figure includes both funded and unfunded arrangements for Ian King and Peter Lynas.

3. Accrued benefit for Ian King and Peter Lynas is annual pension payable on retirement. Accrued benefit for Jerry DeMuro is the sum of the defined contribution scheme contributions.

Note: The figures in this table relate to directors with a prospective benefit. Linda Hudson left employment with the BAE Systems Group during 2014 and encashed her benefit entitlements as detailed below; no 2014 figures have therefore been included for her in the table above.

The above table has been subject to audit.

Current UK executive directors are members of the BAE Systems Executive Pension Scheme (ExPS) and the BAE Systems 2000 Pension Plan (2000 Plan) which together provide a pension for executive directors payable at 62 of 1/30th of three-year final average salary for each year of service subject to the payment of members' contributions (currently 8%). Benefits paid prior to age 62 will be subject to actuarial reduction.

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.

The review of pension policies carried out in 2010 by the Committee concluded that the pension benefits 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. The current executive directors were given the choice to remain in the current arrangement and pay the increased tax or to take an unfunded promise: they both elected for the latter. 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. Where an unfunded pension is taken, ten years after retirement, the executive will be given a further opportunity to commute the residual value of the unfunded pension for a lump sum.

As stated above, Ian King and Peter Lynas already have an unfunded promise from the Company arising from the 2006 changes to the taxation of pension benefits, 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 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. Therefore, their individual total pensions are the sum of their 2000 Plan benefits plus the top up from the ExPS, most of which is provided through the unfunded promise referred to above.

Jerry DeMuro participates in a Section 401(k) defined contribution arrangement set up for US employees in which the company will match his contributions up to a maximum contribution of 6% of salary, up to regulatory limits (for 2015 \$265,000). In 2014, the company paid contributions of \$13,408 into this 401(k) arrangement.

# ANNUAL REMUNERATION REPORT CONTINUED

Linda Hudson stepped down from the Board on 1 February 2014 and ceased to be a Group employee on 31 May 2014. Her leaving arrangements were disclosed in the 2013 Annual Remuneration Report (and on page 71). Linda Hudson was a member of a US retirement plan which provides a cash sum at retirement equal to a percentage of career average pay. After her departure from the company, she received full payment of her qualified and non-qualified pension benefits in the amounts of \$141,420 and \$1,404,625, respectively.

In addition, Linda Hudson participated 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 2014, the company paid contributions of \$15,600 into this 401(k) arrangement.

## External directorships

Fees retained in 2014 by executive directors during the period in which they served in that capacity in respect of non-executive directorships were: Ian King £23,481 in respect of his (then) non-executive directorship of Rotork p.l.c.; Peter Lynas £36,875 in respect of his directorship of SSE plc; Jerry DeMuro \$45,833 in respect of his directorship of Aero Communications, Inc.; and Linda Hudson \$20,000 in respect of her non-executive directorship of Bank of America. These amounts are not included in the remuneration table on page 70.

## Share interests

### SCHEME INTERESTS AWARDED DURING THE FINANCIAL YEAR

Scheme	Type of interest	Date of grant	Number of shares	Basis of award	Face value of award <sup>1</sup> £	Exercise price £	Date to which performance is measured	Performance condition	Percentage of interests receivable if minimum performance achieved
<b>Ian King</b>									
PSP <sup>TSR</sup>	Performance Shares/nil cost option	26.03.14	292,542	125% of salary	1,203,810	nil	Three years to 31.12.16	TSR/secondary financial measure	25%
PSP <sup>EPS</sup>	Performance Shares/nil cost option	26.03.14	292,543	125% of salary	1,203,814	nil	Three years to 31.12.16	EPS	0% <sup>2</sup>
ExSOP <sup>2012</sup>	Share option	26.03.14	702,102	300% of salary	2,889,150	4.12	Three years to 31.12.16	TSR	25%
<b>Peter Lynas</b>									
PSP <sup>TSR</sup>	Performance Shares/nil cost option	26.03.14	142,636	107.5% of salary	586,947	nil	Three years to 31.12.16	TSR/secondary financial measure	25%
PSP <sup>EPS</sup>	Performance Shares/nil cost option	26.03.14	142,637	107.5% of salary	586,951	nil	Three years to 31.12.16	EPS	0% <sup>2</sup>
ExSOP <sup>2012</sup>	Share option	26.03.14	398,055	300% of salary	1,637,996	4.12	Three years to 31.12.16	TSR	25%
<b>Jerry DeMuro</b>									
PSP <sup>TSR</sup>	Performance Shares	26.03.14	169,258	121% of salary	696,497	n/a	Three years to 31.12.16	TSR/secondary financial measure	25%
PSP <sup>EPS</sup>	Performance Shares	26.03.14	169,258	121% of salary	696,497	n/a	Three years to 31.12.16	EPS	0% <sup>2</sup>
ExSOP <sup>2012</sup>	Share option	26.03.14	545,543	390% of salary	2,244,909	4.12	Three years to 31.12.16	TSR	25%
RSP	Retention	26.03.14	139,882	100% of salary	575,614	n/a	n/a	n/a	n/a

The table above has been subject to audit.

1. The value of the award is calculated on the date of grant by reference to the middle market quotation at the close of the preceding day.
2. A sliding scale operates – further detail is provided in the summary of performance conditions overleaf.

Note: PSP and RSP – Shares under award attract dividends prior to vesting. The nil cost options under the PSP are intended to be free share awards and are structured as an option to give the participant more flexibility as to the timing of the benefit. For the US executive director, grants under the PSP are classified as contingent awards (rather than share options) and are deliverable on the third, fourth and fifth anniversary of grant, subject to attainment of the performance condition.

**Description of share plans and summary of performance conditions**

**PSP**

Shares under award vest after satisfaction of the three-year performance condition. Shares under award attract dividends prior to vesting. Awards that vest are exercisable in three tranches between the third and seventh anniversary of vesting (being capable of exercise on a phased basis from the third, fourth and fifth anniversary of grant). For US participants, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved. In 2015, shares will be awarded under the Long-Term Incentive Plan (a single umbrella plan) that was approved at the 2014 AGM as detailed on pages 83 and 85.

Awards made to the UK executive directors since 2008 have been weighted 50% on the PSP<sup>EPS</sup> performance condition and 50% on the PSP<sup>TSR</sup> performance condition. Awards made to the US executive director were weighted in the same way until 2011 and in 2014. In 2012 and 2013, the weighting for the US executive director was 50% on the PSP<sup>EPS</sup> performance condition and 50% on the PSP<sup>OCF</sup> performance condition. The TSR comparator groups are shown below.

Plan	Performance condition
PSP <sup>EPS</sup>	<p>For awards made in 2015, rate of average annual EPS growth over the three-year performance period, with 25% vesting at 3% average growth per annum, 50% vesting at 5% average growth per annum and 100% vesting at 7% average growth per annum, with vesting on a straight-line basis between these parameters. Awards will not vest unless the Board is satisfied that there has been a sustained improvement in the underlying financial performance of the Company (taking account of items such as cash, order book, risk and project performance).</p> <p>Pre-2015, rate of average annual EPS growth over the three-year performance period, with nil vesting at 5% average growth per annum and 100% vesting at 11% average growth per annum, with vesting on a straight-line basis between these two parameters.</p>
PSP <sup>TSR</sup>	<p>The proportion of the award capable of exercise is determined by:</p> <p>(i) the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. No 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, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters; and</p> <p>(ii) whether there has been a sustained improvement in the Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA<sup>1</sup>; order book; turnover; risk; and underlying project performance.</p>
PSP <sup>OCF</sup>	<p>Long-term operating cash performance at the level of the US businesses over a three-year performance period. The Committee is of the view that cash performance figures are commercially sensitive and that it would be detrimental to the interests of the Company to disclose them in advance.</p>

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

**The TSR comparator group referred to above comprises:**

Cobham	L-3 Communications	Raytheon
Finmeccanica	Lockheed Martin	SAIC
General Dynamics	Meggitt	Thales
ITT Exelis	Northrop Grumman	United Technologies

**The comparator group for PSP<sup>TSR</sup> awards from 2008 to 2011 comprises:**

Boeing	General Dynamics	Raytheon
Cobham	GKN	Rockwell Collins
Dassault Aviation	Goodrich <sup>2</sup>	Rolls-Royce
EADS	Honeywell International	Smiths Group
Embraer PN	Lockheed Martin	Thales
Finmeccanica	Northrop Grumman	United Technologies

2. Goodrich is now part of United Technologies.

# ANNUAL REMUNERATION REPORT CONTINUED

## ExSOP<sup>2012</sup>

Options are normally exercisable between the third and tenth anniversary of their grant, subject to the performance condition set out below being achieved. In 2015, shares will be awarded under the single umbrella plan (the Long-Term Incentive Plan) that was approved at the 2014 AGM as detailed on pages 83 and 85. Awards made from 2015 will be subject to a further two-year clawback period after the three-year vesting period.

Plan	Performance condition
ExSOP <sup>2012</sup>	The proportion of the award capable of exercise is determined by the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. No 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, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters.

## RSP

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US. 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). Shares under award attract dividends prior to vesting. In 2015, shares will be awarded under the single umbrella plan that was approved at the 2014 AGM as detailed on pages 83 and 85. Awards made from 2015 will be subject to a further two-year clawback period after the initial three-year vesting period.

## SMP

The SMP was a standalone investment plan linked to the award under the Annual Incentive Plan. It operated for the final time in 2013 in relation to the annual incentive relating to 2012 performance. Executive directors were required to invest at least one-third (and maximum 50%) of their annual incentive into the SMP and were granted a conditional award of matching shares against the gross value of the annual incentive invested. The matching shares attract dividends during the three-year deferral period, released on vesting of any matching shares.

Plan	Performance condition
SMP	In respect of a three-year performance period, nil match for average EPS growth of 5% per annum increasing uniformly to a maximum 2:1 match at 11% growth per annum.

## Statement of directors' shareholdings and share interests

### Minimum Shareholding Requirement (MSR)

Executive directors are compulsorily required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes and Long-Term Incentive schemes by retaining 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired under these schemes. Once the Initial Value is achieved, a Subsequent Value must be achieved in the same way, except that a minimum of 25% of the net value must be retained on each exercise or acquisition. Shares owned beneficially by the director and his/her spouse count towards the MSR. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

The following table sets out MSR Initial Value and Subsequent Value:

Director	Initial Value	Subsequent Value
Ian King	150%	300%
Peter Lynas	100%	200%
Jerry DeMuro	175%	350%
Linda Hudson	175%	350%

Ian King and Peter Lynas were both in excess of their 'Subsequent Value' MSR at 31 December 2014. Following the announcement in 2013 of Linda Hudson's retirement in 2014, the Committee agreed to reduce her MSR to 175% and she subsequently retained a holding to that level until she ceased to be a director. Jerry DeMuro joined the Board in 2014 and does not yet hold shares in the Company.

There are no shareholding requirements for the Chairman or the non-executive directors.



**Share interests as at 31 December 2014 (or on ceasing to be a director of the Company)**

The interests of the directors who served during the year ended 31 December 2014 in the shares of BAE Systems plc, or scheme interests in relation to those shares, were as follows:

	Shares	Scheme interests: Options and awards over shares				Total scheme interests
		Share awards with performance	Share awards without performance	Share options with performance	Share options with performance, vested but unexercised	
P M Anderson <sup>1</sup>	10,000	–	–	–	–	–
Sir Roger Carr	50,246	–	–	–	–	–
J DeMuro <sup>2</sup>	–	338,516	139,882	545,543	–	1,023,941
H Green	–	–	–	–	–	–
C M Grigg	24,555	–	–	–	–	–
L P Hudson <sup>3</sup>	264,846	1,490,991	515,227	1,542,390	133,740	3,682,348
I G King	1,731,836	685,460	–	3,699,419	319,403	4,704,282
P J Lynas	332,627	183,624	–	2,050,939	171,820	2,406,383
Sir Richard Olver <sup>3</sup>	53,343	–	–	–	–	–
P Rosput Reynolds	21,200	–	–	–	–	–
N C Rose	55,000	–	–	–	–	–
C G Symon	20,000	–	–	–	–	–
I P Tyler	–	–	–	–	–	–

1. Retired from the Board on 31 December 2014.

2. Appointed to the Board on 1 February 2014.

3. Retired from the Board on 1 February 2014.

The above table has been subject to audit.

The interests of directors include those of their connected persons. The shares held by Paula Rosput Reynolds are represented by 5,300 American Depositary Shares. Details of the share interests in options and awards held by the executive directors as at 31 December 2014 are given on pages 80 and 81, together with details of share options exercised in 2014.

Awards under the PSP are classified as share awards with performance for the US executive director and as share options with performance for the UK executive directors.

Since 31 December 2014, Ian King has acquired an additional 80 shares 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 1,731,916.

# ANNUAL REMUNERATION REPORT CONTINUED

## Breakdown of scheme interests: Options and awards held as at 31 December 2014

IAN KING				
	31 December 2014	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP <sup>TSR</sup>	199,968 <sup>1</sup>	29.03.12	nil	29.03.15
PSP <sup>EPS</sup>	199,969 <sup>1</sup>	29.03.12	nil	29.03.15
PSP <sup>TSR</sup>	154,771 <sup>2</sup>	25.03.13	nil	25.03.16
PSP <sup>EPS</sup>	154,771 <sup>2</sup>	25.03.13	nil	25.03.16
PSP <sup>TSR</sup>	292,542 <sup>2</sup>	26.03.14	nil	26.03.17
PSP <sup>EPS</sup>	292,543 <sup>2</sup>	26.03.14	nil	26.03.17
	<b>1,294,564</b>			
ExSOP	145,443 <sup>3</sup>	12.04.06	4.28	12.04.09
ExSOP	173,960 <sup>3</sup>	30.03.07	4.57	30.03.10
ExSOP <sup>2012</sup>	959,850 <sup>1</sup>	29.03.12	3.01	29.03.15
ExSOP <sup>2012</sup>	742,903 <sup>2</sup>	25.03.13	3.89	25.03.16
ExSOP <sup>2012</sup>	702,102 <sup>2</sup>	26.03.14	4.12	26.03.17
	<b>2,724,258</b>			
SMP	479,048 <sup>1</sup>	29.03.12	n/a	29.03.15
SMP	206,412 <sup>2</sup>	25.03.13	n/a	25.03.16
	<b>685,460</b>			

PETER LYNAS				
	31 December 2014	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP <sup>EPS</sup>	9,025 <sup>3</sup>	24.03.09	nil	24.03.14
PSP <sup>TSR</sup>	113,372 <sup>1</sup>	29.03.12	nil	29.03.15
PSP <sup>EPS</sup>	113,372 <sup>1</sup>	29.03.12	nil	29.03.15
PSP <sup>TSR</sup>	87,747 <sup>2</sup>	25.03.13	nil	25.03.16
PSP <sup>EPS</sup>	87,747 <sup>2</sup>	25.03.13	nil	25.03.16
PSP <sup>TSR</sup>	142,636 <sup>2</sup>	26.03.14	nil	26.03.17
PSP <sup>EPS</sup>	142,637 <sup>2</sup>	26.03.14	nil	26.03.17
	<b>696,536</b>			
ExSOP	13,386 <sup>3</sup>	22.12.05	3.56	22.12.08
ExSOP	75,887 <sup>3</sup>	12.04.06	4.28	12.04.09
ExSOP	73,522 <sup>3</sup>	30.03.07	4.57	30.03.10
ExSOP <sup>2012</sup>	544,186 <sup>1</sup>	29.03.12	3.01	29.03.15
ExSOP <sup>2012</sup>	421,187 <sup>2</sup>	25.03.13	3.89	25.03.16
ExSOP <sup>2012</sup>	398,055 <sup>2</sup>	26.03.14	4.12	26.03.17
	<b>1,526,223</b>			
SMP	101,156 <sup>1</sup>	29.03.12	n/a	29.03.15
SMP	82,468 <sup>2</sup>	25.03.13	n/a	25.03.16
	<b>183,624</b>			

JERRY DEMURO				
	31 December 2014	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP <sup>TSR</sup>	169,258 <sup>2</sup>	26.03.14	nil	26.03.17
PSP <sup>EPS</sup>	169,258 <sup>2</sup>	26.03.14	nil	26.03.17
	<b>338,516</b>			
ExSOP <sup>2012</sup>	545,543 <sup>2</sup>	26.03.14	4.12	26.03.17
RSP	139,882	26.03.14	n/a	26.03.17

1. The outstanding award will lapse, or partially lapse, after the end of the financial year having not met the full performance condition.
2. Performance condition yet to be tested.
3. Share options vested but unexercised.

**Breakdown of scheme interests: Options and awards held as at 1 February 2014 (date of ceasing to be a director)**

<b>LINDA HUDSON</b>					
	1 February 2014	Date of grant	Exercise price £	Normal date from which exercisable or part exercisable	
PSP <sup>EPS</sup>	14,821 <sup>1</sup>	24.03.09	nil	24.03.14	
PSP <sup>TSR</sup>	147,376 <sup>2</sup>	18.05.11	nil	18.05.14	
PSP <sup>EPS</sup>	147,376 <sup>2</sup>	18.05.11	nil	18.05.14	
PSP <sup>OCF</sup>	158,818 <sup>3,4</sup>	29.03.12	nil	29.03.15	
PSP <sup>EPS</sup>	158,819 <sup>3,4</sup>	29.03.12	nil	29.03.15	
PSP <sup>OCF</sup>	127,907 <sup>3,5</sup>	25.03.13	nil	25.03.16	
PSP <sup>EPS</sup>	127,908 <sup>3,5</sup>	25.03.13	nil	25.03.16	
	<b>883,025</b>				
ExSOP	133,740 <sup>1</sup>	30.03.07	4.57	30.03.10	
ExSOP <sup>2012</sup>	854,334 <sup>3,6</sup>	29.03.12	3.01	29.03.15	
ExSOP <sup>2012</sup>	688,056 <sup>3,5</sup>	25.03.13	3.89	25.03.16	
	<b>1,676,130</b>				
SMP	219,610 <sup>2</sup>	18.05.11	n/a	18.05.14	
SMP	208,032 <sup>3,4</sup>	29.03.12	n/a	29.03.15	
SMP	180,324 <sup>3,5</sup>	25.03.13	n/a	25.03.16	
	<b>607,966</b>				
RSP	119,743 <sup>7</sup>	18.05.11	n/a	18.05.14	
RSP	219,060 <sup>3,7</sup>	29.03.12	n/a	29.03.15	
RSP	176,424 <sup>3,7</sup>	25.03.13	n/a	25.03.16	
	<b>515,227</b>				

Note: Linda Hudson retired as a director on 1 February 2014 and ceased to be a Group employee on 31 May 2014.

1. Performance condition already met.
2. Award lapsed in 2014 having not met the performance condition.
3. Award subsequently time pro-rated after ceasing to be a Group employee.
4. Residual time pro-rated award will lapse after end of the financial year having not met the performance condition.
5. Residual time pro-rated award is subject to a performance condition that is yet to be tested.
6. Residual time pro-rated award will partially lapse after the end of the financial year having not met the full performance condition.
7. Award, or residual time pro-rated award, vested.

**Options exercised during 2014**

<b>IAN KING</b>					
	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP <sup>EPS</sup>	32,610	nil	08.09.08	27.03.14	4.10
PSP <sup>EPS</sup>	46,412	nil	24.03.09	27.03.14	4.10
ExSOP	221,903	2.64	24.03.05	13.08.14	4.31

The two PSP options exercised by Ian King attracted reinvested dividends which equated to an additional 10,918 shares.

The tables on pages 80 and 81 have been subject to audit.

**Performance conditions**

Performance conditions for the PSP, ExSOP<sup>2012</sup> and SMP are detailed on pages 77 and 78. The ExSOP (Executive Share Option Plan) was established in 2001 and its ten-year life expired in 2011. Options granted under this plan are usually exercisable between the third and tenth anniversary of grant. The existing options granted between 2005 and 2007 have met their performance condition (EPS growth of 5% or more per annum over the three-year performance period).

**Statement of voting**

Shareholder voting on the resolutions to approve the Directors' Remuneration Policy and the Annual Remuneration Report put to the 2014 AGM was as follows:

<b>DIRECTORS' REMUNERATION POLICY</b>					
Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,141,307,622	92.95	162,437,084	7.05	2,303,744,706	19,304,785

<b>ANNUAL REMUNERATION REPORT</b>					
Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,159,108,550	93.23	156,853,937	6.77	2,315,962,487	7,087,004

# ANNUAL REMUNERATION REPORT CONTINUED

## Remuneration Committee composition and advisers

The Committee members comprise Carl Symon (Chairman), Chris Grigg and Nick Rose. Advisers to the Remuneration Committee are shown below.

Adviser	Services provided	Appointment	Governance	Fees
Kepler Associates	Advises Committee members on remuneration matters, including independent advice on the information and proposals presented to the Committee by Company executives.	Committee appointment.	Kepler engage directly with the members of the Committee.  Kepler do not undertake any other work for the Company.  Kepler are members of the Remuneration Consultants Group (RCG) and are signatories to the RCG's code of conduct.	£30,000  Fee basis: Hourly
Linklaters	Legal services, principally regarding remuneration policy regulations and the drafting of share plan rules in accordance with the policy determined by the Committee.	By the Company with the approval of the Committee.	Only provide legal compliance, legal drafting and review services, and do not advise the Committee.  The Committee is aware that Linklaters are one of a number of legal firms that provide legal advice and services to the Company on a range of matters.  Linklaters are regulated by the Law Society.	£66,674 (in respect of services provided to the Committee)  Fee basis: Hourly
PricewaterhouseCoopers	Information on market trends and the competitive positioning of packages.	By the Company at the request of the Committee.	The Committee is aware that PricewaterhouseCoopers provide a variety of other services to the Company, including tax and pensions advice. They also provide a range of consultancy services.  The nature of the advice provided to the Committee is primarily related to market comparator information and does not include advice on the design of remuneration policy.  PricewaterhouseCoopers are members of the Remuneration Consultants Group (RCG) and are signatories to the RCG's code of conduct.	£68,250 (in respect of services provided to the Committee)  Fee basis: Hourly
Hewitt New Bridge Street	Advice on the TSR outcomes as required for assessing the performance condition under the Performance Share Plan.	By the Company.	The Committee is aware that Hewitt New Bridge Street provide a variety of other HR-related services to the Company.  The nature of the advice provided to the Committee is limited to factual information concerning the performance of the Company's shares.  Hewitt New Bridge Street are members of the Remuneration Consultants Group (RCG) and are signatories to the RCG's code of conduct.	£9,750 (in respect of services provided to the Committee)  Fee basis: Fixed fee

During the year, the Committee received material assistance and advice on remuneration policy from the Group Human Resources Director, Lynn Minella, and the Human Resources Director, Reward, Paul Farley. Ian King, Chief Executive, also provided advice that was of material assistance to the Committee.

## Non-Executive Directors' Fees Committee

The non-executive directors' fees are set by the Non-Executive Directors' Fees Committee which, since 1 February 2014, has comprised Sir Roger Carr, Philip Bramwell, Jerry DeMuro and Ian King. From 1 January to 31 January 2014, this Committee comprised Sir Richard Olver, Philip Bramwell, Linda Hudson and Ian King.

# PREFACE TO THE DIRECTORS' REMUNERATION POLICY

The Directors' Remuneration Policy ('the Policy') set out on pages 84 to 92 was agreed by shareholders at the Annual General Meeting (AGM) on 7 May 2014. For the purposes of the Companies Act 2006, the Policy took legal effect on 1 January 2015. As stated in last year's Annual Report, this Policy has been operating in practice from the 2014 AGM. The approved policy has been re-printed verbatim from the 2013 Annual Report, updated only so that the page numbers refer to the 2014 Annual Report in order to aid readability.

## Directors' remuneration for 2015

For 2015, it remains our intention to operate the Policy that was agreed by shareholders at the 2014 AGM. This section sets out how the Policy will apply in 2015.

Following approval of the single Long-Term Incentive Plan (LTIP) at the 2014 AGM, the first awards will be made under this plan in Spring 2015. As set out in our Remuneration Committee Chairman's letter on page 67, the Committee intends to make the following changes to our executive remuneration arrangements for 2015 which do not constitute a change to the Policy approved by shareholders in 2014:

### Earnings per Share (EPS) performance condition applicable to Long-Term Incentive (LTI) grants

It is proposed to set a performance range of 3% to 7% average annual EPS growth for the 2015 awards of Performance Shares under the LTIP. Achievement of threshold performance will result in 25% vesting; there will be 50% vesting for 5% average annual EPS growth and 100% vesting for 7% average annual EPS growth, with pro-rata vesting for intermediate performance. The revised EPS performance condition will be subject to the same 'quality of earnings' performance hurdle as applies to the Total Shareholder Return (TSR) condition, such that awards will not vest unless the Board is satisfied that there has been a sustained improvement in the underlying financial performance of the Company (taking account of items such as cash, order book, risk and project performance).

### Malus and clawback provisions

In accordance with the changes to the UK Corporate Governance Code in 2014, the Committee has strengthened the malus and clawback provisions applicable to incentive awards made to the executive directors and to all members of the Executive Committee from and including 2015 as follows:

- a two-year clawback period will be added to the end of the three-year vesting period applicable to Share Options and Restricted Shares awarded under the LTIP; and
- the definition of circumstances and trigger events has been extended.

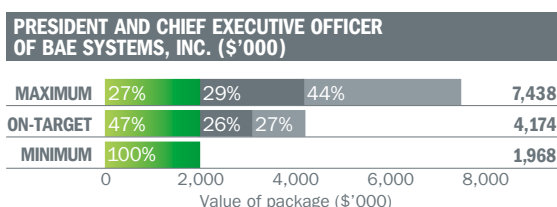
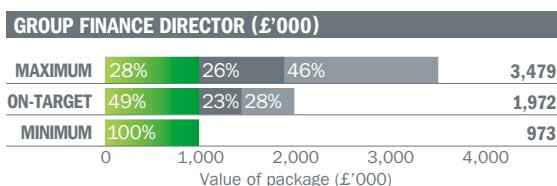
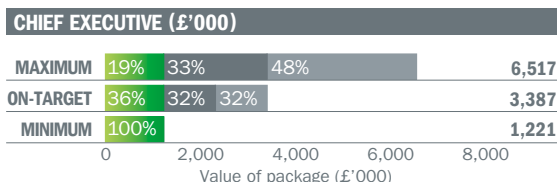
## Metrics and weightings applicable in 2015

- The performance metrics and weightings applicable to the 2015 annual incentive are unchanged from those set out last year (see page 85).
- Performance Shares will continue to have 50% of the award based on TSR growth as set out on page 86. For 2015, the remaining 50% of the award is subject to the EPS performance condition set out above. For US participants, other than members of the Executive Committee, 50% of the awards made in 2014 and 2015 are subject to the long-term operating cash performance of the US business in place of TSR growth.
- There is no change in 2015 to the performance metrics and weightings applying to Share Options or Restricted Shares.

## Illustration of application of policy

The following charts show the value of the package each of the executive directors would receive based on 2015 base salaries, remuneration and 2015 LTI awards assuming the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 70); pay receivable assuming on-target performance is met; and maximum pay assuming variable elements pay out in full. The scenarios below exclude any share price appreciation and dividends.

UK legislation requires that these charts are given in relation to the first year in which the remuneration policy takes legal effect. As detailed in last year's Annual Report, the charts below are reporting the actual levels for 2015.



■ Fixed elements of remuneration  
■ Annual bonus  
■ Performance Shares and Share Options

 TO VIEW THE POLICY ONLINE VISIT [BAESYSTEMS.COM/INVESTORS](http://BAESYSTEMS.COM/INVESTORS)

# DIRECTORS' REMUNERATION POLICY

It is intended in practice to operate the Directors' Remuneration Policy ('the Policy') from the 2014 AGM. For the purposes of the Companies Act 2006, the Policy will only take legal effect on 1 January 2015 subject to shareholder approval at the 2014 AGM.

The Committee considers remuneration policy annually to ensure that it remains aligned with business needs and is appropriately positioned relative to the market. However, in the absence of exceptional or unexpected circumstances which may necessitate a change to the Policy, there is currently no intention to revise the Policy more frequently than every three years. We use target performance to estimate the total potential reward and benchmark it against reward packages paid by BAE Systems' competitors.

Our Policy is to set base salary with reference to the relevant market-competitive level. Actual total direct reward reflects the performance of the individual and the Company as a whole. The aim is to deliver an overall remuneration package for executive directors which provides an appropriate balance between short-term and long-term reward and between fixed and variable reward as described in the table below.

Whilst our long-term incentive plans provide the Committee with discretion in respect of vesting outcomes that affect the actual level of reward payable to individuals, such discretion would only be used in exceptional circumstances and, if exercised, disclosed at the latest in the report on implementation of the remuneration policy (i.e. the Annual Remuneration Report) for the year in question.

EXECUTIVE DIRECTORS' POLICY TABLE
<b>BASE SALARY</b>
<p><b>Purpose and link to strategy</b> Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.</p>
<p><b>Operation</b> Salaries are reviewed annually. Business and individual performance, skills, the scope of the role and the individual's time in the role are taken into account when assessing salaries, as is market data for similar roles in the relevant market comparator group.</p> <p>The comparator group for UK executive directors is comprised of selected companies from the top 70 of the FTSE 100 and is constructed to position BAE Systems around the median in terms of market capitalisation. For the President and Chief Executive Officer of BAE Systems, Inc., the comparator group is drawn from companies in the US aerospace and defence sectors, together with similar organisations in the general industry sector where BAE Systems, Inc. is positioned at the median of the comparator group by reference to revenue size.</p>
<p><b>Maximum opportunity</b> When considering salary increases for the executive directors in their current roles, the Committee considers the general level of salary increase across the Group and in the relevant external market.</p> <p>Actual increases for the executive directors in their current roles will generally not exceed the average percentage increase for employees as a whole, taking account of the level of movement within the relevant UK/US comparator group.</p> <p>As a maximum, in exceptional circumstances (such as a material increase in job size or complexity, or a recently appointed executive director where the salary is positioned low against the market), the increase will not exceed 10% in any single year.</p>
<p><b>Performance metrics used, weighting and time period applicable</b> None.</p>
<b>ANNUAL INCENTIVE</b>
<p><b>Purpose and link to strategy</b> Drive and reward annual performance of individuals and teams on both financial and non-financial metrics, including leadership behaviours in order to deliver sustainable growth in shareholder value.</p> <p>Compulsory deferral into shares increases alignment with shareholder interests.</p>
<p><b>Operation</b> 75–80% of the annual incentive is driven off in-year financial performance, and 20–25% is based on driving performance and improvement in the area of corporate responsibility and other non-financial objectives supporting the Group's strategy.</p> <p>One-third of the total annual incentive amount is subject to compulsory deferral for three years in BAE Systems shares without any matching.</p> <p>A clawback mechanism exists under which part or all of the deferred bonus can be recovered if performance for which the bonus was awarded is subsequently restated or shown to be materially inaccurate or misleading or where the executive's employment can be terminated for cause.</p> <p>Cash dividends are payable to the participants on the shares during this three-year deferral period.</p>
<p><b>Maximum opportunity</b> Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary Group Finance Director: 160% of salary</p> <p>The pay-out for maximum performance is 200% of on-target. The pay-out for achieving a threshold performance is 40% of the target, with no pay-out for achieving less than this. Pay-out for performance between targets is calculated on a straight-line basis.</p>

**EXECUTIVE DIRECTORS' POLICY TABLE** continued**ANNUAL INCENTIVE** continued**Performance metrics used, weighting and time period applicable**

Metrics and weightings applicable in 2014:

Group earnings per share (EPS) – 40%

Group cash – 25%

Order intake – 15%

Safety – 5%

Personal objectives – 15%

Performance is assessed on an annual basis, using a combination of the Group's main performance indicators for the year. The measures include financial and non-financial metrics as well as the achievement of personal objectives. Measures will be weighted each year according to business priorities.

See notes 4 and 5 on page 88 regarding the selection and weighting of performance metrics.

Notwithstanding performance against the above metrics, all bonus payments are at the discretion of the Remuneration Committee, which will be based on an assessment of the individual's personal contribution to business performance over the relevant year and leadership behaviours demonstrated in making that contribution, relative to others.

**LONG-TERM INCENTIVES (LTI)****Operation**

All awards are granted based on a percentage of salary and share price at the date of grant.

Dividend equivalents in respect of vested shares are paid at the time of vesting and are not taken into account when determining individual limits.

Pre-vesting clawback provisions apply to all awards and 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.

The Committee will establish the targets for each measure at the start of each performance period based on Group projections and market expectations for the business. The performance conditions for previous awards are described in the Annual Remuneration Report.

Awards and performance conditions can be adjusted to take account of variations of share capital and other transactions or events.

On a change of control or similar transaction, awards generally will vest to the extent performance conditions are then satisfied (if applicable) and then be pro-rated to reflect the acceleration of vesting unless the Committee decides otherwise. Alternatively, awards may be exchanged for equivalent awards over shares in the acquiring company.

The share plan rules may be amended from time-to-time by the Committee in certain circumstances including minor changes for administrative, tax or other regulatory purposes.

Subject to this Policy, performance conditions may be amended in other circumstances if the Committee considers it appropriate.

**Performance metrics used, weighting and time period applicable**

See notes 4 and 5 on page 88 regarding the selection and weighting of performance metrics.

**Operation**

It is proposed to consolidate the three long-term incentive plans described below into a single umbrella plan with effect from 1 January 2015, subject to shareholder approval at the 2014 AGM<sup>1</sup>.

**Maximum opportunity**

Subject to shareholder approval of the proposed umbrella plan at the 2014 AGM<sup>1</sup>, over the lifetime of this remuneration policy, the Committee will have discretion to vary the weighting and mix of different types of awards within the following limits:

**(a) Performance Shares:**

UK executive directors:

Between 50% and 75% of overall LTI Expected Value (EV)

US executive directors:

Between 25% and 50% of overall LTI EV

**(b) Share Options:**

Between 25% and 50% of overall LTI EV

**(c) Restricted Shares:**

Applicable to US executive directors only. No more than one-third of overall LTI EV

The maximum opportunity in respect of each element is as set out below.

**Performance metrics used, weighting and time period applicable**

See below in relation to Performance Shares and Share Options.

See notes 4 and 5 on page 88.

1. Approved at the AGM on 7 May 2014.

# DIRECTORS' REMUNERATION POLICY CONTINUED

## EXECUTIVE DIRECTORS' POLICY TABLE continued

### LONG-TERM INCENTIVES – PERFORMANCE SHARES

#### Purpose and link to strategy

Drive and reward delivery of sustained long-term EPS and Total Shareholder Return (TSR) performance aligned to the interests of shareholders.

#### Operation

Awards, typically in the form of nil-cost options, vest and become exercisable in three tranches on the third, fourth and fifth anniversary of grant, subject to performance conditions.

For US participants, awards are delivered as conditional share awards (RSUs) which vest automatically on the third, fourth and fifth anniversary of grant, subject to performance conditions.

#### Maximum opportunity

Chief Executive: 250% of salary

Group Finance Director: 215% of salary

President and Chief Executive Officer of BAE Systems, Inc.: 242% of salary

#### Performance metrics used, weighting and time period applicable

Metrics and weightings applicable to 2014 awards:

- 50% of award based on TSR growth relative to a comparator group of at least 12 companies over the three-year performance period.
- Nil vesting if TSR ranked below median in the peer group; 25% exercisable if TSR ranked at the median; 100% exercisable if TSR ranked in the upper quintile; pro-rata vesting for performance between median and upper quintile. Award subject to a secondary financial measure as set out on page 77.
- 50% of award based on average annual EPS growth over the three years with nil vesting at average annual EPS growth of 5% and 100% vesting at 11% growth.
- Pro-rata vesting for intermediate performance.
- 50% of awards made in 2012 and 2013 for US participants were based on long-term operating cash performance measured at the level of the US businesses in place of TSR growth.

See notes 4 and 5 on page 88.

### LONG-TERM INCENTIVES – SHARE OPTIONS

#### Purpose and link to strategy

Drive and reward delivery of TSR performance and sustained improvement in the Company's share price.

#### Operation

Subject to a TSR performance condition. Market value options are normally exercisable between the third and tenth anniversary of their grant.

#### Maximum opportunity

Chief Executive: 300% of salary

Group Finance Director: 300% of salary

President and Chief Executive Officer of BAE Systems, Inc.: 390% of salary

#### Performance metrics used, weighting and time period applicable

For share option awards made to the executive directors only, exercise is subject to a TSR performance condition as set out above.

See notes 4 and 5 on page 88.

### LONG-TERM INCENTIVES – RESTRICTED SHARES

#### Purpose and link to strategy

Provide long-term reward through time-vesting awards principally in the Company's US market.

#### Operation

The shares are subject only to the condition that the participant remains employed by the Group on the vesting date (three years after the award date). These awards are not subject to a performance condition as it is designed to address retention issues principally in the US.

#### Maximum opportunity

Chief Executive and Group Finance Director: Not eligible

President and Chief Executive Officer of BAE Systems, Inc.: 100% of salary

#### Performance metrics used, weighting and time period applicable

None.

See notes 4 and 5 on page 88.



EXECUTIVE DIRECTORS' POLICY TABLE continued	
BENEFITS	
<b>Purpose and link to strategy</b>	Provide employment benefits which ensure that the overall package is market competitive when these elements are taken into account.
<b>Operation</b>	<p>Benefits include provision of a company car (or cash equivalent), life assurance and ill-health benefit cover which are provided directly or through membership of the Company's pension schemes.</p> <p>Opportunity for UK executive directors to participate in the Share Incentive Plan, a tax approved all-employee plan.</p> <p>Additional benefits such as relocation assistance may also be provided in certain circumstances if considered reasonable and appropriate by the Committee.</p>
<b>Maximum opportunity</b>	<p>Benefits are set at a level which the Remuneration Committee considers to be appropriate against comparable roles in companies of similar size in the relevant market.</p> <p>Relocation assistance comprises reimbursement for direct items of expenditure, such as legal, estate agency, removals and temporary accommodation, based on actual costs incurred which are linked to the size and value of the property, plus a maximum relocation allowance of £2,500.</p> <p>Benefits are as reported and itemised within the single total figure shown as part of the Annual Remuneration Report on page 70. The main benefits in the UK include a car allowance (£16,000 per annum) and private use of a chauffeur-driven car, plus life assurance and ill-health benefit cover provided through membership of the Company's pension schemes. In the US, the benefits include a cash allowance for car and parking (\$20,900 per annum) and private use of a chauffeur-driven car, medical and dental benefits, and insured life and disability benefits. The maximum cost of such benefits will reflect the associated market-competitive cost of provision.</p> <p>Participation limits for the Share Incentive Plan are those set by the UK tax authorities from time-to-time.</p>
<b>Performance metrics used, weighting and time period applicable</b>	None.
PENSION	
<b>Purpose and link to strategy</b>	Provide competitive post-retirement benefits or cash allowance equivalent.
<b>Operation</b>	<p>For any new externally appointed executive directors in the UK, membership of the Company's executive defined contribution plan is offered with Company contributions set as a percentage of base salary. Individuals may elect to receive some or all of their pension contribution as a cash allowance.</p> <p>Current UK executive directors are members of the BAE Systems Executive Pension Scheme and members of the underlying employee pension plan, which provide a target benefit for executive directors payable at normal retirement age (62) of 1/30th of final pensionable earnings (FPE) for each year of service up to a maximum of two-thirds of FPE. Member contributions are currently 8%. Further detail is provided on page 75 as part of the Annual Remuneration Report.</p> <p>Any new externally appointed US executive directors would be offered membership of the US defined contribution plan.</p>
<b>Maximum opportunity</b>	<p>Company contribution of 19% (in addition to employee contribution of 6%) of base salary only.</p> <p>Under the existing defined benefit scheme, a maximum of two-thirds of FPE accrued at 1/30th for each year of service.</p> <p>The US defined contribution plan provides 100% company matching contributions up to a maximum of 6% of base salary, subject to US statutory limits.</p>
<b>Operation</b>	Where executive directors' pension entitlement or accrual is restricted to the Lifetime Allowance and/or the Annual Allowance under the relevant pension scheme the Company may offer an unfunded pension promise to offset the impact of these restrictions.
<b>Maximum opportunity</b>	The difference between the value of the registered pension scheme benefits as restricted to the Lifetime Allowance and Annual Allowance and the full value of those registered pension scheme benefits that would be payable if there were no Annual Allowance or Lifetime Allowance restrictions.

# DIRECTORS' REMUNERATION POLICY CONTINUED

## Notes to the executive directors' policy table

### Remuneration policy for other employees

- The Company's approach to annual salary reviews is consistent across the Group, with consideration given to the scope of the role, level of experience, performance and market data for similar roles in other companies.
- All leaders may participate in an annual bonus scheme with similar metrics to those used for the executive directors. Other employees may participate in performance-based incentive plans which vary by organisational level and with relevant metrics for the particular area of the business.
- Long-Term Incentive grants may be made to the most senior managers in the business (approximately 250 individuals globally). The nature of the awards depends on the individuals' location, roles and responsibilities, in particular:
  - performance measures and targets for performance share grants are made in line with those applying to executive directors;
  - there are no performance conditions attached to share option grants below executive director level; and
  - Restricted Share grants are currently made to the most senior managers in the US reflecting competitive market practice.

### Performance measures and targets

- The Committee selected the performance conditions because these are central to the Company's overall strategy and are the key metrics used by the executive directors to oversee the operation of the business. The non-financial performance targets are determined by the Committee in consultation with the Corporate Responsibility Committee.
- The performance measures and targets are determined annually by the Committee, taking account of the Group's strategic objectives, the internal business plan and budgets, as well as external market expectations and general economic conditions. The Committee is of the view that the performance targets for the annual bonus are commercially sensitive and that it would be detrimental to the interests of the Company to disclose them before the start of the financial year. The targets will be disclosed retrospectively after the end of the relevant financial year.

### Minimum Shareholding Requirement (MSR)

- The Committee has agreed a policy whereby the executive directors are required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes and other Long-Term Incentive schemes by retaining 50% of the net value (i.e. the value after deduction of exercise costs and tax) of shares acquired under these schemes. Once the Initial Value is achieved, a Subsequent Value must be achieved in the same way, except that a minimum of 25% of the net value must be retained on each exercise or acquisition. Shares owned beneficially by the director and his/her spouse count towards the MSR. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

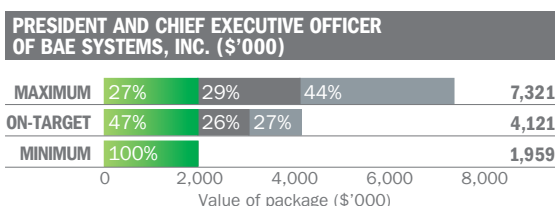
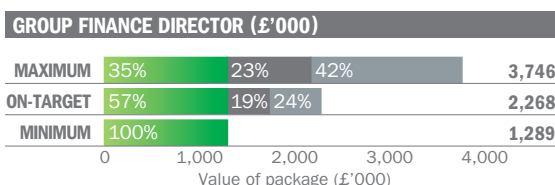
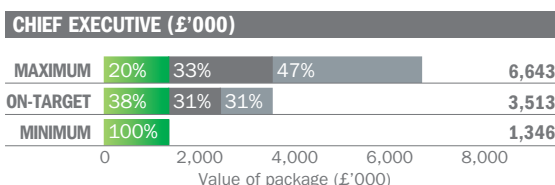
The following table sets out MSR Initial Value and Subsequent Value:

	Initial Value	Subsequent Value
Chief Executive	150%	300%
Group Finance Director	100%	200%
President and Chief Executive Officer of BAE Systems, Inc.	175%	350%

### Illustration of application of remuneration policy

The charts opposite show the value of the package each of the executive directors would receive based on 2014 base salaries, remuneration and 2014 LTI awards assuming the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 70); pay receivable assuming on-target performance is met; and maximum pay assuming variable elements pay out in full. The scenarios opposite exclude any share price appreciation and dividends.

UK legislation requires that these charts are given in relation to the first year in which the remuneration policy takes legal effect. Rather than providing further charts for assumed 2015 remuneration and awards, we invite shareholders to assume similar levels for 2015 and we will report on actual levels in 2015.



■ Fixed elements of remuneration  
■ Annual bonus  
■ PSP and Share options

<b>NON-EXECUTIVE DIRECTORS' (NEDs) POLICY TABLE</b>	
<b>FEES</b>	
<b>Purpose and link to strategy</b>	To attract NEDs who have a broad range of experience and skills to provide independent judgement on issues of strategy, performance, resources and standards of conduct.
<b>Operation</b>	<p>NEDs fees are set by the Non-Executive Directors' Fees Committee.</p> <p>NEDs receive a basic fee with an additional fee for those who are chairmen of committees and/or undertake the role of Senior Independent Director.</p> <p>NEDs also receive a travel allowance per meeting on each occasion that a scheduled 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.</p> <p>Fees are typically reviewed annually, taking into account time commitment requirements and responsibility of the individual roles, and after reviewing practice in other comparable companies.</p> <p>The Chairman's fees are set by the Remuneration Committee on a three-year basis and not normally subject to review during that period.</p>
<b>Maximum opportunity</b>	<p>Actual fee levels are disclosed in the Annual Remuneration Report for the relevant financial year.</p> <p>The current Chairman's fee has been set at £650,000 and fixed at this level for three years from the date of appointment (1 February 2014).</p> <p>The aggregate cost of fees and benefits paid to NEDs (including the Chairman) will not exceed an annual limit of £2.5m.</p>
<b>Performance metrics used, weighting and time period applicable</b>	None.
<b>BENEFITS</b>	
<b>Purpose and link to strategy</b>	Reimbursement for reasonable and documented expenses incurred in the performance of duties.
<b>Operation</b>	<p>NEDs are not eligible to participate in any pension benefits provided by the Company, nor do they participate in any performance-related incentives.</p> <p>The Chairman is provided with a chauffeur-driven car. This may be used for non-Company business, but the cost of the benefit of such usage shall be paid by the Chairman.</p> <p>Reimbursement of travel and subsistence costs (including payment of the associated tax cost) incurred by the director or his/her spouse whilst undertaking duties on behalf of the Company that may be assessed as a benefit for tax purposes.</p>
<b>Maximum opportunity</b>	See the aggregate limit under 'Fees' above.

# DIRECTORS' REMUNERATION POLICY CONTINUED

## Prior commitments

The Company will honour any commitments made in respect of executive director and non-executive director remuneration before the date on which either: (i) the Directors' Remuneration Policy becomes effective or (ii) an individual becomes a director, even where such commitments are not consistent with the policy prevailing at the time any such commitment is fulfilled. This includes (without limitation) all existing share awards as detailed on pages 80 and 81 under the PSP, SMP, RSP, ExSOP and ExSOP<sup>2012</sup>, Linda Hudson's leaving arrangements as detailed on page 71 and Peter Lynas' second residence allowance as detailed on page 70.

## Approach to recruitment remuneration

The recruitment policy provides an appropriate framework within which to attract individuals of the required calibre to lead a company of BAE Systems' size, scale and complexity. The Remuneration Committee determines the remuneration package for any appointment to an executive director position, either from within or outside BAE Systems.

### Operation

The Remuneration Committee will take into consideration all relevant factors, including overall total remuneration, the type of remuneration being offered and the jurisdiction from which the candidate was recruited, and will operate in order to ensure that arrangements are in the best interests of the Company and its shareholders without paying more than is necessary to secure the individual of the required calibre.

The fees and benefits applicable to the appointment of any new non-executive directors will be in accordance with the policy table on page 89.

### Opportunity

The Committee seeks to align the remuneration package offered with the policy set out in the executive directors' policy table above recognising that participation under the policy above varies by geography.

- For UK and other non-US executive director appointments, participation in annual incentive plans will not exceed 225% of annual salary and long-term awards under this policy will not exceed 550% of annual salary.
- For US executive director appointments, participation in annual incentive plans will not exceed 225% of annual salary and long-term awards under this policy will not exceed 750% of annual salary.

The Committee may make awards on hiring an external candidate to 'buy-out' existing equity or, in exceptional circumstances, other elements of remuneration forfeited on leaving the previous employer. In doing so, the Committee will take account of relevant factors including any performance conditions attached to these awards, the form in which they were granted (e.g. cash or shares) and the time over which they would have vested. Buy-out awards would be capped to be no higher, on recruitment, than the fair value of those forfeited. Full details will be disclosed in the next Annual Remuneration Report following recruitment which will include details of the need to grant a buy-out award.

### Fixed elements (base salary, retirement and other benefits)

The salary level will be set in accordance with the policy described in the executive directors' policy table above.

The executive director shall be eligible to participate in applicable BAE Systems' employee benefit plans, including coverage under applicable executive and employee pension and benefit programmes in accordance with the terms and conditions of such plans, as may be amended by the Company in its sole discretion from time to time.

In the case of promotion of an existing Group employee to an executive directorship on the Board, commitments made before such promotion will continue to be honoured whether or not they are consistent with the remainder of this policy.

### Annual Incentive Plan

The appointed executive director will be eligible to earn a discretionary annual bonus in accordance with the Annual Incentive framework as described in the executive directors' policy table above.

The level of opportunity will be consistent with the policy disclosed in the executive directors' policy table in this report and subject to the maximums referred to therein.

### Long-Term Incentive Plans

The executive director will be eligible for equity awards in such amounts as the Committee may determine in its sole discretion, subject to this policy and the rules of the Long-Term Incentive Plans.

The level of opportunity will be consistent with the policy set out in the executive directors' policy table above and subject to the maximums referred to therein.

### Other

For internal and external appointments, the Committee may agree that the Company will meet certain relocation expenses in accordance with the provisions described under the Benefits section of the policy table on page 87.

**Service contracts****Executive directors****Operation**

In accordance with long-established policy, all executive directors have rolling service agreements which may be terminated in accordance with the terms of these agreements.

**Dates of appointment for executive directors**

Name	Date of appointment	Notice period
Ian King	27 June 2008	12 months either party
Peter Lynas	1 April 2011	12 months either party
Jerry DeMuro	1 February 2014	90 days either party <sup>1</sup>

1. Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal.

**Notice period**

The Committee's policy is that the service contracts of executive directors will not exceed 12 months. In exceptional circumstances, in relation to newly recruiting an executive director operating in a US environment, the notice period may be extended to a maximum of 24 months and structured such that it automatically reduces to 12 months at the end of the first complete year of service.

**Change of control**

No executive director has provisions in his service contract that relate to a change of control of the Company.

**Chairman**

The Chairman's appointment is documented in a letter of appointment and he is required to devote no fewer than two days a week to his duties as Chairman. His appointment as Chairman will automatically terminate if he ceases to be a director of the Company. His appointment is for a term of three years from 1 February 2014 unless terminated earlier in accordance with the Company's Articles of Association or by the Company or the Chairman giving not less than six months' notice. The Chairman's appointment is to be reviewed by the Nominations Committee prior to the end of the three-year term and the Chairman may be invited to serve for an additional period.

**Non-executive directors**

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 are shown below:

Name	Date of appointment	Expiry of current term
Paul Anderson <sup>1</sup>	08.10.2009	–
Harriet Green	01.11.2010	31.10.2016
Chris Grigg	01.07.2013	30.06.2016
Paula Rosput Reynolds	01.04.2011	31.03.2017
Nick Rose	08.02.2010	07.02.2016
Carl Symon	11.06.2008	10.06.2015
Ian Tyler	08.05.2013	07.05.2016

1. Retired from the Board on 31 December 2014.

Note: The above table has been amended to reflect the position as of 18 February 2015.

The non-executive directors are normally appointed for an initial three-year term that, subject to review, may be extended subsequently for further such terms. Any third term of three years is subject to rigorous review, 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.

In accordance with the UK Corporate Governance Code, all directors are subject to annual election or re-election at the Company's AGM.

# DIRECTORS' REMUNERATION POLICY CONTINUED

## Policy on payment for loss of office

### Operation

The policy on payment for loss of office provides a clear set of principles that govern the payments that will be made for loss of office, and take account of the need to ensure a smooth transition for leadership roles during times of change. The policy that will apply for a specific executive director's payment for loss of office will be the policy that was in place at the point when the payment for loss of office was agreed for the executive director in question.

### Notice and pay in lieu of notice

Executive directors' contracts allow for termination with contractual notice from either party or termination by way of payment in lieu of notice, at the Company's discretion. Neither notice nor a payment in lieu of notice will be given in the event of gross misconduct. 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 of not more than one year's base salary.

Any compensation payment made in connection with the departure of an executive director will be subject to approval by the Remuneration Committee, having regard to the terms of the service contract and the specific circumstances surrounding the termination, including whether the scenario aligns to an example under the approved leaver criteria, performance, service and health or other circumstances that may be relevant.

Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal. If the employment is (a) terminated by the Company (other than for cause as defined in the contract) or (b) he resigned for a 'Good Reason' (as defined in his contract), he is entitled to a termination payment equal to (i) one year's base salary and (ii) a pro-rated bonus for the relevant financial year. He will also be entitled to a continuation of medical benefits for 18 months (or a cash payment in lieu).

### Retirement benefits

As governed by the rules of the relevant pension plan. No enhancement for leavers will be made.

### Annual Incentive Plan

The Remuneration Committee may exercise its discretion to make an annual incentive payment as part of the termination package.

Where an executive director's employment is terminated after the end of a performance year but before the payment is made, the executive director will remain eligible for an annual incentive award for that performance year subject to an assessment based on performance achieved over the period. No award will be made in the event of gross misconduct.

Where an executive director leaves by reason of death, ill-health, retirement, a transfer of business or redundancy, the Remuneration Committee may use its discretion to determine that an executive director is entitled to receive a bonus (subject to an assessment based on performance over the period and pro-rated for time) in respect of the financial year in which the individual ceased employment.

If the Remuneration Committee regards it necessary to use their discretion, it must be shown how this is in the interests of the Company and its shareholders.

The Committee's policy is not to award an annual incentive for any portion of the notice period not served.

### Long-Term Incentive Plans

The treatment of outstanding share awards in the event that an executive director leaves is governed by the relevant share plan rules.

Under the Long-Term Incentive Plans, awards and options generally vest and/or become exercisable where an executive director leaves by reason of ill-health, injury, disability, retirement with the agreement of the Company, redundancy or leaving in such circumstances as the Committee determines (each an 'approved leaver'). Awards and options generally continue and vest on the normal vesting date (or, in the case of Performance Shares, the first normal vesting date), unless the Committee determines that the awards should vest on cessation. Any performance conditions will be applied at the time of vesting.

In the event of death, awards generally vest at the time of death subject to the satisfaction of any performance conditions at that time. Awards are then pro-rated as set out below.

On the vesting and/or exercise of awards and/or options as set out above, the number of shares received will, unless the Committee decides otherwise, be reduced pro-rata to reflect the period in which the executive director was in employment as a proportion of the relevant vesting or performance period (as applicable).

Where an executive director's employment is terminated for any other reason, his awards and options will lapse.

If the Remuneration Committee regards it necessary to exercise its discretion as permissible under the share plan rules, then disclosure will include an explanation of how the application of discretion was in the best interests of the Company and its shareholders.

Where an executive director's employment is terminated or an executive director is under notice of termination for any reason at the date of award of any Long-Term Incentive awards, no Long-Term Incentive awards will be made.

## Consideration of employment conditions elsewhere in the Company

The Remuneration Committee does not consult directly with employees as part of the process for reviewing executive pay. When considering salary increases for the executive directors, the Remuneration Committee considers the general level of salary increase across the Group and in the external market.

## Stakeholder considerations

The Remuneration Committee conducts an annual programme of consultation with major shareholders in order to seek their input to the development of remuneration policy or plans.

# DIRECTORS' REPORT

## Company registration

BAE Systems plc is registered in England and Wales with the registered number 1470151.

## Directors

The current directors who served during the 2014 financial year are listed on pages 56 and 57. Of those directors, Jerry DeMuro was appointed to the Board on 1 February 2014. Paul Anderson served as a director throughout the period until his retirement from the Board on 31 December 2014. Sir Richard Olver and Linda Hudson also served as directors during the period until their retirement from the Board on 1 February 2014.

## Dividend

An interim dividend of 8.2p per share was paid on 1 December 2014. The directors propose a final dividend of 12.3p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2015 to shareholders on the share register on 17 April 2015. Information on dividend waivers is given on page 143.

## Annual General Meeting (AGM)

The Company's AGM will be held on 7 May 2015. The Notice of Annual General Meeting is enclosed with this Annual Report and details the resolutions to be proposed at the meeting.

## Certain information in the Strategic Report

The following items are set out in the Strategic Report on pages 1 to 53:

- disclosures in relation to the use of financial instruments;
- particulars of important events affecting the Group which have occurred since 31 December 2014;
- an indication of likely future developments in the business of the Group;
- an indication of the activities of the Group in the field of research and development;
- actions taken to introduce, maintain or develop arrangements aimed at employees; and
- greenhouse gas emissions.

## Office of Fair Trading undertakings

As a consequence of the merger between British Aerospace and the former Marconi Electronic 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 half-year results announcement on 31 July 2014, 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 (and which replaced the profit forecast made in the Group's full-year results announcement on 20 February 2014 and in the Annual Report 2013):

"With the non-recurring benefit from the Salam price escalation settlement in the second half of 2013, and before exchange translation, the Group continues to expect reported earnings per share to be some 5% to 10% lower than in 2013. Exchange translation, assuming an average US\$1.70 exchange rate, is expected to impact those earnings by around one pence compared to previous guidance."

Underlying earnings per share was 42.0p in 2013. In 2014, underlying earnings per share was 38.0p. The average US\$ exchange rate for 2014 was 1.647.

## Employees

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.

## Political donations

No political donations were made in 2014.

## Issued share capital

As at 31 December 2014, BAE Systems' issued share capital of £86,720,655 comprised 3,468,826,200 ordinary shares of 2.5p each and one Special Share of £1.

## Share buyback

During the year, 67,417,000 ordinary shares of 2.5p each were repurchased under the buyback programme announced on 21 February 2013 and such repurchased shares have been cancelled. The total consideration for the purchase of the shares, including commission and stamp duty, was £282,501,089. The percentage of called up share capital (excluding treasury shares) as at 31 December 2014, which the shares repurchased in 2014 represents, is 2.1%.

## Treasury shares

As at 1 January 2014, the number of shares held in treasury totalled 327,644,952 (having a total nominal value of £8,191,124 and representing 9.3% of the Company's called up share capital at 1 January 2014). During 2014, the Company used 11,818,338 treasury shares (having a total nominal value of £295,458 and representing 0.3% of the Company's called up share capital at 31 December 2014) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (6,051,063 shares in aggregate), awards vested under the Performance Share Plan (1,043,407 shares) and the Restricted Share Plan (3,193,509 shares), and options exercised under the Executive Share Option Plan (1,530,359 shares). The treasury shares utilised in respect of the Share Incentive Plan, the Performance Share Plan and the Restricted Share Plan were disposed of by the Company for nil consideration. The 1,530,359 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 £4,775,649. As at 31 December 2014, the number of shares held in treasury totalled 315,826,614 (having a total nominal value of £7,895,665 and representing 9.1% of the Company's called up share capital at 31 December 2014).

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.

# DIRECTORS' REPORT CONTINUED

## 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 Long-Term Incentive Plan 2014, Deferred Bonus Plan and Share Incentive Plan are subject to restrictions on the transfer of shares prior to vesting and/or release.

The Company is not aware of any arrangements between its shareholders that may result in restrictions on the transfer of shares and/or voting rights.

## Significant direct and indirect holders of securities

As at 18 February 2015, 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%
BlackRock, Inc.	5.00%
The Capital Group Companies, Inc.	6.13%
Franklin Resources Inc., and affiliates	4.92%
Invesco Limited	9.97%
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 2015 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 2014 AGM, the directors were given the power to buy back a maximum number of 317,455,371 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 2015 AGM or 30 June 2015. A special resolution will be proposed at the 2015 AGM to renew the Company's authority to acquire its own shares.

At the 2014 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,451,968. This power will expire on the earlier of the conclusion of the 2015 AGM or 30 June 2015. Accordingly, a resolution will be proposed at the 2015 AGM to renew the Company's authority to issue further new shares. At the 2014 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £26,451,968 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2015 AGM or 30 June 2015, and a resolution will be proposed at the 2015 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.

#### **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 2014 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.

# DIRECTORS' REPORT CONTINUED

## 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 12 December 2013 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 2014.

- 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 Ministry of Defence (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 of control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. In the event that there is a change of 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.

On 30 September 2014, BAE Systems Surface Ships Limited and the MoD entered into an agreement which sets out terms for the progressive suspension, amendment and termination of the ToBA through the entering into of other contracts, such as the Maritime Support Delivery Framework (MSDF) agreement (see below) which triggered the deletion of elements of the ToBA relating to surface ship support. The current scope of the ToBA has, therefore, been reduced to focus on surface shipbuilding and the MoD retains its right to terminate the ToBA if there is a change of control notwithstanding the objection of the MoD.

- The MSDF agreement between BAE Systems Surface Ships Limited and the MoD became effective on 1 October 2014 and establishes a framework until March 2019 for the provision of surface ship support work and services relating to HM Naval Base Portsmouth. Where the MoD considers that a proposed change of control of BAE Systems Surface Ships Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. If there is a change of control without notice or notwithstanding the objection of the MoD, the MoD shall be entitled to terminate the MSDF.

- In August 2008, BAE Systems Land Systems (Munitions & Ordnance) Limited (now BAE Systems Global Combat Systems Munitions Limited) and the MoD entered into a 15-year partnering agreement for the provision of ammunition to UK Forces (the Munitions Acquisition Supply Solution (MASS) partnering agreement). Where the MoD considers that a proposed change of control of BAE Systems Global Combat Systems Munitions Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement with the MoD is established. In the event that there is a change of control of BAE Systems Global Combat Systems Munitions Limited, notwithstanding the objection of the MoD on such grounds, the MoD may, having followed the dispute resolution process, terminate the MASS agreement for default.

- In November 2012, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 4 of the Astute Class programme (the Agreement). Where the MoD considers that a proposed change of control of BAE Systems Marine Limited would be contrary to the defence, national security or national interest of the UK, then the change of control shall not proceed until agreement is established with the MoD. In the event that there is a change of control of BAE Systems Marine Limited, notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the Agreement immediately.

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 LLP have indicated their willingness to be re-appointed as the auditors for the Company 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 strategic report, 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**  
 18 February 2015

**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 Strategic Report and Directors' Report, taken together, include a fair review of the development and performance of the business, and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

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.

Sir Roger Carr	Chairman
Ian King	Chief Executive
Jerry DeMuro	President and Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	Group Finance Director
Harriet Green	Non-executive director
Chris Grigg	Non-executive director
Paula Rosput Reynolds	Non-executive director
Nick Rose	Non-executive director
Carl Symon	Non-executive director
Ian Tyler	Non-executive director

On behalf of the Board

**Sir Roger Carr**  
**Chairman**  
 18 February 2015

# INDEPENDENT AUDITOR'S REPORT

to the members of  
BAE Systems plc only

## Opinions and conclusions arising from our audit

### 1. Our opinion on the financial statements is unmodified

We have audited the financial statements of BAE Systems plc for the year ended 31 December 2014 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. 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 2014 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with UK accounting standards; 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.

### 2. Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements the risks of material misstatement that had the greatest effect on our audit were as follows:

#### **Recognition of revenues and profits on long-term contracts**

Refer to page 62 (Audit Committee Report) and page 108 (accounting policy and financial disclosures)

#### **Audit risk**

A significant proportion of the Group's revenues and profits are derived from long-term contracts.

These contracts include complex technical and commercial risks and often specify performance milestones to be achieved throughout the contract period, which can last many years. This results in estimates and assumptions being made to:

- assess the proportion of revenues to recognise in line with contract completion;
- forecast the profit margin on each contract after making appropriate allowances for technical and commercial risks related to performance milestones yet to be achieved; and
- appropriately provide for loss-making contracts.

The risk of misstatement is that the accounting for the Group's significant contracts does not accurately reflect the status of the relevant contract.

#### **Procedures to address these audit risks included those listed below**

The directors have detailed procedures and processes, called Lifecycle Management (LCM), in place to manage the commercial, technical and financial aspects of the Group's long-term contracts. The LCM process includes the regular preparation of a Contract Status Report (CSR) which includes key accounting information for the relevant contract.

We considered the design and tested the effective operation of key controls within the LCM process and supporting contract-related balances, including:

- transactional controls that underpin the production of long-term contract-related balances, including cost information on contracts, such as purchase-to-pay cycle and payroll controls;
- programme-level controls such as periodic peer-reviews performed by experienced employees independent to the contract at pre-determined stages of the contract lifecycle; and
- higher-level controls, such as monthly contract review meetings, quarterly business unit review meetings and Group-level review meetings, covering all key contracts.

For significant contracts, determined on the basis of the current and future technical or commercial complexity, financial significance and any forecast to be in significant loss-making positions, we also:

- obtained an understanding of the performance and status of the contract through discussion with contract project teams, Group and business unit directors as well as attendance at project teams' contract review meetings;
- corroborated managements' positions through the examination of externally available evidence, such as customer correspondence, and, in the case of one significant programme, met the customer directly to further corroborate the status of contracts;
- corroborated the consistency of information presented in the year-end CSRs to other financial information received and knowledge gained through the above procedures; and
- used our cumulative knowledge of contract issues to challenge the appropriateness of the contract positions reflected in the financial statements at the year end, including the assessment of margin traded on contracts based on allowances made for risks.

The contracts requiring the highest degree of judgement that occupied a significant proportion of the audit effort and discussion with management included:

- US commercial shipbuilding contracts;
- Korea F-16;
- European Typhoon;
- Saudi Typhoon;
- Astute Class submarines; and
- Queen Elizabeth Class aircraft carriers.

We also considered the adequacy of the Group's segmental disclosures in respect of changes in the status of contracts which had a material impact on the Group's financial performance for the year.

#### **Carrying value of US goodwill (£7.3bn)**

Refer to page 62 (Audit Committee Report) and page 118 (accounting policy and financial disclosures)

#### **Audit risk**

An impairment charge of £87m was recognised against the US Cash-Generating Units in the period (2013 £865m impairment).

The uncertainty over future US defence spending and the importance of securing certain export contracts increases the risk that the goodwill allocated to the Group's US Cash-Generating Units will not be recoverable.

Due to the inherent uncertainty involved in forecasting and discounting future cash flows, which are the basis of the assessment of recoverability, this is one of the key judgemental areas that our audit is concentrated on.

#### **Procedures to address these audit risks included those listed below**

The directors' annual goodwill impairment testing is based on the Group's five-year Integrated Business Plan, as approved by the Board.

#### **In respect of the cash flows:**

We considered the Group's budgeting procedures upon which the forecasts are based and the principles and integrity of the Group's discounted cash flow model. To support the reasonableness of those cash flows, we assessed the historical accuracy of the Group's forecasting and considered the forecasts with reference to publicly available information regarding future defence expenditure.

#### **In respect of the discount rate:**

We compared the Group's assumptions to externally-derived data (for example, bond yields and inflation statistics) where possible. We conducted our own assessments in relation to other key inputs, such as projected economic growth and gearing leverage. We also used our own valuation specialists in assessing the overall discount rates used.

#### **In respect of Cash-Generating Unit recoverable amounts:**

As an additional sense check to challenge the recoverable values of Cash-Generating Units, we performed a breakeven analysis on the key assumptions and compared the sum of discounted cash flows to the Group's market capitalisation.

#### **In respect of the disclosures:**

We assessed whether the Group's disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions reflected the risks inherent in the valuation of goodwill.

#### **Retirement benefit obligations (£5.5bn)**

Refer to page 62 (Audit Committee Report) and page 134 (accounting policy and financial disclosures)

#### **Audit risk**

As presented in note 21 of the financial statements, the Group's share of the pension schemes' net deficit was £5.5bn after allocating £1.4bn to equity accounted investments and other participating employers.

Small changes in assumptions and estimates used to value the Group's retirement benefit obligation, including those supporting the proportion allocated to equity accounted investments and other participating employers, have a significant impact on the Group's share of the retirement benefit obligation.

#### **Procedures to address these audit risks included those listed below**

#### **In respect of the multi-employer allocation:**

We considered whether the methodology used by the directors, to allocate a proportion of the Group's retirement benefit obligation to the equity accounted investments and other participating employers, was appropriate. We assessed this estimate with reference to agreements between the Group and the equity accounted investments and other participating employers, which we examined.

#### **In respect of the deficit valuation:**

We challenged the key assumptions supporting the Group's retirement benefit obligations valuation, with input from our own actuarial specialists. This included a comparison of the discount rate, inflation and life expectancy assumptions used against externally-derived data. In order to sense check the reasonableness of these assumptions, we performed a benchmarking exercise against comparator companies' assumptions. We also agreed scheme assets to external valuations.

#### **In respect of the disclosures:**

We considered the adequacy of the Group's disclosures in respect of these key assumptions, including the sensitivity of the deficit to changes.

#### **Tax accruals**

#### **Audit risk**

Accruals for tax contingencies require the directors to make judgements and estimates in relation to tax risks. This is one of the key judgemental areas that our audit is concentrated on due to the Group operating in a number of tax jurisdictions and the complexities of international tax legislation.

The tax matters are at various stages, from preliminary discussions with tax authorities through to tax tribunal or court proceedings where the matters can take many years to resolve. The risk to the financial statements is that the eventual resolution of a matter with tax authorities is at an amount materially different to the estimated accrual.

#### **Procedures to address these audit risks included those listed below**

Together with our own tax specialists, we considered any large or unusual items in the effective tax reconciliation and whether or not these current year items would indicate a requirement for further accruals.

In considering the judgements and estimates of tax accruals, we used our own international and local tax specialists to assess the Group's tax positions. This included the assessment of its correspondence with the relevant tax authorities and the Company's external tax advisers; we also used our knowledge and experience of the application of the international and local legislation by the relevant authorities and courts in order to challenge the positions taken by management. In support of these discussions, we separately met with certain key external tax advisers of the Company.

We also analysed and challenged the assumptions used to determine the tax accruals and tested the accuracy of calculations.

We have also considered the adequacy of the Group's tax disclosures.

#### **3. Our application of materiality and an overview of the scope of our audit**

The materiality for the Group financial statements as a whole was set at £80m, determined with reference to a benchmark of Group profit before tax, excluding the impairment charge for the year of £170m as disclosed on the face of the Consolidated Income Statement. This represents 7.6% of the adjusted benchmark.

We reported to the Audit Committee any corrected or uncorrected identified misstatements exceeding £4m for income statement items, in addition to other identified misstatements that warranted reporting on qualitative grounds.

# INDEPENDENT AUDITOR'S REPORT CONTINUED

Of the Group's 36 reporting components, we subjected ten to audits for Group reporting purposes and nine to specified risk-focused audit procedures. The latter were not individually financially significant enough to require an audit for Group reporting purposes, but did present specific individual risks that needed to be addressed.

The components within the scope of our work accounted for the following percentages of the Group's results:

	Number of components	Group revenue %	Group profit before tax %	Group total assets %
Audits for Group reporting purposes <sup>1</sup>	10	68	73	83
Specified risk-focused audit procedures <sup>2</sup>	9	24	16	13
<b>Total</b>	<b>19</b>	<b>92</b>	<b>89</b>	<b>96</b>

1. In the UK, US, Saudi Arabia and Australia.

2. In the UK and US.

For the remaining components, we performed analysis at an aggregated level to re-examine our assessment that there were no significant risks of material misstatement within these.

The Group audit team instructed component auditors as to the significant areas to be covered, including the relevant risks detailed above and the information to be reported back. The Group audit team approved the component materialities, which ranged from £8m to £40m, having regard to the mix of size and risk profile of the Group across the components. The work on 17 of the 19 components was performed by component auditors and the rest by the Group audit team.

The Group audit team held a global audit conference in the year, where all significant components came together in London to consider the audit risk and strategy. In addition, the Group audit team visited component teams in the UK, US, Saudi Arabia and Australia, to assess the audit risk and strategy, discuss and moderate the results of controls testing and discuss preliminary findings of components' final procedures. Video and telephone conference meetings were also held with these component auditors and the others that were not physically visited. At these visits and meetings, the findings reported to the Group audit team were discussed in more detail, and any further work required by the Group audit team was then performed by the component auditor.

#### 4. Our opinion on other matters prescribed by the Companies Act 2006 is unmodified

In our opinion:

- the part of the Annual Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

#### 5. We have nothing to report in respect of the matters on which we are required to report by exception

Under International Standards on Auditing (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the Annual Report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading.

In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy; or
- the Audit Committee Report does not appropriately address matters communicated by us to the Audit Committee.

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 Annual 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 60, in relation to going concern; and
- the part of the Governance section relating to the Company's compliance with the ten provisions of the 2012 UK Corporate Governance Code specified for our review.

We have nothing to report in respect of the above responsibilities.

### Scope of report and responsibilities

As explained more fully in the directors' responsibilities statement set out on page 97, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. 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](http://www.frc.org.uk/auditscopeukprivate). This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at [www.kpmg.com/uk/auditscopeukco2014a](http://www.kpmg.com/uk/auditscopeukco2014a), which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

**Ian Starkey**  
Senior Statutory Auditor

For and on behalf of  
**KPMG LLP**  
Statutory Auditor

Chartered Accountants  
15 Canada Square  
London, E14 5GL  
18 February 2015

# FINANCIAL STATEMENTS



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#### Group accounting policies

Accounting policies are included within the relevant note to the Group accounts.

# GROUP ACCOUNTS

## PREPARATION

The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis, as discussed in the Corporate Governance Report on page 60, 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).

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.

### Principal accounting policies, judgements and estimates

The principal accounting policies applied in the preparation of these consolidated financial statements are set out in the relevant notes. These policies have been applied consistently to all the years presented, unless otherwise stated.

Certain of the Group's principal 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 critical accounting policies are listed below and explained in more detail in the relevant notes to the Group accounts:

Critical accounting policy	Description	Notes
<b>Revenue and profit recognition</b>		
		1
– The recognition of revenue and profit on long-term contracts.	<p>The majority of long-term contracts are accounted for under IAS 11, Construction Contracts. Revenue on long-term contracts is recognised when performance milestones have been completed.</p> <p>The ultimate profitability of long-term contracts 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.</p> <p>Revenue and cost estimates are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances.</p> <p>Profit is recognised progressively as risks have been mitigated or retired.</p>	
<b>Carrying value of intangible assets</b>		
		9
– The valuation of acquired intangible assets; and	<p>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 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.</p>	
– the determination of assumptions underpinning goodwill impairment testing.	<p>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 and the pre-tax discount rate used in discounting these projected cash flows.</p>	
<b>Valuation of retirement benefit obligations</b>		
		21
– The determination of assumptions underpinning the valuation of retirement benefit obligations for defined benefit pension schemes; and	<p>Pension scheme accounting valuations are prepared by independent actuaries. For each of the actuarial assumptions used to measure the Group's pension scheme liabilities, 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.</p>	
– the determination of the share of the pension deficit allocated to the Group's equity accounted investments and other participating employers.	<p>The Group has allocated a share of the pension deficit to its equity accounted investments and other participating employers using a consistent allocation method intended to reflect a reasonable approximation of their share of the deficit.</p>	

In addition to the critical accounting policies, the directors exercise judgement to determine the amount of tax provisions. Provision is made for known issues based on interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The resolution of tax positions taken by the Group can take a considerable period of time to conclude and, in some cases, it is difficult to predict the outcome. To the extent that the outcome differs from the estimates made, tax adjustments may be required in future periods.

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.



**PREPARATION** continued**Changes in accounting policies**

With effect from 1 January 2014, the Group has adopted the following new standards and amendments to existing standards:

- IFRS 10, Consolidated Financial Statements
- IFRS 11, Joint Arrangements
- IFRS 12, Disclosure of Interests in Other Entities
- IAS 27, Separate Financial Statements (revised 2011)
- IAS 28, Investments in Associates and Joint Ventures (revised 2011)

With the exception of new disclosure requirements, none of these have impacted the consolidated financial statements of the Group.

There are no other EU-endorsed IFRSs or IFRIC interpretations that are not yet effective that are expected to have a material impact on the Group.

IFRS 15, Revenue from Contracts with Customers, issued in May 2014, is not yet EU endorsed. Management is in the process of reviewing the impact that this will have on the Group.

IFRS 9, Financial Instruments, issued in July 2014, is not yet EU endorsed. It is not 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.

A subsidiary is an entity controlled by the Group. The Group controls a subsidiary when it is exposed, or has the rights, to variable returns from its involvement with the subsidiary and has the ability to affect those returns through its power over the subsidiary.

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.

Joint ventures are accounted for under the equity method where the Consolidated Income Statement includes the Group's share of their profits and losses, and the Consolidated Balance Sheet includes its share of their net assets within equity accounted investments.

The assets and liabilities of overseas subsidiaries and equity accounted investments are translated at the exchange rates ruling at the balance sheet date. The 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 in equity since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

# CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER

	Notes	2014		2013	
		£m	Total £m	£m	Total £m
<b>Continuing operations</b>					
<b>Combined sales of Group and share of equity accounted investments</b>	1	<b>16,637</b>		18,180	
Less: share of sales of equity accounted investments	1	<b>(1,207)</b>		(1,316)	
<b>Revenue</b>	1	<b>15,430</b>		16,864	
Operating costs	2	<b>(14,387)</b>		(16,297)	
Other income	4	<b>174</b>		128	
<b>Group operating profit</b>		<b>1,217</b>		695	
Share of results of equity accounted investments	1	<b>83</b>		111	
<i>Underlying EBITA<sup>1</sup></i>	1	<b>1,702</b>		1,925	
<i>Non-recurring items</i>	1	<b>-</b>		6	
<i>EBITA</i>		<b>1,702</b>		1,931	
<i>Amortisation of intangible assets</i>	1,9	<b>(184)</b>		(189)	
<i>Impairment of intangible assets</i>	9	<b>(170)</b>		(887)	
<i>Financial expense of equity accounted investments</i>	5	<b>(30)</b>		(8)	
<i>Taxation expense of equity accounted investments</i>		<b>(18)</b>		(41)	
<b>Operating profit</b>	1		<b>1,300</b>		806
<i>Financial income</i>		<b>241</b>		216	
<i>Financial expense</i>		<b>(659)</b>		(600)	
<b>Finance costs</b>	5		<b>(418)</b>		(384)
<b>Profit before taxation</b>			<b>882</b>		422
Taxation expense	6		<b>(130)</b>		(246)
<b>Profit for the year</b>			<b>752</b>		176
<b>Attributable to:</b>					
Equity shareholders			<b>740</b>		168
Non-controlling interests			<b>12</b>		8
			<b>752</b>		176
<b>Earnings per share</b>					
Basic earnings per share	8		<b>23.4p</b>		5.2p
Diluted earnings per share			<b>23.3p</b>		5.2p

1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

# CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER

	Notes	2014			2013		
		Other reserves <sup>1</sup> £m	Retained earnings £m	Total £m	Other reserves <sup>1</sup> £m	Retained earnings £m	Total £m
<b>Profit for the year</b>		-	<b>752</b>	<b>752</b>	-	176	176
<b>Other comprehensive income</b>							
<b>Items that will not be reclassified to the income statement:</b>							
Remeasurements on retirement benefit schemes:							
Subsidiaries		-	<b>(2,023)</b>	<b>(2,023)</b>	-	918	918
Equity accounted investments		-	<b>(73)</b>	<b>(73)</b>	-	8	8
Tax on items that will not be reclassified to the income statement	6	-	<b>503</b>	<b>503</b>	-	(421)	(421)
<b>Items that may be reclassified to the income statement:</b>							
Currency translation on foreign currency net investments:							
Subsidiaries		<b>251</b>	-	<b>251</b>	(246)	-	(246)
Equity accounted investments		<b>13</b>	-	<b>13</b>	(3)	-	(3)
Reclassification of cumulative currency translation reserve on disposal		-	-	-	(8)	-	(8)
Fair value gain on available-for-sale financial assets		-	<b>4</b>	<b>4</b>	-	-	-
Amounts (charged)/credited to hedging reserve	14	<b>(92)</b>	-	<b>(92)</b>	53	-	53
Tax on items that may be reclassified to the income statement	6	<b>19</b>	-	<b>19</b>	(14)	-	(14)
<b>Total other comprehensive income for the year (net of tax)</b>		<b>191</b>	<b>(1,589)</b>	<b>(1,398)</b>	(218)	505	287
<b>Total comprehensive income for the year</b>		<b>191</b>	<b>(837)</b>	<b>(646)</b>	(218)	681	463
<b>Attributable to:</b>							
Equity shareholders		<b>191</b>	<b>(849)</b>	<b>(658)</b>	(212)	673	461
Non-controlling interests		-	<b>12</b>	<b>12</b>	(6)	8	2
		<b>191</b>	<b>(837)</b>	<b>(646)</b>	(218)	681	463

1. An analysis of other reserves is provided in note 23.

# 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 <sup>1</sup> £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2014	89	1,249	4,868	(2,825)	3,381	37	3,418
Profit for the year	-	-	-	740	740	12	752
Total other comprehensive income for the year	-	-	191	(1,589)	(1,398)	-	(1,398)
Share-based payments	-	-	-	42	42	-	42
Net purchase of own shares	(2)	-	2	(281)	(281)	-	(281)
Ordinary share dividends	-	-	-	(642)	(642)	(14)	(656)
<b>At 31 December 2014</b>	<b>87</b>	<b>1,249</b>	<b>5,061</b>	<b>(4,555)</b>	<b>1,842</b>	<b>35</b>	<b>1,877</b>
At 1 January 2013	90	1,249	5,079	(2,698)	3,720	54	3,774
Profit for the year	-	-	-	168	168	8	176
Total other comprehensive income for the year	-	-	(212)	505	293	(6)	287
Share-based payments	-	-	-	49	49	-	49
Net purchase of own shares	(1)	-	1	(212)	(212)	-	(212)
Ordinary share dividends	-	-	-	(638)	(638)	(11)	(649)
Disposal of non-controlling interest	-	-	-	1	1	(8)	(7)
At 31 December 2013	89	1,249	4,868	(2,825)	3,381	37	3,418

1. An analysis of other reserves is provided in note 23.

# CONSOLIDATED BALANCE SHEET

## AS AT 31 DECEMBER

	Notes	2014 £m	2013 £m
<b>Non-current assets</b>			
Intangible assets	9	9,983	9,735
Property, plant and equipment	10	1,589	1,936
Investment property	11	129	135
Equity accounted investments	12	229	283
Other investments		7	3
Other receivables	13	347	321
Retirement benefit surpluses	21	162	156
Other financial assets	14	38	42
Deferred tax assets	15	1,327	901
		<b>13,811</b>	13,512
<b>Current assets</b>			
Inventories	16	690	680
Trade and other receivables including amounts due from customers for contract work	13	2,850	3,038
Current tax		7	8
Other financial assets	14	46	81
Cash and cash equivalents	17	2,308	2,222
Assets held for sale	7	76	140
		<b>5,977</b>	6,169
<b>Total assets</b>	18	<b>19,788</b>	19,681
<b>Non-current liabilities</b>			
Loans	19	(2,868)	(2,524)
Other payables	20	(932)	(1,160)
Retirement benefit obligations	21	(5,530)	(3,665)
Other financial liabilities	14	(79)	(59)
Deferred tax liabilities	15	(21)	(7)
Provisions	22	(436)	(403)
		<b>(9,866)</b>	(7,818)
<b>Current liabilities</b>			
Loans and overdrafts	19	(482)	(402)
Trade and other payables	20	(6,670)	(7,074)
Other financial liabilities	14	(107)	(81)
Current tax		(448)	(497)
Provisions	22	(315)	(391)
Liabilities held for sale	7	(23)	–
		<b>(8,045)</b>	(8,445)
<b>Total liabilities</b>		<b>(17,911)</b>	(16,263)
<b>Net assets</b>		<b>1,877</b>	3,418
<b>Capital and reserves</b>			
Issued share capital	23	87	89
Share premium		1,249	1,249
Other reserves	23	5,061	4,868
Retained earnings – deficit		(4,555)	(2,825)
<b>Total equity attributable to equity holders of the parent</b>		<b>1,842</b>	3,381
<b>Non-controlling interests</b>		<b>35</b>	37
<b>Total equity</b>		<b>1,877</b>	3,418

Approved by the Board on 18 February 2015 and signed on its behalf by:

I G King  
Chief Executive

P J Lynas  
Group Finance Director

# CONSOLIDATED CASH FLOW STATEMENT

## FOR THE YEAR ENDED 31 DECEMBER

	Notes	2014 £m	2013 £m
<b>Profit for the year</b>		<b>752</b>	176
Taxation expense	6	<b>130</b>	246
Share of results of equity accounted investments	1	<b>(83)</b>	(111)
Finance costs	5	<b>418</b>	384
Depreciation, amortisation and impairment	2	<b>657</b>	1,397
Profit on disposal of property, plant and equipment	2,4	<b>(20)</b>	(6)
Profit on disposal of investment property	2,4	<b>(12)</b>	(13)
Profit on disposal of businesses	2,4	<b>–</b>	(6)
Fair value gain	4	<b>(47)</b>	–
Cost of equity-settled employee share schemes		<b>42</b>	49
Movements in provisions		<b>(153)</b>	63
Decrease in liabilities for retirement benefit obligations		<b>(345)</b>	(337)
(Increase)/decrease in working capital:			
Inventories		<b>(1)</b>	(35)
Trade and other receivables		<b>197</b>	(275)
Trade and other payables		<b>(622)</b>	(1,327)
<b>Cash inflow from operating activities</b>		<b>913</b>	205
Interest paid		<b>(152)</b>	(177)
Taxation paid		<b>(92)</b>	(138)
<b>Net cash inflow/(outflow) from operating activities</b>		<b>669</b>	(110)
Dividends received from equity accounted investments	12	<b>63</b>	95
Interest received		<b>7</b>	11
Purchase of property, plant and equipment, and investment property		<b>(263)</b>	(236)
Purchase of intangible assets		<b>(59)</b>	(33)
Proceeds from sale of property, plant and equipment, and investment property		<b>539</b>	93
Proceeds from sale of intangible assets		<b>–</b>	28
Purchase of subsidiary undertakings	24	<b>(233)</b>	(1)
Cash and cash equivalents acquired from purchase of subsidiary undertakings	24	<b>3</b>	–
Equity accounted investment funding	12	<b>(2)</b>	(5)
Proceeds from sale of subsidiary undertakings (net of cash disposed)		<b>–</b>	5
<b>Net cash inflow/(outflow) from investing activities</b>		<b>55</b>	(43)
Net purchase of own shares		<b>(281)</b>	(212)
Equity dividends paid	23	<b>(642)</b>	(638)
Dividends paid to non-controlling interests		<b>(14)</b>	(11)
Cash inflow/(outflow) from matured derivative financial instruments		<b>8</b>	(47)
Cash inflow/(outflow) from movement in cash collateral		<b>10</b>	(10)
Cash inflow from loans		<b>679</b>	–
Cash outflow from repayment of loans		<b>(398)</b>	–
<b>Net cash outflow from financing activities</b>		<b>(638)</b>	(918)
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>86</b>	(1,071)
Cash and cash equivalents at 1 January		<b>2,222</b>	3,334
Effect of foreign exchange rate changes on cash and cash equivalents		<b>5</b>	(41)
<b>Cash and cash equivalents at 31 December</b>		<b>2,313</b>	2,222
Comprising:			
Cash and cash equivalents	17	<b>2,308</b>	2,222
Cash and cash equivalents (included within assets held for sale)	7	<b>6</b>	–
Overdrafts	19	<b>(1)</b>	–
<b>Cash and cash equivalents at 31 December</b>		<b>2,313</b>	2,222

# NOTES TO THE GROUP ACCOUNTS

## 1. SEGMENTAL ANALYSIS

### Revenue and profit recognition

Sales include the Group's 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.

### Research and development

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Where the research and development activity is performed on behalf of customers, the revenue arising is recognised in the income statement in accordance with the Group's revenue recognition policy.

### Key Performance Indicator – 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, underlying EBITA is disclosed on page 110 on a segmental basis and reconciled to the reporting segment result and operating profit in the consolidated financial statements.

### Non-recurring items

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. As part of a planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia and an enhancement of its existing relationship with Riyadh Wings Aviation Academy LLC (Riyadh Wings), BAE Systems has acquired an additional 59% shareholding in Saudi Development and Training Company (SDT) from Riyadh Wings and expects to complete the disposal of its 85.7% shareholding in Aircraft Accessories and Components Company (AACC) during 2015, subject to the satisfaction of certain regulatory approvals. Accordingly, AACC is presented as held for sale at 31 December 2014. Upon classification of AACC as held for sale, the carrying value of the business was in excess of the expected proceeds of the proposed disposal and, therefore, a charge of £47m has been taken in 2014. Upon acquisition of the additional shareholding in SDT and control of the company, the Group has recognised a £47m fair value gain on its existing 40% shareholding. The Group considers the combined impact of these two transactions in Saudi Arabia to meet its definition of non-recurring items, being profit/loss on business transactions, and, therefore, they have been presented within non-recurring items in the Group's income statement.

### Reporting segments

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 Applied Intelligence 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, and the US-based services and sustainment activities, including ship repair and munitions services;
- **Platforms & Services (UK)** comprises the Group's UK-based air, maritime, combat vehicle, munitions and shared services activities;
- **Platforms & Services (International)** comprises the Group's businesses in Saudi Arabia, Australia and Oman, together with its 37.5% interest in the pan-European MBDA joint venture; and
- **HQ** comprises the Group's business in India and head office activities, together with a 49% interest in Air Astana.

**1. SEGMENTAL ANALYSIS** continued

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 the Group and its share of equity accounted investments, and underlying EBITA. Finance costs and taxation expense are managed on a Group basis.

Following a restructuring of its US operations in 2014 to improve competitiveness, including reduced management and administrative overhead, some activities previously included in the Group's Platforms & Services (US) segment will, from 1 January 2015, be reported within the Cyber & Intelligence segment. Consistent with financial information regularly reviewed by the Group's Executive Committee, the impact of the restructuring on the Group's external reporting segments will be reflected in 2015 and comparatives for 2014 restated at that time.

**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	
	2014 £m	2013 <sup>1</sup> £m	2014 £m	2013 <sup>1</sup> £m	2014 £m	2013 <sup>1</sup> £m	2014 £m	2013 <sup>1</sup> £m
Electronic Systems	<b>2,415</b>	2,466	<b>(74)</b>	(61)	<b>74</b>	61	<b>2,415</b>	2,466
Cyber & Intelligence	<b>1,085</b>	1,243	-	-	-	-	<b>1,085</b>	1,243
Platforms & Services (US)	<b>3,266</b>	3,912	<b>(83)</b>	(68)	-	-	<b>3,183</b>	3,844
Platforms & Services (UK)	<b>6,623</b>	7,174	<b>(1,207)</b>	(1,176)	<b>1,104</b>	1,078	<b>6,520</b>	7,076
Platforms & Services (International)	<b>3,572</b>	4,063	<b>(793)</b>	(873)	-	-	<b>2,779</b>	3,190
HQ	<b>279</b>	306	<b>(279)</b>	(306)	-	-	-	-
	<b>17,240</b>	19,164	<b>(2,436)</b>	(2,484)	<b>1,178</b>	1,139	<b>15,982</b>	17,819
Intra-group sales/revenue	<b>(603)</b>	(984)	-	-	<b>51</b>	29	<b>(552)</b>	(955)
	<b>16,637</b>	18,180	<b>(2,436)</b>	(2,484)	<b>1,229</b>	1,168	<b>15,430</b>	16,864

	Intra-group revenue		Revenue from external customers	
	2014 £m	2013 <sup>1</sup> £m	2014 £m	2013 <sup>1</sup> £m
Electronic Systems	<b>104</b>	100	<b>2,311</b>	2,366
Cyber & Intelligence	<b>21</b>	21	<b>1,064</b>	1,222
Platforms & Services (US)	<b>40</b>	36	<b>3,143</b>	3,808
Platforms & Services (UK)	<b>381</b>	792	<b>6,139</b>	6,284
Platforms & Services (International)	<b>6</b>	6	<b>2,773</b>	3,184
	<b>552</b>	955	<b>15,430</b>	16,864

**Sales and revenue by customer location**

	Sales		Revenue	
	2014 £m	2013 £m	2014 £m	2013 £m
UK	<b>3,703</b>	3,678	<b>3,518</b>	3,515
Rest of Europe <sup>2</sup>	<b>2,215</b>	2,361	<b>1,514</b>	1,565
US	<b>5,979</b>	6,686	<b>5,978</b>	6,685
Canada	<b>51</b>	49	<b>51</b>	49
Saudi Arabia	<b>3,320</b>	3,556	<b>3,153</b>	3,430
Rest of Middle East	<b>154</b>	241	<b>124</b>	130
Australia	<b>682</b>	822	<b>680</b>	819
Rest of Asia and Pacific	<b>420</b>	616	<b>326</b>	516
Africa, and Central and South America	<b>113</b>	171	<b>86</b>	155
	<b>16,637</b>	18,180	<b>15,430</b>	16,864

**Revenue by category**

	2014 £m	2013 £m
Long-term contracts	<b>8,687</b>	9,618
Sale of goods	<b>3,211</b>	3,576
Provision of services	<b>3,518</b>	3,665
Royalty income	<b>14</b>	5
	<b>15,430</b>	16,864

1. Re-presented for the transfer of the UK Munitions business from Platforms & Services (US) to Platforms & Services (UK) from 1 January 2014.

2. Includes £1.1bn (2013 £1.0bn) generated under the Typhoon work share agreement with Eurofighter Jagdflugzeug GmbH.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 1. SEGMENTAL ANALYSIS continued

#### Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2014 £m	2013 £m
UK Ministry of Defence <sup>1</sup>	4,230	4,196
US Department of Defense	3,655	4,347
Kingdom of Saudi Arabia Ministry of Defence and Aviation	3,124	3,399

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 £1.1bn (2013 £1.0bn) generated under the Typhoon work share agreement with Eurofighter Jagdflugzeug GmbH.

#### Reporting segment result

	Underlying EBITA <sup>2</sup>		Non-recurring items <sup>4</sup>		Amortisation of intangible assets		Impairment of intangible assets		Reporting segment result	
	2014 £m	2013 <sup>3</sup> £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 <sup>3</sup> £m
Electronic Systems	373	346	–	–	(14)	(15)	(1)	(4)	358	327
Cyber & Intelligence	123	115	–	–	(58)	(63)	–	(425)	65	(373)
Platforms & Services (US)	147	229	–	7	(18)	(21)	(169)	(458)	(40)	(243)
Platforms & Services (UK)	772	915	–	–	(84)	(84)	–	–	688	831
Platforms & Services (International)	366	429	–	(1)	(10)	(6)	–	–	356	422
HQ <sup>5</sup>	(79)	(109)	–	–	–	–	–	–	(79)	(109)
	<b>1,702</b>	1,925	–	6	<b>(184)</b>	(189)	<b>(170)</b>	(887)	<b>1,348</b>	855
Financial expense of equity accounted investments									<b>(30)</b>	(8)
Taxation expense of equity accounted investments									<b>(18)</b>	(41)
<b>Operating profit</b>									<b>1,300</b>	806
Finance costs									<b>(418)</b>	(384)
<b>Profit before taxation</b>									<b>882</b>	422
Taxation expense									<b>(130)</b>	(246)
<b>Profit for the year</b>									<b>752</b>	176

#### Share of results of equity accounted investments within reporting segments

	2014 £m	2013 <sup>3</sup> £m
Underlying EBITA <sup>2</sup> :		
Electronic Systems	2	3
Platforms & Services (US)	12	5
Platforms & Services (UK)	21	15
Platforms & Services (International)	70	112
HQ	31	25
	<b>136</b>	160
Amortisation of intangible assets	<b>(5)</b>	–
Financial expense	<b>(30)</b>	(8)
Taxation expense	<b>(18)</b>	(41)
	<b>83</b>	111

2. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

3. Re-presented for the transfer of the UK Munitions business from Platforms & Services (US) to Platforms & Services (UK) from 1 January 2014.

4. In 2014, Platforms & Services (International) comprises a £47m gain upon acquisition of an additional 59% shareholding in Saudi Development and Training Company and control of the company, and a £47m charge against the carrying value of Aircraft Accessories and Components Company upon classification of the business as held for sale (see note 7).

5. In 2014, the HQ reporting segment includes a £30m benefit (2013 £nil) from re-assessment of a long-term liability. In 2013, there was a £32m charge in respect of a US contract pricing dispute.



**2. OPERATING COSTS****Leases**

Payments, including any incentives, made under operating leases are recognised in the income statement on a straight-line basis over the lease term.

Lease incentives granted are charged to the income statement over the term of the lease.

**Research and development**

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Group-funded expenditure on both research and development activities not meeting the conditions for capitalisation is written off as incurred and charged to the income statement.

Customer-funded expenditure on research and development activities is held in long-term contract balances as a contract cost within trade and other receivables and recognised in the income statement in accordance with the Group's revenue recognition policy.

	2014 £m	2013 £m
Raw materials, subcontracts and other bought-in items	6,114	6,205
Change in inventories of finished goods and work-in-progress	8	275
Cost of inventories expensed	6,122	6,480
Staff costs (note 3)	4,827	5,054
Depreciation, amortisation and impairment	657	1,397
Loss on disposal of property, plant and equipment, and investment property	1	9
Loss on disposal of businesses	-	4
Other operating charges	2,780	3,353
<b>Operating costs</b>	<b>14,387</b>	<b>16,297</b>

Included within the analysis of operating costs are the following expenses:

Lease and sublease expense	242	185
Research and development expense including amounts funded under contract	1,343	1,037 <sup>1</sup>

1. Restated.

**Fees payable to the Company's auditor and its associates included in operating costs**

	2014			2013		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
<b>Fees payable to the Company's auditor for the audit of the Company's annual accounts*</b>	1,669	-	1,669	1,621	-	1,621
<b>Fees payable to the Company's auditor and its associates for other services pursuant to legislation:</b>						
The audit of the Company's subsidiaries*	2,652	3,388	6,040	2,628	3,994	6,622
Interim review*	485	-	485	486	-	486
Other	200	2	202	41	2	43
<b>Audit-related assurance services:</b>						
Advice on accounting matters	9	2	11	9	1	10
<b>Tax compliance services</b>	7	637	644	76	512	588
<b>Tax advisory services</b>	59	141	200	63	185	248
<b>Corporate finance services:</b>						
M&A	-	-	-	108	-	108
<b>Other assurance services:</b>						
Due diligence	-	134	134	-	40	40
IT advisory	123	-	123	77	-	77
Financial model reviews	-	-	-	169	-	169
<b>Other non-audit services</b>	515	19	534	88	93	181
<b>Total fees payable to the Company's auditor and its associates</b>	<b>5,719</b>	<b>4,323</b>	<b>10,042</b>	<b>5,366</b>	<b>4,827</b>	<b>10,193</b>
*Total fees payable to the Company's auditor and its associates for audit services and interim review			8,194			8,729
<b>Fees in respect of BAE Systems pension schemes:</b>						
Audit	139	214	353	146	256	402
Tax compliance	44	-	44	47	6	53
Tax advisory	-	-	-	31	-	31
	<b>183</b>	<b>214</b>	<b>397</b>	<b>224</b>	<b>262</b>	<b>486</b>

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 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	
	2014 Number '000	2013 <sup>1</sup> Number '000	2014 Number '000	2013 <sup>1</sup> Number '000
Electronic Systems	12	12	12	12
Cyber & Intelligence	8	8	8	8
Platforms & Services (US)	17	19	16	18
Platforms & Services (UK)	29	29	29	29
Platforms & Services (International)	10	11	10	10
HQ	1	1	1	1
	<b>77</b>	80	<b>76</b>	78

1. Re-presented for the transfer of the UK Munitions business from Platforms & Services (US) to Platforms & Services (UK) from 1 January 2014.

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were as follows:

	2014 £m	2013 £m
Wages and salaries	4,184	4,367
Social security costs	334	352
Share-based payments (note 29)	14	21
Pension costs – defined contribution plans (note 21)	125	130
Pension costs – defined benefit plans (note 21)	169	183
US healthcare costs (note 21)	1	1
	<b>4,827</b>	5,054

### 4. OTHER INCOME

#### Rental income

Rental income is recognised in other income on a straight-line basis over the term of the relevant lease.

	2014 £m	2013 £m
Rental income from operating leases – investment property	21	21
Rental income from operating leases – other	20	20
Profit on disposal of property, plant and equipment	21	12
Profit on disposal of investment property	12	16
Profit on disposal of businesses	–	10
Fair value gain <sup>1</sup> (note 26)	47	–
Management recharges to equity accounted investments (note 30)	17	17
Other <sup>2</sup>	36	32
<b>Other income</b>	<b>174</b>	128

1. Fair value gain on the Group's existing 40% shareholding in Saudi Development and Training Company upon acquisition of an additional 59% and control of the company (see non-recurring items in note 1).
2. There are no individual amounts in excess of £10m.

**5. FINANCE COSTS****Interest income and borrowing costs**

Interest income and borrowing costs are recognised in the income statement in the period in which they are incurred.

	<b>2014</b>	2013
	<b>£m</b>	£m
Interest income	<b>28</b>	48
Gain on remeasurement of financial instruments at fair value through profit or loss	<b>99</b>	51
Foreign exchange gains	<b>114</b>	117
Financial income	<b>241</b>	216
Interest expense on bonds and other financial instruments	<b>(177)</b>	(197)
Facility fees	<b>(4)</b>	(11)
Net present value adjustments	<b>(48)</b>	(20)
Net interest expense on retirement benefit obligations (note 21)	<b>(147)</b>	(186)
Loss on remeasurement of financial instruments at fair value through profit or loss	<b>(75)</b>	(146)
Foreign exchange losses	<b>(208)</b>	(40)
Financial expense	<b>(659)</b>	(600)
<b>Finance costs</b>	<b>(418)</b>	(384)
<b>Additional analysis</b>		
	<b>2014</b>	2013
	<b>£m</b>	£m
Finance costs:		
Group	<b>(418)</b>	(384)
Share of equity accounted investments	<b>(30)</b>	(8)
	<b>(448)</b>	(392)
Analysed as:		
Underlying interest (expense)/income:		
Group	<b>(201)</b>	(180)
Share of equity accounted investments	<b>(3)</b>	1
	<b>(204)</b>	(179)
Other:		
Group:		
Net interest expense on retirement benefit obligations	<b>(147)</b>	(186)
Fair value and foreign exchange adjustments on financial instruments and investments	<b>(70)</b>	(18)
Share of equity accounted investments:		
Net interest expense on retirement benefit obligations	<b>(8)</b>	(9)
Fair value and foreign exchange adjustments on financial instruments and investments	<b>(19)</b>	–
	<b>(448)</b>	(392)

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 6. TAXATION EXPENSE

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

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.

#### Deferred tax

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.

#### Taxation expense

	2014 £m	2013 £m
<b>Current taxation</b>		
UK:		
Current tax	(90)	(179)
Double tax relief	1	1
Adjustment in respect of prior years	24	(16)
	<b>(65)</b>	(194)
Overseas:		
Current year	(56)	(106)
Adjustment in respect of prior years <sup>1</sup>	20	22
	<b>(36)</b>	(84)
	<b>(101)</b>	(278)
<b>Deferred taxation</b>		
UK:		
Origination and reversal of temporary differences	21	22
Adjustment in respect of prior years	8	25
Tax rate adjustment <sup>2</sup>	–	(8)
	<b>29</b>	39
Overseas:		
Origination and reversal of temporary differences	(67)	6
Adjustment in respect of prior years	9	(13)
	<b>(58)</b>	(7)
	<b>(29)</b>	32
<b>Taxation expense</b>	<b>(130)</b>	(246)
UK	<b>(36)</b>	(155)
Overseas	<b>(94)</b>	(91)
<b>Taxation expense</b>	<b>(130)</b>	(246)

1. 2014 includes a £51m credit in respect of the re-assessment of existing tax provisions. The complexity and duration of some of the Group's activities can result in delays in agreeing and closing certain tax positions. The Group continually updates its estimates for those positions whenever new information becomes available. The £51m credit relates to one such position in respect of an overseas issue where information received in the year enabled the estimate to be updated.
2. The UK current tax rate was reduced from 23% to 21% with effect from 1 April 2014, and will be reduced to 20% with effect from 1 April 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities was reduced from 23% to 20%, creating a rate adjustment in 2013, 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.

	2014 £m	2013 £m
<b>Profit before taxation</b>	<b>882</b>	422
UK corporation tax rate	<b>21.5%</b>	23.25%
Expected income tax expense	<b>(190)</b>	(98)
Effect of tax rates in foreign jurisdictions, including US state taxes	<b>(18)</b>	(24)
Expenses not tax effected	<b>(12)</b>	(9)
Income not subject to tax	<b>17</b>	17
Research and development tax credits and patent box benefits	<b>29</b>	39
Non-deductible goodwill impairment	<b>(35)</b>	(201)
Chargeable gains and non-taxable gains/non-deductible losses on disposal of businesses	–	(1)
Utilisation of previously unrecognised tax losses	<b>3</b>	5
Recoverable deferred tax asset previously unrecognised	–	5
Adjustments in respect of prior years <sup>1</sup>	<b>61</b>	18
Adjustments in respect of equity accounted investments	<b>18</b>	26
Tax rate adjustment <sup>2</sup>	–	(8)
Other	<b>(3)</b>	(15)
<b>Taxation expense</b>	<b>(130)</b>	(246)
<b>Calculation of the underlying effective tax rate</b>		
	<b>2014 £m</b>	2013 £m
Profit before taxation	<b>882</b>	422
Add back/(deduct):		
Taxation expense of equity accounted investments (note 1)	<b>18</b>	41
Non-recurring items (note 1)	–	(6)
Goodwill impairment (note 9)	<b>161</b>	865
	<b>1,061</b>	1,322
Taxation expense	<b>(130)</b>	(246)
Taxation expense of equity accounted investments (note 1)	<b>(18)</b>	(41)
Taxation expense (including equity accounted investments)	<b>(148)</b>	(287)
Exclude: Re-assessment of existing tax provisions <sup>1</sup>	<b>(51)</b>	–
<b>Underlying taxation expense (including equity accounted investments)</b>	<b>(199)</b>	(287)
<b>Underlying effective tax rate</b>	<b>19%</b>	22%

- 2014 includes a £51m credit in respect of the re-assessment of existing tax provisions. The complexity and duration of some of the Group's activities can result in delays in agreeing and closing certain tax positions. The Group continually updates its estimates for those positions whenever new information becomes available. The £51m credit relates to one such position in respect of an overseas issue where information received in the year enabled the estimate to be updated.
- The UK current tax rate was reduced from 23% to 21% with effect from 1 April 2014, and will be reduced to 20% with effect from 1 April 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities was reduced from 23% to 20%, creating a rate adjustment in 2013, which is partly reflected in the Consolidated Income Statement and partly in the Consolidated Statement of Comprehensive Income.

# NOTES TO THE GROUP ACCOUNTS CONTINUED

## 6. TAXATION EXPENSE continued

### Tax recognised in other comprehensive income

	2014			2013		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
<b>Items that will not be reclassified to the income statement:</b>						
Remeasurements on retirement benefit schemes:						
Subsidiaries	(2,023)	482	(1,541)	918	(323)	595
Equity accounted investments	(73)	16	(57)	8	(7)	1
Share-based payments	–	4	4	–	4	4
Other	–	1	1	–	1	1
Tax rate adjustment <sup>1</sup>	–	–	–	–	(96)	(96)
<b>Items that may be reclassified to the income statement:</b>						
Currency translation on foreign currency net investments:						
Subsidiaries	251	–	251	(246)	–	(246)
Equity accounted investments	13	–	13	(3)	–	(3)
Fair value gain on available-for-sale financial assets	4	–	4	–	–	–
Reclassification of cumulative currency translation reserve on disposal	–	–	–	(8)	–	(8)
Amounts (charged)/credited to hedging reserve	(92)	19	(73)	53	(14)	39
	<b>(1,920)</b>	<b>522</b>	<b>(1,398)</b>	722	(435)	287

	2014			2013		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
<b>Current tax</b>						
Financial instruments	–	–	–	1	–	1
Pensions	–	59	59	–	60	60
Other	–	1	1	–	2	2
	–	60	60	1	62	63
<b>Deferred tax</b>						
Subsidiaries	19	427	446	(15)	(380)	(395)
Tax rate adjustment <sup>1</sup>	–	–	–	–	(96)	(96)
Equity accounted investments – pensions	–	16	16	–	(7)	(7)
	19	443	462	(15)	(483)	(498)
<b>Tax on other comprehensive income</b>	<b>19</b>	<b>503</b>	<b>522</b>	(14)	(421)	(435)

1. The UK current tax rate was reduced from 23% to 21% with effect from 1 April 2014, and will be reduced to 20% with effect from 1 April 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities was reduced from 23% to 20%, creating a rate adjustment in 2013, which is partly reflected in the Consolidated Income Statement and partly in the Consolidated Statement of Comprehensive Income.

## 7. HELD FOR SALE

Held for sale comprises assets and liabilities that are expected to be recovered primarily through sale rather than continuing use. Assets and liabilities held for sale are measured at the lower of their carrying value and fair value less costs to sell.

In August, the Group announced an agreement for the proposed sale of its 75% holding in BAE Systems Land Systems South Africa (Pty) Limited (LSSA) for cash consideration of 641 million Rand (£36m), subject to closing adjustments. The proposed disposal, which is conditional upon receiving regulatory and other approvals, is expected to complete during 2015. Accordingly, LSSA is presented as held for sale at 31 December 2014.

As part of a planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia, BAE Systems expects to complete the disposal of its 85.7% shareholding in Aircraft Accessories and Components Company (AACC) during 2015, subject to the satisfaction of certain regulatory approvals. Accordingly, AACC is presented as held for sale at 31 December 2014.

	LSSA <sup>1</sup> £m	AACC £m	Total £m
Intangible assets (note 9)	19	–	19
Property, plant and equipment (note 10)	9	–	9
Inventories	7	11	18
Receivables	12	9	21
Deferred tax assets (note 15)	3	–	3
Cash and cash equivalents (note 17)	6	–	6
<b>Assets held for sale</b>	<b>56</b>	<b>20</b>	<b>76</b>
Payables	(9)	(8)	(17)
Deferred tax liabilities (note 15)	(2)	–	(2)
Provisions (note 22)	(4)	–	(4)
<b>Liabilities held for sale</b>	<b>(15)</b>	<b>(8)</b>	<b>(23)</b>

1. The carrying value of LSSA includes a non-controlling interest of £5m.

## 8. EARNINGS PER SHARE

### Key Performance Indicator – Underlying earnings per share

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.

	2014			2013		
	£m	Basic pence per share	Diluted pence per share	£m	Basic pence per share	Diluted pence per share
Profit for the year attributable to equity shareholders	740	23.4	23.3	168	5.2	5.2
(Deduct)/add back:						
Re-assessment of existing tax provisions	(51)			–		
Non-recurring items	–			(6)		
Net interest expense on retirement benefit obligations, post tax	126			153		
Fair value and foreign exchange adjustments on financial instruments and investments, post tax	72			14		
Amortisation and impairment of intangible assets, post tax	156			165		
Impairment of goodwill	161			865		
<b>Underlying earnings, post tax</b>	<b>1,204</b>	<b>38.0</b>	<b>37.9</b>	1,359	42.0	41.8
		Millions	Millions		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		3,165	3,165		3,234	3,234
Incremental shares in respect of employee share schemes			10			14
Weighted average number of shares used in calculating diluted earnings per share			3,175			3,248

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 9. INTANGIBLE ASSETS

Intangible assets are carried at cost or valuation, less accumulated amortisation and impairment losses.

#### Cost or valuation

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing. The Group's accounting policy on business combinations is included in note 26.

#### 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. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

#### Programme and customer-related

The most significant intangible assets recognised by the Group are in relation to ongoing programmes within businesses acquired, mainly in respect of customer relationships and order backlog.

#### Other intangible assets

Other intangible assets include:

- **Computer software licences acquired** 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;
- **Software development 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. Group-funded expenditure associated with enhancing or maintaining computer software programs for sale is recognised as an expense as incurred;
- **Research and development expenditure** funded by the Group 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; and
- **Patents, trademarks and licences.**

#### Amortisation

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of the intangible assets.

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.

The estimated useful lives are as follows:

<b>Programme and customer-related</b>	up to 15 years
<b>Other intangible assets:</b>	
Computer software licences acquired	2 to 5 years
Software development costs	2 to 5 years
Research and development expenditure	up to 10 years
Patents, trademarks and licences	up to 20 years
Other intangibles	up to 10 years

The Group has no indefinite life intangible assets other than goodwill.

#### Impairment of intangible assets, property, plant and equipment, investment property and equity accounted investments

The carrying amounts of the Group's intangible assets, property, plant and equipment, investment property and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, Impairment of Assets. If any such indication exists, the asset's recoverable amount is estimated. For intangible assets that are not yet available for use, impairment testing is performed annually.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

The recoverable amount is the greater of 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 flows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Impairment losses are recognised in the income statement.

An impairment loss in respect of goodwill is not reversed.

An impairment loss in respect of other intangible assets, property, plant and equipment, investment property and equity accounted investments is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised or 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.



**9. INTANGIBLE ASSETS** continued

	Goodwill £m	Programme and customer- related £m	Other £m	Total £m
<b>Cost or valuation</b>				
At 1 January 2013	13,358	1,859	551	15,768
Additions:				
Acquired separately	–	–	24	24
Internally developed	–	–	12	12
Disposals <sup>1</sup>	–	(95)	(62)	(157)
Business disposals	(25)	(6)	(16)	(47)
Foreign exchange adjustments	(153)	(29)	(5)	(187)
At 31 December 2013	13,180	1,729	504	15,413
Additions:				
Acquired separately	–	–	33	33
Internally developed	–	–	23	23
Business acquisitions (note 26)	208	51	30	289
Disposals <sup>1</sup>	–	(1,061)	(77)	(1,138)
Transfer to held for sale	(19)	–	(3)	(22)
Transfer from property, plant and equipment	–	–	9	9
Transfer from inventories	–	–	4	4
Foreign exchange adjustments	339	20	10	369
<b>At 31 December 2014</b>	<b>13,708</b>	<b>739</b>	<b>533</b>	<b>14,980</b>
<b>Amortisation and impairment</b>				
At 1 January 2013	2,992	1,485	363	4,840
Amortisation charge	–	141	48	189
Impairment charge	865	5	17	887
Disposals <sup>1</sup>	–	(95)	(34)	(129)
Business disposals	(20)	(6)	(12)	(38)
Foreign exchange adjustments	(38)	(28)	(5)	(71)
At 31 December 2013	3,799	1,502	377	5,678
Amortisation charge	–	142	37	179
Impairment charge	161	8	1	170
Disposals <sup>1</sup>	–	(1,061)	(77)	(1,138)
Transfer to held for sale	–	–	(3)	(3)
Foreign exchange adjustments	84	18	9	111
<b>At 31 December 2014</b>	<b>4,044</b>	<b>609</b>	<b>344</b>	<b>4,997</b>
<b>Net book value</b>				
<b>At 31 December 2014</b>	<b>9,664</b>	<b>130</b>	<b>189</b>	<b>9,983</b>
At 31 December 2013	9,381	227	127	9,735
At 1 January 2013	10,366	374	188	10,928

1. Includes intangible assets with nil net book value no longer used by the Group.

**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 7.12% (2013 7.96%) (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.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 9. INTANGIBLE ASSETS continued

#### Significant CGUs

Goodwill allocated to CGUs which are largely dependent on US government spending on defence, aerospace and security represents £7.3bn (2013 £7.1bn) of the Group's total goodwill balance. The Group monitors changes in defence budgets on an ongoing basis.

Cash-Generating Unit	Key assumptions	Allocated goodwill		Pre-tax discount rate	
		2014 £bn	2013 <sup>1</sup> £bn	2014 %	2013 %
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	3.2	3.1	9.4	10.8
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	1.0	0.9	9.4	10.8
Land & Armaments (within Platforms & Services (US))	Continued demand in the Group's principal markets for existing and successor military tracked vehicles, naval guns, missile launchers, artillery systems, munitions, upgrade programmes and support	2.2	2.2	8.8	9.6
Support Solutions (within Platforms & Services (US))	Continued demand in the US for complex infrastructure, maritime and aviation services, and operations support	0.9	0.9	9.3	10.8

1. Re-presented for the transfer of the UK Munitions business from Land & Armaments (within Platforms & Services (US)) to Platforms & Services (UK) from 1 January 2014.

The final year growth rate assumption in the value-in-use calculations is in the range 1% to 2%.

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2014 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 terminal value growth rate assumption and a 1% increase in the discount rate used in the value-in-use calculations.

Cash-Generating Unit	Headroom as at 31 December		Headroom assuming a 1% reduction in the terminal value growth rate assumption		Headroom assuming a 1% increase in the discount rate	
	2014 £bn	2013 £bn	2014 £bn	2013 £bn	2014 £bn	2013 £bn
Electronic Systems	1.6	0.3	0.8	(0.2)	0.6	(0.3)
Intelligence & Security	0.1	–	(0.1)	(0.1)	(0.1)	(0.2)
Land & Armaments	0.5	–	–	(0.3)	(0.1)	(0.4)
Support Solutions	–	0.2	(0.2)	–	(0.2)	(0.1)

#### Other CGUs

The remaining goodwill balance of £2.4bn (2013 £2.3bn) is allocated across multiple CGUs, including £0.5bn (2013 £0.5bn) in the Applied Intelligence CGU, with no individual CGU exceeding 10% 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 Applied Intelligence, the future cash flow projections are based on the expectation of growth in cyber and intelligence, in the UK and overseas government markets, together with increasing demand for products and services in commercial markets.

#### Impairment – goodwill

In 2014, the impairment charge of £161m comprises the Support Solutions CGU (£87m), reflecting performance issues at the US commercial shipbuilding business, and the Land & Armaments CGU (£74m), reflecting the agreement to sell the Group's 75% holding in BAE Systems Land Systems South Africa (Pty) Limited at a price below its total carrying value.

In 2013, the impairment charge of £865m comprised the US Intelligence & Security (£417m) and Land & Armaments (£448m) CGUs.

#### Impairment – intangible assets

In 2014, the impairment charge of £9m relates to the Electronic Systems (£1m) and Platforms & Services (US) (£8m) reporting segments.

In 2013, the impairment charge of £22m related to the Electronic Systems (£4m), Cyber & Intelligence (£8m) and Platforms & Services (US) (£10m) reporting segments.

**10. PROPERTY, PLANT AND EQUIPMENT**

**Cost**

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. The cost of demonstration assets is written off as incurred.

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and impairment losses.

**Depreciation**

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:

<b>Buildings</b>	up to 50 years, or the lease term if shorter
<b>Plant and machinery:</b>	
Computing equipment and motor vehicles	4 to 5 years
Other equipment	10 to 20 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.

**Impairment**

The carrying amounts of the Group’s property, plant and equipment are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 9.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 10. PROPERTY, PLANT AND EQUIPMENT continued

	Land and buildings £m	Plant and machinery £m	Total £m
<b>Cost</b>			
At 1 January 2013	2,385	2,724	5,109
Additions	66	147	213
Business acquisitions	1	–	1
Transfer to investment property	(22)	–	(22)
Transfer to held for sale <sup>1</sup>	(215)	–	(215)
Transfer from held for sale <sup>2</sup>	4	86	90
Reclassification between categories	18	(18)	–
Disposals	(68)	(157)	(225)
Business disposals	(9)	(5)	(14)
Foreign exchange adjustments	(57)	(42)	(99)
At 31 December 2013	2,103	2,735	4,838
Additions	55	208	263
Business acquisitions (note 26)	–	7	7
Transfer from long-term contract balances	–	21	21
Transfer to other intangible assets	–	(9)	(9)
Transfer to held for sale	(11)	(24)	(35)
Disposals	(463)	(244)	(707)
Foreign exchange adjustments	38	59	97
<b>At 31 December 2014</b>	<b>1,722</b>	<b>2,753</b>	<b>4,475</b>
<b>Depreciation and impairment</b>			
At 1 January 2013	951	1,873	2,824
Depreciation charge for the year	131	173	304
Impairment charge for the year	9	4	13
Transfer to investment property	(11)	–	(11)
Transfer to held for sale <sup>1</sup>	(75)	–	(75)
Transfer from held for sale <sup>2</sup>	4	86	90
Disposals	(33)	(149)	(182)
Business disposals	(6)	(4)	(10)
Foreign exchange adjustments	(24)	(27)	(51)
At 31 December 2013	946	1,956	2,902
Depreciation charge for the year	91	157	248
Impairment charge for the year	48	8	56
Transfer from provisions	10	–	10
Transfer to held for sale	(6)	(20)	(26)
Disposals	(145)	(220)	(365)
Foreign exchange adjustments	19	42	61
<b>At 31 December 2014</b>	<b>963</b>	<b>1,923</b>	<b>2,886</b>
<b>Net book value</b>			
<b>At 31 December 2014</b>	<b>759</b>	<b>830</b>	<b>1,589</b>
At 31 December 2013	1,157	779	1,936
At 1 January 2013	1,434	851	2,285

1. Represents a residential and office facility in Saudi Arabia (net book value £140m). A sale and leaseback transaction was completed in January 2014.

2. Represents the property, plant and equipment of the Regional Aircraft Support & Engineering business, which was reclassified from held for sale in 2013 (net book value £nil).

**10. PROPERTY, PLANT AND EQUIPMENT** continued**Net book value**

	Land and buildings £m	Plant and machinery £m	Total £m
Freehold property	612	–	612
Long leasehold property	23	–	23
Short leasehold property	124	–	124
Plant and machinery	–	732	732
Fixtures, fittings and equipment	–	98	98
<b>At 31 December 2014</b>	<b>759</b>	<b>830</b>	<b>1,589</b>

**Impairment**

	2014 £m	2013 £m
Electronic Systems	–	2
Platforms & Services (US)	1	9
Platforms & Services (UK)	4	2
Platforms & Services (International)	51	–
	<b>56</b>	13

**2014**

The impairment in Platforms & Services (International) includes the charge against the carrying value of AACC upon classification of the business as held for sale (see note 7).

**2013**

The Platforms & Services (US) impairment of £9m mainly reflected a charge in respect of the carrying value of land and buildings at the Sealy, Texas, facility due to its closure in 2014.

**Assets in the course of construction**

	Land and buildings £m	Plant and machinery £m	Total £m
<b>At 31 December 2014</b>	<b>36</b>	<b>154</b>	<b>190</b>
At 31 December 2013	33	94	127

**Operating leases**

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (see note 11)) are as follows:

	2014 £m	2013 £m
Receipts due:		
Not later than one year	23	23
Later than one year and not later than five years	84	87
Later than five years	99	118
	<b>206</b>	228

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.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 11. INVESTMENT PROPERTY

#### Cost

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 impairment losses.

#### Depreciation

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.

#### Impairment

The carrying amounts of the Group's investment property are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 9.

	£m
<b>Cost</b>	
At 1 January 2013	171
Additions	24
Transfer from property, plant and equipment	22
Disposals	(18)
At 31 December 2013	199
Additions	8
Disposals	(21)
<b>At 31 December 2014</b>	<b>186</b>
<b>Depreciation and impairment</b>	
At 1 January 2013	49
Depreciation charge for the year	4
Transfer from property, plant and equipment	11
At 31 December 2013	64
Depreciation charge for the year	4
Disposals	(11)
<b>At 31 December 2014</b>	<b>57</b>
<b>Net book value</b>	
<b>At 31 December 2014</b>	<b>129</b>
At 31 December 2013	135
At 1 January 2013	122
<b>Fair value</b>	
<b>At 31 December 2014</b>	<b>226</b>
At 31 December 2013	263

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.

## 12. EQUITY ACCOUNTED INVESTMENTS

A joint venture is a joint arrangement whereby the parties that have joint control have rights to the net assets of the arrangement.

### Carrying value

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 carrying amounts of the Group's equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 9.

### 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
Air Astana (Held by BAE Systems (Kazakhstan) Limited)	Carriage by air of passengers and cargo	49% common	Kazakhstan	Kazakhstan

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<sup>1</sup> or that represent a significant proportion of the total carrying value of equity accounted investments. A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2014 will be annexed to the Company's next annual return filed with the Registrar of Companies.

The following tables summarise the financial information of the Group's principal equity accounted investments included in their own financial statements, as adjusted for fair value adjustments at acquisition and differences in accounting policies, and reconcile this to the Group's interest in those equity accounted investments.

	2014			2013		
	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m
<b>Revenue (100%)</b>	<b>3,281</b>	<b>1,929</b>	<b>570</b>	3,166	2,402	625
EBITA <sup>1</sup> excluding depreciation	46	215	91	37	354	63
Depreciation and amortisation	–	(54)	(28)	(1)	(65)	(12)
Financial income	2	68	–	2	65	1
Financial expense	(1)	(79)	(44)	–	(77)	(4)
Taxation expense	(13)	(19)	(6)	(11)	(85)	(11)
<b>Profit for the year (100%)</b>	<b>34</b>	<b>131</b>	<b>13</b>	27	192	37
Remeasurements on retirement benefit schemes, net of tax	–	(151)	–	19	(16)	–
Foreign exchange adjustments	–	(6)	(29)	–	(1)	(4)
<b>Total comprehensive income for the year (100%)</b>	<b>34</b>	<b>(26)</b>	<b>(16)</b>	46	175	33
Group's share of total comprehensive income for the year before elimination of unrealised profit	11	(10)	(8)	15	66	16
Elimination of unrealised profit	–	(4)	–	–	–	–
<b>Group's share of total comprehensive income for the year</b>	<b>11</b>	<b>(14)</b>	<b>(8)</b>	15	66	16
Non-current assets	9	1,507	358	10	1,501	353
Cash and cash equivalents	6	1,182	16	–	1,260	9
Current assets excluding cash and cash equivalents	1,102	2,940	194	1,413	2,947	174
Current assets	1,108	4,122	210	1,413	4,207	183
Non-current financial liabilities excluding trade and other payables, and provisions	–	(10)	(267)	–	(12)	(221)
Other non-current liabilities	(18)	(903)	–	(17)	(771)	–
Non-current liabilities	(18)	(913)	(267)	(17)	(783)	(221)
Current financial liabilities excluding trade and other payables, and provisions	(4)	(20)	(26)	(4)	(11)	(23)
Other current liabilities	(1,062)	(4,580)	(103)	(1,382)	(4,649)	(109)
Current liabilities	(1,066)	(4,600)	(129)	(1,386)	(4,660)	(132)
<b>Net assets (100%)</b>	<b>33</b>	<b>116</b>	<b>172</b>	20	265	183

1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 12. EQUITY ACCOUNTED INVESTMENTS continued

	2014			2013		
	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m
Group's share of net assets	11	43	84	7	99	90
Elimination of unrealised profit	–	(4)	–	–	–	–
Goodwill	–	15	–	–	18	–
<b>Carrying value</b>	<b>11</b>	<b>54</b>	<b>84</b>	<b>7</b>	<b>117</b>	<b>90</b>

	2014			2013		
	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m
<b>Dividends received</b>	<b>6</b>	<b>44</b>	<b>3</b>	<b>9</b>	<b>33</b>	<b>7</b>

#### Group summary

The Group also has a number of individually immaterial joint ventures. The following table shows a reconciliation of opening to closing carrying value for both the Group's principal and immaterial joint ventures in aggregate.

	Eurofighter Jagdflugzeug, MBDA and Air Astana £m	Other £m	Total £m
At 1 January 2013	165	100	265
Group's share of profit for the year	98	13	111
Group's share of remeasurements on retirement benefit schemes	8	–	8
Tax on items that will not be reclassified to the income statement	(7)	–	(7)
Foreign exchange adjustments	(2)	–	(2)
Group's share of total comprehensive income for the year	97	13	110
Equity accounted investment funding	–	5	5
Dividends received from equity accounted investments	(49)	(46)	(95)
Business disposals	–	(1)	(1)
Foreign exchange adjustments	1	(2)	(1)
At 31 December 2013	214	69	283
Group's share of profit for the year	67	16	83
Group's share of remeasurements on retirement benefit schemes	(73)	–	(73)
Tax on items that will not be reclassified to the income statement	16	–	16
Foreign exchange adjustments	(17)	1	(16)
Elimination of unrealised profit	(4)	–	(4)
Group's share of total comprehensive income for the year	(11)	17	6
Equity accounted investment funding	–	2	2
Dividends received from equity accounted investments	(53)	(10)	(63)
Business disposals (note 26)	–	(2)	(2)
Foreign exchange adjustments	(1)	4	3
<b>At 31 December 2014</b>	<b>149</b>	<b>80</b>	<b>229</b>

#### Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.



### 13. TRADE AND OTHER RECEIVABLES

Trade and other receivables are stated at their cost less provision for bad debts. A provision for bad debt 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.

A loss on provision for bad debt 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 includes long-term contract balances and amounts due from contract customers, less attributable progress payments.

Long-term contract balances are stated at cost less provision for any anticipated losses. 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 long-term contract balances for that portion of the work which has already been completed, and the remainder is included as amounts due to long-term contract customers within trade and other payables. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

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 Group performance, as cash received on customers' account.

Amounts due from contract customers represent unbilled income and are stated at cost, plus attributable profit.

	2014 £m	2013 £m
<b>Non-current</b>		
Prepayments and accrued income <sup>1</sup>	85	62
US deferred compensation plan assets	238	211
Other receivables	24	48
	<b>347</b>	321
<b>Current</b>		
Long-term contract balances	6,183	6,085
Less: Attributable progress payments	(5,341)	(5,526)
Amounts due from contract customers	476	843
Amounts due from customers for contract work <sup>2</sup>	1,318	1,402
Trade receivables	935	1,138
Amounts owed by equity accounted investments (note 30)	92	56
Prepayments and accrued income <sup>1</sup>	251	232
Other receivables	254	210
	<b>2,850</b>	3,038

1. Includes £51m (2013 £56m) non-current and £22m (2013 £39m) current receivable in respect of a UK Ministry of Defence settlement agreement relating to maritime rationalisation costs charged to the income statement in 2013.

2. There are no retentions against long-term contracts (2013 £nil) and no amounts that are past due within amounts due from customers for contract work (2013 £nil).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2014 are estimated to be £30.2bn (2013 £31.7bn).

Trade receivables are disclosed net of a provision for bad debts. Disclosures relating to the ageing of trade receivables and movements in the provision for bad debts are provided in note 28.

Other receivables do not contain assets which are considered to be impaired.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 14. OTHER FINANCIAL ASSETS AND LIABILITIES

#### 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.

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.

	2014 Assets £m	2014 Liabilities £m	2013 Assets £m	2013 Liabilities £m
<b>Non-current</b>				
Cash flow hedges – foreign exchange contracts	28	(79)	42	(55)
Other foreign exchange/interest rate contracts	–	–	–	(4)
Debt-related derivative financial instruments – assets <sup>1</sup>	10	–	–	–
	<b>38</b>	<b>(79)</b>	42	(59)
<b>Current</b>				
Cash flow hedges – foreign exchange contracts	41	(97)	60	(59)
Other foreign exchange/interest rate contracts	5	(10)	15	(22)
Debt-related derivative financial instruments – assets <sup>1</sup>	–	–	6	–
	<b>46</b>	<b>(107)</b>	81	(81)

1. Includes fair value hedges of £4m (2013 £6m).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (see note 19).

#### 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 charged to the hedging reserve in respect of cash flow hedges were £92m (2013 credited £53m), including a £1m credit on reclassification to profit and loss on maturity and a £93m charge on contracts held at 31 December 2014.

#### Fair value hedges

The loss arising in the income statement on fair value hedging instruments was £2m (2013 £7m). The loss arising in the income statement on the fair value of the underlying hedged items was £1m (2013 gain £7m). The ineffective portion recognised in the income statement arising from fair value hedges was £3m (2013 £nil).

**15. DEFERRED TAX**

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.

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.

**Deferred tax assets/(liabilities)**

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Property, plant and equipment	15	20	(93)	(82)	(78)	(62)
Intangible assets	4	–	(39)	(45)	(35)	(45)
Provisions and accruals	287	308	–	–	287	308
Goodwill	–	–	(273)	(221)	(273)	(221)
Pension/retirement schemes:						
Deficits	1,154	692	–	–	1,154	692
Additional contributions and other <sup>1</sup>	121	124	–	–	121	124
Share-based payments	21	19	–	–	21	19
Financial instruments	26	7	(5)	(6)	21	1
Other items	66	59	–	–	66	59
Rolled over capital gains	–	–	(13)	(13)	(13)	(13)
Capital losses carried forward	13	13	–	–	13	13
Trading losses carried forward	22	19	–	–	22	19
<b>Deferred tax assets/(liabilities)</b>	<b>1,729</b>	<b>1,261</b>	<b>(423)</b>	<b>(367)</b>	<b>1,306</b>	<b>894</b>
Set off of tax	(402)	(360)	402	360	–	–
<b>Net deferred tax assets/(liabilities)</b>	<b>1,327</b>	<b>901</b>	<b>(21)</b>	<b>(7)</b>	<b>1,306</b>	<b>894</b>

1. Includes deferred tax assets on US deferred compensation plans.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 15. DEFERRED TAX continued

#### Movement in temporary differences during the year

	At 1 January 2014 £m	Foreign exchange adjustments £m	Acquisitions and disposals <sup>1</sup> £m	Recognised in income £m	Recognised in equity £m	At 31 December 2014 £m
Property, plant and equipment	(62)	(6)	–	(10)	–	<b>(78)</b>
Intangible assets	(45)	1	(29)	38	–	<b>(35)</b>
Provisions and accruals	308	13	(2)	(32)	–	<b>287</b>
Goodwill	(221)	(15)	–	(37)	–	<b>(273)</b>
Pension/retirement schemes:						
Deficits	692	15	–	12	435	<b>1,154</b>
Additional contributions and other <sup>2</sup>	124	7	–	2	(12)	<b>121</b>
Share-based payments	19	–	–	(2)	4	<b>21</b>
Financial instruments	1	–	–	1	19	<b>21</b>
Other items	59	(3)	–	10	–	<b>66</b>
Rolled over capital gains	(13)	–	–	–	–	<b>(13)</b>
Capital losses carried forward	13	–	–	–	–	<b>13</b>
Trading losses carried forward	19	1	13	(11)	–	<b>22</b>
	<b>894</b>	<b>13</b>	<b>(18)</b>	<b>(29)</b>	<b>446</b>	<b>1,306</b>

	At 1 January 2013 £m	Foreign exchange adjustments £m	Acquisitions and disposals £m	Recognised in income £m	Recognised in equity £m	At 31 December 2013 £m
Property, plant and equipment	(81)	1	(1)	19	–	(62)
Intangible assets	(91)	(1)	–	44	3	(45)
Provisions and accruals	317	(11)	(1)	3	–	308
Goodwill	(186)	6	–	(41)	–	(221)
Pension/retirement schemes:						
Deficits	1,144	8	–	5	(465)	692
Additional contributions and other <sup>2</sup>	137	(2)	–	6	(17)	124
Share-based payments	16	–	–	–	3	19
Financial instruments	8	–	–	8	(15)	1
Other items	62	(4)	–	1	–	59
Rolled over capital gains	(15)	–	–	2	–	(13)
Capital losses carried forward	15	–	–	(2)	–	13
Trading losses carried forward	36	(4)	–	(13)	–	19
	<b>1,362</b>	<b>(7)</b>	<b>(2)</b>	<b>32</b>	<b>(491)</b>	<b>894</b>

1. Includes net deferred tax liabilities on acquisition of subsidiaries (£17m) (see note 26) and the transfer of net deferred tax assets to held for sale (£1m) (see note 7).

2. Includes deferred tax assets on US deferred compensation plans.

#### Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2014 £m	2013 £m
Deductible temporary differences, including tax credits	<b>2</b>	1
Capital losses carried forward	<b>38</b>	36
Trading and other losses carried forward	<b>62</b>	62
	<b>102</b>	99

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be accurately predicted at this time.

#### Future changes in tax rates

Under the Finance Act 2013, the UK current tax rate reduced from 23% to 21% with effect from 1 April 2014, and will then reduce to 20% with effect from 1 April 2015. This will reduce future current tax charges accordingly.

The reduction from 23% to 20% was substantively enacted before 31 December 2013. In line with this change, the rate applying to UK deferred tax assets and liabilities was reduced from 23% to 20%, creating a rate adjustment in 2013, which was 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 2013 were calculated at 20% and this rate continues to apply as at 31 December 2014.

**16. INVENTORIES**

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

	2014 £m	2013 £m
Short-term work-in-progress	439	381
Raw materials and consumables	189	227
Finished goods and goods for resale	62	72
	<b>690</b>	680

The Group recognised £4m (2013 £4m) as a write down of inventories to net realisable value.

**17. CASH AND CASH EQUIVALENTS**

Cash and cash equivalents includes cash in hand, call and term 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.

	2014 £m	2013 £m
Cash	537	460
Short-term deposits	1,777	1,762
	<b>2,314</b>	2,222
Less: Cash and cash equivalents (included within assets held for sale) (note 7)	(6)	–
	<b>2,308</b>	2,222

**18. GEOGRAPHICAL ANALYSIS OF ASSETS****Analysis of non-current assets by geographical location**

Asset location	Notes	2014 £m	2013 £m
UK		2,505	2,705
Rest of Europe		546	667
US		8,444	8,078
Saudi Arabia		316	453
Australia		469	494
Rest of Asia and Pacific		2	1
Africa, and Central and South America		2	15
<b>Non-current segment assets</b>		<b>12,284</b>	12,413
Other financial assets	14	74	117
Inventories	16	690	680
Current trade and other receivables	13	2,850	3,038
<b>Total segment assets</b>		<b>15,898</b>	16,248
Retirement benefit surpluses	21	162	156
Tax		1,334	909
Cash (as defined by the Group) <sup>1</sup>	25	2,318	2,228
Assets held for sale	7	76	140
<b>Consolidated total assets</b>		<b>19,788</b>	19,681

1. Includes cash and cash equivalents (note 17) and debt-related derivative financial instrument assets (note 14).

## NOTES TO THE GROUP ACCOUNTS CONTINUED

### 19. 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 either amortised cost or, where hedge accounting has been adopted, fair value in respect of the hedged risk. Any difference between the amount initially recognised and the redemption value is recognised in the income statement over the period of the borrowings on an effective interest basis.

	2014 £m	2013 £m
<b>Non-current</b>		
US\$750m 5.2% bond, repayable 2015	–	453
US\$350m 3.5% bond, repayable 2016	224	211
Albertville Hangar bond, repayable 2018	6	6
US\$1bn 6.375% bond, repayable 2019	642	607
US\$500m 4.75% bond, repayable 2021	320	301
£400m 4.125% bond, repayable 2022	398	397
US\$800m 3.8% bond, repayable 2024	514	–
US\$500m 7.5% bond, repayable 2027	319	299
US\$400m 5.8% bond, repayable 2041	254	238
US\$300m 4.75% bond, repayable 2044	190	–
Debt-related derivative financial instruments – liabilities	1	12
	<b>2,868</b>	2,524
<b>Current</b>		
Euro-Sterling £100m 10¾% bond, repayable 2014	–	100
US\$500m 4.95% bond, repayable 2014	–	302
US\$750m 5.2% bond, repayable 2015	481	–
Overdrafts	1	–
	<b>482</b>	402

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 June 2019 and give an effective rate during 2014 of 4.8%.

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 7.7%.

On 7 October, BAE Systems issued US\$800m of 3.8% fixed rate debt maturing in October 2024 and US\$300m of 4.75% fixed rate debt maturing in October 2044. Subsequently, the Group entered into interest rate derivatives to swap US\$500m of the ten-year fixed rate debt into a floating rate to October 2019. The swaps are at an average rate of LIBOR +1.9% for each three-month period and the initial fixing was at 2.1% inclusive of LIBOR, giving an effective rate during 2014 of 2.8%. US\$500m of the US\$800m bond is measured at fair value.

The debt-related derivative financial instruments represent the fair value of interest rate and cross-currency derivatives relating to the US\$500m 7.5% bond, repayable 2027, and the US\$800m 3.8% bond, repayable 2024. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk. Debt-related derivative financial liabilities are presented within loans and overdrafts above and debt-related derivative financial assets are presented within other financial assets (see note 14).

**20. TRADE AND OTHER PAYABLES**

Trade and other payables are stated at their cost.

	<b>2014</b> £m	2013 £m
<b>Non-current</b>		
Amounts due to long-term contract customers	<b>404</b>	699
Amounts owed to equity accounted investments (note 30)	<b>40</b>	–
Accruals and deferred income	<b>45</b>	39
US deferred compensation plan liabilities	<b>262</b>	237
Other payables	<b>181</b>	185
	<b>932</b>	1,160
<b>Current</b>		
Amounts due to long-term contract customers	<b>3,713</b>	4,023
Amounts due to other customers	<b>285</b>	232
Cash received on customers' account <sup>1</sup>	–	1
Trade payables	<b>599</b>	651
Amounts owed to equity accounted investments (note 30)	<b>454</b>	563
Other taxes and social security costs	<b>76</b>	82
Accruals and deferred income	<b>1,181</b>	1,019
Other payables	<b>362</b>	503
	<b>6,670</b>	7,074
Included above:		
Amounts due to long-term contract customers, including contract losses	<b>4,117</b>	4,722
Advances from long-term contract customers	<b>3,935</b>	4,498

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.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 21. RETIREMENT BENEFIT OBLIGATIONS

#### Defined contribution pension schemes

Obligations for contributions are recognised as an expense in the income statement as incurred.

#### Defined benefit pension 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. Remeasurements, including actuarial gains and losses, are recognised in the Consolidated Statement of Comprehensive Income in the period in which they occur. Past service costs resulting from a plan amendment or curtailment are recognised immediately in the income statement.

The retirement benefit obligation recognised in the Group's balance sheet represents the present value of the defined benefit obligations calculated using a number of actuarial assumptions as set out on page 136 reduced by the fair value of scheme assets.

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 a share of the IAS 19, Employee Benefits, pension deficit to its equity accounted investments and other participating employers using a consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The deficit allocation method for all schemes is based on the BAE Systems Pension Scheme's (Main Scheme) schedule of contributions agreed with the sponsoring employers and trustees as part of the triennial funding valuations performed in 2014. Following the completion of the triennial funding valuations, there will be discussions between the participating employers on the allocation of the deficit and the outcome of those discussions will be reflected in the allocation of the IAS 19 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.

#### Pension schemes

##### Background

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 two largest funded defined benefit schemes are the Main Scheme and the BAE Systems 2000 Pension Plan (2000 Plan) which, in aggregate, represent 71% (2013 72%) of the total IAS 19 defined benefit obligation at 31 December 2014. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2014, the weighted average durations of the UK and US defined benefit pension obligations were 19 years (2013 18 years) and 12 years (2013 12 years), respectively.

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the Main Scheme, 2000 Plan and US schemes in aggregate is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme <sup>1</sup>	32	19	49
2000 Plan <sup>2</sup>	14	29	57
US schemes <sup>3</sup>	35	18	47

1. Source: Main Scheme actuarial valuation report as at 31 March 2014.

2. Source: 2000 Plan actuarial valuation report as at 31 March 2014.

3. Source: Annual updates of the US schemes as at 1 January 2014.

##### Regulatory framework

The funded UK schemes are registered and subject to the statutory scheme specific-funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and the Group.

The funded US schemes are tax-qualified pension schemes regulated by the Pension Protection Act 2006 and insured by the Pension Benefit Guarantee Corporation (PBGC) up to certain limits. These schemes were established under and are governed by the US Employee Retirement Income Security Act 1974 and the BAE Systems Administrative Committee is a named fiduciary with the authority to manage their operation.

##### Benefits

The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The Normal Retirement Age for active members of the Main Scheme and 2000 Plan is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: [www.baesystemspensions.com](http://www.baesystemspensions.com).

The US defined benefit schemes ceased to be final salary schemes in January 2013. The benefits accrued based on the final salaries of members at that point will become payable on retirement. The Normal Retirement Age for the largest scheme in the US is 65.



**21. RETIREMENT BENEFIT OBLIGATIONS** continued**Funding**

The majority of the UK and US defined benefit pension schemes are funded by the Group's subsidiaries, equity accounted investments and other participating employers. The individual pension schemes' funding requirements are based on actuarial measurement frameworks set out in their funding policies.

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

The separate actuarial valuations for funding purposes include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 136. The latest valuations of the Main Scheme and 2000 Plan were performed as at 31 March 2014 and showed a funding deficit of £2.6bn. The total net funding deficit in respect of all of the UK schemes was £2.7bn. Deficit recovery plans agreed with the trustees of the relevant schemes run until 2026.

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.

The total Group contributions made to the defined benefit schemes in the year ended 31 December 2014 were £548m (2013 £560m) excluding those amounts allocated to equity accounted investments and participating employers of £92m (2013 £86m). This includes additional contributions of £108m into the UK schemes relating to the share buyback programme (2013 £44m).

In 2015, the Group expects to make contributions at a similar level to the recurring contributions and deficit funding as made in 2014.

The Group incurred a charge in respect of cash contributions of £125m (2013 £130m) paid to defined contribution schemes for employees.

**Risk management**

The defined benefit pension schemes expose the Group to actuarial risks, including market (investment) risk, interest rate risk, inflation risk and longevity risk.

Risk	Mitigation
<b>Market (investment) risk</b>	
Asset returns may not move in line with the liabilities and may be subject to volatility.	<p>The investment portfolios are highly diversified, investing in a wide range of assets, in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities.</p> <p>Some 46% (2013 50%) of the Group's pension scheme assets are held in equities and pooled investment vehicles due to the higher expected level of return over the long term.</p> <p>Some of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of market risk. In August 2013, the Main Scheme implemented a long-dated equity option strategy protecting £1.4bn of assets against a significant fall in equity markets.</p>
<b>Interest rate risk</b>	
Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	In addition to investing in bonds as part of the matching portfolio, the principal UK schemes invest in interest rate swaps to reduce the exposure to movements in interest rates. The swaps are held with several banks to reduce counterparty risk.
<b>Inflation risk</b>	
Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	<p>In addition to investing in index-linked bonds as part of the matching portfolio, the principal UK schemes invest in long-term inflation swaps to reduce the exposure to movements in inflation. The swaps are held with several banks to reduce counterparty risk.</p> <p>Effective 1 May 2014, the Main Scheme implemented a pension increase exchange to allow retired members to elect for a higher current pension in exchange for foregoing certain rights to future pension increases.</p>
<b>Longevity risk</b>	
Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	<p>Longevity Adjustment Factors are used in the majority of the UK pension schemes in order to adjust the pension benefits payable so as to share the cost of people living longer with employees.</p> <p>In February 2013, with the agreement of the Company, the trustees of the 2000 Plan entered into an arrangement with Legal &amp; General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. In December 2013, similar arrangements were entered into, with Legal &amp; General, by the trustees of the Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme, covering £0.9bn and £0.8bn of pension scheme liabilities, respectively. These arrangements will reduce the funding volatility relating to increasing life expectancy.</p>

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 21. RETIREMENT BENEFIT OBLIGATIONS continued

#### Principal actuarial assumptions

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the long-term nature of the obligation covered, may not necessarily occur in practice.

	UK			US		
	2014	2013	2012	2014	2013	2012
<b>Financial assumptions</b>						
Discount rate (%)	3.6	4.5	4.5	4.1	4.9	4.1
Inflation (%)	3.2	3.4	2.9	n/a	n/a	n/a
Rate of increase in salaries (%)	3.2	3.4	3.4	n/a	n/a	3.7
Rate of increase in pensions in payment (%)	1.8 – 3.6	1.9 – 3.7	1.8 – 3.5	n/a	n/a	n/a
Rate of increase in deferred pensions (%)	2.3/3.2	2.5/3.4	2.3/2.9	n/a	n/a	n/a
<b>Demographic assumptions</b>						
Life expectancy of a male currently aged 65 (years)	87 – 89	87 – 89	87 – 89	87	84	84
Life expectancy of a female currently aged 65 (years)	89 – 90	89 – 90	89 – 90	89	86	86
Life expectancy of a male currently aged 45 (years)	89 – 91	88 – 90	88 – 90	87	84	84
Life expectancy of a female currently aged 45 (years)	91 – 92	91 – 92	91 – 92	89	86	86

#### Discount rate

Discount rate assumptions are based on third-party AA corporate bond indices and yields that reflect the maturity profile of the expected benefit payments.

#### Inflation

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

#### Rate of increase in salaries

The rate of increase in salaries for the UK schemes is assumed to be Retail Prices Index (RPI) inflation of 3.2% (2013 RPI inflation of 3.4%), plus a promotional scale. From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.

#### Rate of increase in pensions in payment

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.

#### Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on CPI inflation of 2.3% (2013 CPI inflation of 2.5%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.2% (2013 RPI inflation of 3.4%). For all UK schemes, the rate of increase in deferred pensions is subject to inflation caps.

#### Life expectancy

For its UK pension schemes, the Group has used the Self-Administered Pension Schemes S2 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 Continuous Mortality Investigation 2013 tables (published by the Institute of Actuaries) have been used, with an assumed long-term rate of future annual mortality improvements of 1.25% (2013 1%), for both pensioner and non-pensioner members.

In October 2014, the Society of Actuaries in the US released updated mortality assumptions reflecting the results of its comprehensive mortality study. For the majority of the US schemes, the mortality tables used at 31 December 2014 are a blend of the fully generational RP-2014 Aggregate table and the RP-2014 White Collar table, both projected using Scale MP-2014. The mortality table changes have resulted in a £0.3bn increase in the US defined benefit obligations. IRS approval of the mortality tables is expected in 2017, following which the tables are expected to be adopted for funding valuation purposes.

#### Retirement benefits other than pensions

##### Background

The Group operates a number of non-pension 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 2014. These valuations were rolled forward to reflect the information at 31 December 2014. The method of accounting for these is similar to that used for defined benefit pension schemes.

#### Principal actuarial assumptions

The assumption for long-term healthcare cost increases is 5.3% (2013 5.3%) based on the assumptions that the increases are 7.9% in 2015 reducing to 5% by 2023 and 5% each year thereafter for pre-retirement, and 7.5% in 2015 reducing to 5% by 2023 and 5% each year thereafter for post-retirement.

**21. RETIREMENT BENEFIT OBLIGATIONS** continued

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.

**Summary of movements in retirement benefit obligations**

	UK £m	US and other £m	Total £m
Total IAS 19 deficit at 1 January 2014	(4,272)	(266)	(4,538)
Actual return on assets excluding amounts included in interest expense	1,240	208	1,448
Increase in liabilities due to changes in financial assumptions	(3,273)	(405)	(3,678)
Increase in liabilities due to changes in demographic assumptions	(341)	(283)	(624)
Experience gains/(losses)	435	(6)	429
Additional contributions in excess of service cost	275	–	275
Recurring contributions in excess of service cost	48	68	116
Past service cost – plan amendments	(3)	(1)	(4)
Net interest expense	(175)	(14)	(189)
Foreign exchange adjustments	–	(35)	(35)
Movement in US healthcare schemes	–	(12)	(12)
<b>Total IAS 19 deficit at 31 December 2014</b>	<b>(6,066)</b>	<b>(746)</b>	<b>(6,812)</b>
Allocated to equity accounted investments and other participating employers	1,444	–	1,444
<b>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 2014</b>	<b>(4,622)</b>	<b>(746)</b>	<b>(5,368)</b>

**Amounts recognised on the balance sheet**

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.

	2014				2013			
	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	(41)	(138)	–	(179)	(53)	(130)	–	(183)
Present value of funded obligations	(26,195)	(4,132)	(146)	(30,473)	(22,550)	(3,210)	(117)	(25,877)
Fair value of scheme assets	20,170	3,505	165	23,840	18,331	3,043	148	21,522
Total IAS 19 (deficit)/surplus, net	(6,066)	(765)	19	(6,812)	(4,272)	(297)	31	(4,538)
Allocated to equity accounted investments and other participating employers	1,444	–	–	1,444	1,029	–	–	1,029
<b>Group's share of IAS 19 (deficit)/surplus, net</b>	<b>(4,622)</b>	<b>(765)</b>	<b>19</b>	<b>(5,368)</b>	<b>(3,243)</b>	<b>(297)</b>	<b>31</b>	<b>(3,509)</b>
Represented by:								
Retirement benefit surpluses	89	41	32	162	79	41	36	156
Retirement benefit obligations	(4,711)	(806)	(13)	(5,530)	(3,322)	(338)	(5)	(3,665)
	(4,622)	(765)	19	(5,368)	(3,243)	(297)	31	(3,509)
<b>Group's share of IAS 19 deficit of equity accounted investments</b>	<b>(165)</b>	<b>–</b>	<b>–</b>	<b>(165)</b>	<b>(115)</b>	<b>–</b>	<b>–</b>	<b>(115)</b>

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £6.0bn (2013 £3.9bn).

# NOTES TO THE GROUP ACCOUNTS CONTINUED

## 21. RETIREMENT BENEFIT OBLIGATIONS continued

### Changes in the fair value of scheme assets before allocation to equity accounted investments and other participating employers

	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 2013	16,611	2,843	129	19,583
<i>Interest income</i>	745	123	5	873
<i>Actual return on assets excluding amounts included in interest income</i>	1,190	214	23	1,427
Actual return on assets	1,935	337	28	2,300
<i>Contributions by employer</i>	529	117	2	648
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	104	–	–	104
Total contributions by employer	633	117	2	752
Members' contributions	13	–	–	13
Administrative expenses	(30)	(10)	–	(40)
Foreign exchange translation	–	(69)	(6)	(75)
Benefits paid	(831)	(175)	(5)	(1,011)
Value of scheme assets at 31 December 2013	18,331	3,043	148	21,522
<i>Interest income</i>	820	146	7	973
<i>Actual return on assets excluding amounts included in interest income</i>	1,240	208	5	1,453
Actual return on assets	2,060	354	12	2,426
<i>Contributions by employer</i>	554	86	1	641
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	105	–	–	105
Total contributions by employer	659	86	1	746
Members' contributions	12	–	–	12
Administrative expenses	(31)	(9)	(1)	(41)
Foreign exchange translation	–	201	10	211
Benefits paid	(861)	(170)	(5)	(1,036)
<b>Value of scheme assets at 31 December 2014</b>	<b>20,170</b>	<b>3,505</b>	<b>165</b>	<b>23,840</b>

**21. RETIREMENT BENEFIT OBLIGATIONS** continued**Assets of defined benefit pension schemes**

	2014								
	UK			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK <sup>1</sup>	4,183	–	4,183	–	–	–	4,183	–	4,183
Overseas	2,920	–	2,920	640	–	640	3,560	–	3,560
Pooled investment vehicles <sup>2</sup>	2,487	270	2,757	454	–	454	2,941	270	3,211
Fixed interest securities:									
UK gilts	2,332	–	2,332	–	–	–	2,332	–	2,332
UK corporates	2,464	–	2,464	–	–	–	2,464	–	2,464
Overseas government	–	–	–	158	–	158	158	–	158
Overseas corporates	377	–	377	2,044	–	2,044	2,421	–	2,421
Index-linked securities:									
UK gilts	2,198	–	2,198	–	–	–	2,198	–	2,198
UK corporates	1,508	–	1,508	–	–	–	1,508	–	1,508
Property <sup>3</sup>	1,176	159	1,335	–	165	165	1,176	324	1,500
Derivatives	–	(509)	(509)	–	–	–	–	(509)	(509)
Cash:									
Sterling	288	–	288	–	–	–	288	–	288
Foreign currency	172	–	172	36	–	36	208	–	208
Other	–	145	145	–	8	8	–	153	153
<b>Total</b>	<b>20,105</b>	<b>65</b>	<b>20,170</b>	<b>3,332</b>	<b>173</b>	<b>3,505</b>	<b>23,437</b>	<b>238</b>	<b>23,675</b>

	2013								
	UK			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK <sup>1</sup>	4,139	–	4,139	–	–	–	4,139	–	4,139
Overseas	2,909	–	2,909	788	–	788	3,697	–	3,697
Pooled investment vehicles <sup>2</sup>	2,064	374	2,438	340	–	340	2,404	374	2,778
Fixed interest securities:									
UK gilts	2,261	–	2,261	–	–	–	2,261	–	2,261
UK corporates	2,081	–	2,081	–	–	–	2,081	–	2,081
Overseas government	103	–	103	172	–	172	275	–	275
Overseas corporates	205	–	205	1,514	–	1,514	1,719	–	1,719
Index-linked securities:									
UK gilts	1,822	–	1,822	–	–	–	1,822	–	1,822
UK corporates	1,120	–	1,120	–	–	–	1,120	–	1,120
Property <sup>3</sup>	1,043	176	1,219	–	184	184	1,043	360	1,403
Derivatives	–	(315)	(315)	–	–	–	–	(315)	(315)
Cash:									
Sterling	242	–	242	–	–	–	242	–	242
Foreign currency	65	–	65	37	–	37	102	–	102
Other	4	38	42	–	8	8	4	46	50
<b>Total</b>	<b>18,058</b>	<b>273</b>	<b>18,331</b>	<b>2,851</b>	<b>192</b>	<b>3,043</b>	<b>20,909</b>	<b>465</b>	<b>21,374</b>

1. Includes £14m of the Company's own ordinary shares (2013 £32m).

2. Primarily comprises equities.

3. Includes £282m of property occupied by Group companies (2013 £259m).

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 21. RETIREMENT BENEFIT OBLIGATIONS continued

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Defined benefit obligations at 1 January 2013	(21,406)	(3,751)	(134)	(25,291)
Current service cost	(205)	(12)	(1)	(218)
Contributions by employer in respect of employee salary sacrifice arrangements	(104)	–	–	(104)
Total current service cost	(309)	(12)	(1)	(322)
Members' contributions	(13)	–	–	(13)
Past service cost – plan amendments	(11)	–	–	(11)
Actuarial (loss)/gain due to changes in financial assumptions	(896)	330	11	(555)
Experience gains	146	21	5	172
Interest expense	(945)	(152)	(5)	(1,102)
Foreign exchange translation	–	49	2	51
Benefits paid	831	175	5	1,011
Defined benefit obligations at 31 December 2013	(22,603)	(3,340)	(117)	(26,060)
Current service cost	(200)	(9)	(1)	(210)
Contributions by employer in respect of employee salary sacrifice arrangements	(105)	–	–	(105)
Total current service cost	(305)	(9)	(1)	(315)
Members' contributions	(12)	–	–	(12)
Past service cost – plan amendments	(3)	(1)	–	(4)
Actuarial loss due to changes in financial assumptions	(3,273)	(405)	(10)	(3,688)
Actuarial loss due to changes in demographic assumptions	(341)	(283)	(6)	(630)
Experience gains/(losses)	435	(6)	(3)	426
Interest expense	(995)	(160)	(5)	(1,160)
Foreign exchange translation	–	(236)	(9)	(245)
Benefits paid	861	170	5	1,036
<b>Defined benefit obligations at 31 December 2014</b>	<b>(26,236)</b>	<b>(4,270)</b>	<b>(146)</b>	<b>(30,652)</b>

Amounts recognised in the income statement after allocation to equity accounted investments and other participating employers

	2014				2013			
	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
<b>Included in operating costs:</b>								
Current service cost	(156)	(9)	(1)	(166)	(160)	(12)	(1)	(173)
Past service cost – plan amendments	(3)	(1)	–	(4)	(11)	–	–	(11)
	(159)	(10)	(1)	(170)	(171)	(12)	(1)	(184)
Administrative expenses	(25)	(9)	(1)	(35)	(24)	(10)	–	(34)
	(184)	(19)	(2)	(205)	(195)	(22)	(1)	(218)
<b>Included in finance costs:</b>								
Net interest (expense)/income on retirement benefit obligations	(135)	(14)	2	(147)	(157)	(29)	–	(186)
<b>Included in share of results of equity accounted investments:</b>								
Group's share of equity accounted investments' operating costs	(8)	–	–	(8)	(9)	–	–	(9)
Group's share of equity accounted investments' finance costs	(5)	–	–	(5)	(5)	–	–	(5)

**21. RETIREMENT BENEFIT OBLIGATIONS** continued**Sensitivity analysis**

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2014 and keeping all other assumptions as set out on page 136.

**Financial assumptions**

Changes in the following financial assumptions would have the following effect on the defined benefit pension obligation:

	(Increase)/decrease £bn
Discount rate:	
0.1 percentage point increase	0.5
0.1 percentage point decrease	(0.5)
Inflation:	
0.1 percentage point increase	(0.5)
0.1 percentage point decrease	0.5

The sensitivity of the valuation of the liabilities to changes in the inflation assumption presented above assumes that a 0.1 percentage point change to expectations of future inflation results in a 0.1 percentage point change to all inflation-related assumptions used to value the liabilities. However, upper and lower limits exist on the majority of inflation-related benefits such that a change in expectations of future inflation may not have the same impact on the inflation-related benefits, and hence will result in a smaller change to the valuation of the liabilities. Accordingly, extrapolation of the above results beyond the specific sensitivity figures shown may not be appropriate. To illustrate this, the (increase)/decrease in the defined benefit pension obligation resulting from larger changes in the inflation assumption would be as follows:

	(Increase)/decrease £bn
Inflation:	
0.5 percentage point increase	(1.8)
0.5 percentage point decrease	1.7
1.0 percentage point increase	(3.6)
1.0 percentage point decrease	3.3

**Demographic assumptions**

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements (see longevity risk on page 135), would have the following effect on the total IAS 19 deficit:

	(Increase)/decrease £bn
Life expectancy:	
One-year increase	(0.9)
One-year decrease	0.9

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 22. 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.

#### 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. 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 possible outcomes against their associated probabilities.

#### Reorganisations

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. The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Future operating costs are not provided for.

#### 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.

#### Other

Other provisions include provisions for onerous contracts, which are 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.

	Warranties and after-sales service £m	Reorganisations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	55	41	232	75	403
Current	47	81	193	70	391
At 1 January 2014	102	122	425	145	794
Created	48	67	62	20	197
Utilised	(45)	(45)	(143)	(21)	(254)
Released	(24)	(7)	(32)	(34)	(97)
Transfer to held for sale	(2)	–	–	(2)	(4)
Transfer from other balance sheet categories	–	–	74	–	74
Net present value adjustments	–	–	20	6	26
Foreign exchange adjustments	1	–	10	4	15
<b>At 31 December 2014</b>	<b>80</b>	<b>137</b>	<b>416</b>	<b>118</b>	<b>751</b>
Represented by:					
Non-current	50	46	281	59	436
Current	30	91	135	59	315
	<b>80</b>	<b>137</b>	<b>416</b>	<b>118</b>	<b>751</b>

#### Warranties and after-sales service

Warranty and after-sales service 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

Reorganisation 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

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

#### Other

Includes a provision taken in 2013 in respect of the Radford Army Ammunition Plant contract. There are no other individually significant provisions included within other provisions.



## 23. SHARE CAPITAL AND OTHER RESERVES

### Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each	Special Share of £1	Number of shares	Nominal value £	Nominal value £m
	Number of shares m	Nominal value £m			
<b>Issued and fully paid</b>					
At 1 January 2013	3,588	90	1	1	90
Repurchased and cancelled	(52)	(1)	–	–	(1)
At 31 December 2013	3,536	89	1	1	89
Repurchased and cancelled	(67)	(2)	–	–	(2)
<b>At 31 December 2014</b>	<b>3,469</b>	<b>87</b>	<b>1</b>	<b>1</b>	<b>87</b>

#### 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.

#### Share buyback

In 2014, 67,417,000 (2013 51,595,000) ordinary shares of 2.5p were repurchased under the buyback programme.

#### Treasury shares

As at 31 December 2014, 315,826,614 (2013 327,644,952) ordinary shares of 2.5p each with an aggregate nominal value of £7,895,665 (2013 £8,191,124) were held in treasury. During 2014, 11,818,338 (2013 9,169,044) treasury shares were used to satisfy awards and options under the Share Incentive Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan.

#### Own shares held

Own shares held, including treasury shares and shares held by BAE Systems Employee Share Option Plan (ESOP) Trust, are recognised as a deduction from retained earnings.

#### BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2014.

At 31 December 2014, the ESOP held 1,509,844 (2013 1,451,631) ordinary shares of 2.5p each, with a market value of £7m (2013 £6m). 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.

Dividend waivers were in operation for the dividends paid in June and December 2014 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants. A dividend waiver was also in operation for the dividends paid in June and December 2014 over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants.

#### Equity 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.

	2014 £m	2013 £m
Prior year final 12.1p dividend per ordinary share paid in the year (2013 11.7p)	383	380
Interim 8.2p dividend per ordinary share paid in the year (2013 8.0p)	259	258
	<b>642</b>	<b>638</b>

After the balance sheet date, the directors proposed a final dividend of 12.3p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 1 June 2015 to shareholders registered on 17 April 2015. The ex-dividend date is 16 April 2015.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 8 May 2015.

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 23. SHARE CAPITAL AND OTHER RESERVES continued

#### Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Capital redemption reserve £m	Total £m
At 1 January 2013	4,589	202	10	286	(8)	–	5,079
Currency translation on foreign currency net investments:							
Subsidiaries	–	–	–	(240)	–	–	(240)
Equity accounted investments	–	–	–	(3)	–	–	(3)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	(8)	–	–	(8)
Amounts credited to hedging reserve	–	–	–	–	53	–	53
Tax on other comprehensive income	–	–	–	–	(14)	–	(14)
Net purchase of own shares	–	–	–	–	–	1	1
At 31 December 2013	4,589	202	10	35	31	1	4,868
Currency translation on foreign currency net investments:							
Subsidiaries	–	–	–	251	–	–	251
Equity accounted investments	–	–	–	13	–	–	13
Amounts charged to hedging reserve	–	–	–	–	(92)	–	(92)
Tax on other comprehensive income	–	–	–	–	19	–	19
Net purchase of own shares	–	–	–	–	–	2	2
<b>At 31 December 2014</b>	<b>4,589</b>	<b>202</b>	<b>10</b>	<b>299</b>	<b>(42)</b>	<b>3</b>	<b>5,061</b>

#### 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.

#### Capital redemption reserve

The capital redemption reserve represents the cumulative nominal value of the Company's ordinary shares repurchased and subsequently cancelled. During the year ended 31 December 2014, 67,417,000 (2013 51,595,000) ordinary shares with a nominal value of £2m (2013 £1m) were repurchased and have been subsequently cancelled.

#### Capital

The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2014, the Group's capital was £1,919m (2013 £3,387m), which comprises total equity of £1,877m (2013 £3,418m), excluding amounts accumulated in equity relating to cash flow hedges of £42m (2013 £31m credit). Net debt (as defined by the Group) was £1,032m (2013 £699m).

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.

**24. CASH FLOW ANALYSIS****Operating business cash flow**

	<b>2014</b> £m	2013 £m
Cash inflow from operating activities	<b>913</b>	205
Purchase of property, plant and equipment, and investment property	<b>(263)</b>	(236)
Purchase of intangible assets	<b>(59)</b>	(33)
Proceeds from sale of property, plant and equipment, and investment property	<b>539</b>	93
Proceeds from sale of intangible assets	–	28
Equity accounted investment funding	<b>(2)</b>	(5)
Dividends received from equity accounted investments	<b>63</b>	95

<b>Operating business cash flow</b>	<b>1,191</b>	147
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	<b>2014</b> £m	2013 <sup>1</sup> £m
Electronic Systems	<b>246</b>	235
Cyber & Intelligence	<b>71</b>	118
Platforms & Services (US)	<b>201</b>	191
Platforms & Services (UK)	<b>173</b>	60
Platforms & Services (International)	<b>881</b>	(189)
HQ	<b>(381)</b>	(268)

<b>Operating business cash flow</b>	<b>1,191</b>	147
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1. Re-presented for the transfer of the UK Munitions business from Platforms & Services (US) to Platforms & Services (UK) from 1 January 2014.

**Cash flows from acquisitions and disposals**

	<b>2014</b> £m	2013 £m
Proceeds from sale of subsidiary undertakings	–	7
Cash and cash equivalents disposed of with subsidiary undertakings	–	(2)
<b>Proceeds from sale of subsidiary undertakings (net of cash disposed)</b>	<b>–</b>	5
Purchase of subsidiary undertakings	<b>(233)</b>	(1)
Cash and cash equivalents acquired from purchase of subsidiary undertakings	<b>3</b>	–

<b>Acquisitions and disposals</b>	<b>(230)</b>	4
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# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 25. NET (DEBT)/CASH (AS DEFINED BY THE GROUP)

#### Key Performance Indicator – Net (debt)/cash

Net (debt)/cash comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account<sup>1</sup>.

#### Movement in net (debt)/cash (as defined by the Group)

	2014 £m	2013 £m
Operating business cash flow (note 24)	1,191	147
Interest	(145)	(166)
Taxation	(92)	(138)
Free cash inflow/(outflow)	954	(157)
Acquisitions and disposals (note 24)	(230)	4
Net purchase of own shares	(281)	(212)
Equity dividends paid	(642)	(638)
Dividends paid to non-controlling interests	(14)	(11)
Cash inflow/(outflow) from matured derivative financial instruments	8	(47)
Cash inflow/(outflow) from movement in cash collateral	10	(10)
Cash inflow from loans	679	–
Cash outflow from repayment of loans	(398)	–
Net increase/(decrease) in cash and cash equivalents	86	(1,071)
Foreign exchange adjustments	(146)	3
Other non-cash movements	13	(19)
Less: Cash classified as held for sale	(6)	–
Less: Movement in cash received on customers' account <sup>1</sup>	1	1
Less: Cash inflow from loans	(679)	–
Less: Cash outflow from repayment of loans	398	–
Movement in net debt (as defined by the Group)	(333)	(1,086)
Opening net (debt)/cash (as defined by the Group)	(699)	387
<b>Closing net debt (as defined by the Group)</b>	<b>(1,032)</b>	<b>(699)</b>

#### Components of net (debt)/cash (as defined by the Group)

	2014 £m	2013 £m
Debt-related derivative financial instrument assets – non-current (note 14)	10	–
Debt-related derivative financial instrument assets – current (note 14)	–	6
Cash and cash equivalents (note 17)	2,314	2,222
Less: Cash classified as held for sale (note 7)	(6)	–
<b>Cash (as defined by the Group) (note 18)</b>	<b>2,318</b>	<b>2,228</b>
Loans – non-current (note 19)	(2,868)	(2,524)
Loans and overdrafts – current (note 19)	(482)	(402)
Less: Cash received on customers' account <sup>1</sup> (note 20)	–	(1)
<b>Debt (as defined by the Group)</b>	<b>(3,350)</b>	<b>(2,927)</b>
<b>Net debt (as defined by the Group)</b>	<b>(1,032)</b>	<b>(699)</b>

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 20).

## 26. ACQUISITIONS

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.

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.

In 2014, BAE Systems acquired: Perimeter Internetworking Corp., trading as SilverSky; an additional 59% shareholding in Saudi Development and Training Company (SDT); and Signal Innovations Group, Inc. (SIG).

If the acquisitions had occurred on 1 January 2014, combined sales of Group and share of equity accounted investments would have been £16.7bn, revenue £15.5bn and profit £752m for the year ended 31 December 2014.

For all acquisitions made in the year, fair values remain provisional, but will be finalised within 12 months of acquisition.

### Summary

Acquisition	Description	Acquisition date	Percentage share acquired	Consideration Currency	Consideration £m
SilverSky	Commercial cyber service provider in the US	11 December 2014	100%	\$232m	149
SDT <sup>1</sup>	Provider of technical and professional training in Saudi Arabia	15 September 2014	59%	SAR440m	72
SIG	Provider of imaging technologies and analytics to the US intelligence community	30 September 2014	100%	\$21m	13

1. The Group previously held a 40% interest in SDT and accounted for its share of the results and net assets of SDT under the equity method, in accordance with IAS 28, Investments in Associates and Joint Ventures (revised 2011).

### Material acquisitions

Acquisition	Support for residual goodwill <sup>2</sup>	Consolidated results for the period from acquisition to 31 December 2014		
		Revenue £m	EBITA <sup>3</sup> £m	Profit after tax <sup>4</sup> £m
SilverSky	Complements Applied Intelligence's existing cyber, intelligence and security products and capabilities; Enhances existing knowledge and expertise in commercial markets, and better positions the Group to compete for new customers, particularly in the US; Increases penetration of target markets through existing sales and marketing capabilities; and Provides a skilled assembled workforce.	3	–	–
SDT	Complements existing training activities in the Kingdom of Saudi Arabia; Enhances existing knowledge and expertise, and better positions the Group to compete for future work from the existing customer base; and Creates the opportunity to access new customers in the Kingdom of Saudi Arabia and also in new geographies.	6 <sup>5</sup>	2	2

2. Goodwill recognised is attributable to specific opportunities and synergies which do not translate into separately identifiable intangible assets, but represent a proportion of the assessed value within each acquired entity.

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

4. Profit after tax includes amortisation charges on acquired intangible assets totalling £1m.

5. Intra-group.

The post-acquisition results above exclude acquisition-related costs of £3m incurred by the Group. These expenses relate to external legal fees and due diligence costs, and are included in operating costs.

## NOTES TO THE GROUP ACCOUNTS CONTINUED

### 26. ACQUISITIONS continued

#### Fair values

The acquisitions had the following effect on the Group's assets and liabilities:

	SilverSky £m	SDT £m	SIG £m	Total £m
Intangible assets	81	–	–	81
Property, plant and equipment	7	–	–	7
Inventories	–	1	–	1
Receivables	8	6	1	15
Deferred tax assets	14	–	–	14
Payables	(11)	(4)	–	(15)
Deferred tax liabilities	(31)	–	–	(31)
Cash and cash equivalents	2	1	–	3
<b>Net assets acquired</b>	<b>70</b>	<b>4</b>	<b>1</b>	<b>75</b>
<b>Goodwill</b>	<b>79</b>	<b>117</b>	<b>12</b>	<b>208</b>
<b>Fair value of net assets acquired and goodwill arising</b>	<b>149</b>	<b>121</b>	<b>13</b>	<b>283</b>
Cash consideration (note 24)	149	72	12	233
Amounts payable in respect of purchase price adjustments	–	–	1	1
<b>Consideration</b>	<b>149</b>	<b>72</b>	<b>13</b>	<b>234</b>
Carrying value of existing 40% shareholding in SDT (note 12)	–	2	–	2
Fair value gain on existing 40% shareholding in SDT (note 4)	–	47	–	47
<b>Fair value of net assets acquired and goodwill arising</b>	<b>149</b>	<b>121</b>	<b>13</b>	<b>283</b>

The intangible assets acquired as part of the acquisition of SilverSky of £81m include customer relationships (£47m), software (£30m) and order backlog (£4m).

Receivables include trade receivables with a fair value and gross contractual value of £10m, which are expected to be fully recoverable.

The goodwill is not expected to be deductible for tax purposes.

## 27. FAIR VALUE MEASUREMENT

### Fair value of financial instruments

Certain of the Group's financial instruments are held at fair value.

The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date.

The fair values of financial instruments held at fair value 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 31 December may not be indicative of the amounts the Group would expect to realise in the current market environment.

### 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).

### Carrying amounts and fair values of certain financial instruments

	Notes	2014		2013	
		Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
<b>Financial instruments measured at fair value:</b>					
<b>Non-current</b>					
Available-for-sale financial assets		7	7	3	3
Other receivables <sup>1</sup>	13	238	238	211	211
Other financial assets	14	38	38	42	42
Other financial liabilities	14	(79)	(79)	(59)	(59)
Loans	19	(325)	(325)	(307)	(307)
Trade and other payables <sup>1</sup>	20	(262)	(262)	(237)	(237)
<b>Current</b>					
Other financial assets	14	46	46	81	81
Other financial liabilities	14	(107)	(107)	(81)	(81)
<b>Financial instruments not measured at fair value:</b>					
<b>Non-current</b>					
Loans	19	(2,543)	(2,900)	(2,217)	(2,367)
<b>Current</b>					
Cash and cash equivalents	17	2,308	2,308	2,222	2,222
Loans and overdrafts	19	(482)	(494)	(402)	(414)

1. Represents US deferred compensation plan assets and liabilities.

All of the financial assets and liabilities measured at fair value are classified as level 2 using the fair value hierarchy. There were no transfers between levels during the year.

Financial assets and liabilities in the Group's Consolidated Balance Sheet are either held at fair value or their carrying value approximates to fair value, with the exception of loans, most of which are held at amortised cost.

The fair value of total loans and overdrafts estimated using market prices at 31 December 2014 is £3,719m (2013 £3,088m).

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 28. FINANCIAL RISK MANAGEMENT

#### 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, including interest rate and cross-currency swaps.

The Group's interest rate management policy is that a minimum of 50% (2013 50%) and a maximum of 90% (2013 90%) of gross debt is maintained at fixed interest rates. At 31 December 2014, the Group had 81% (2013 69%) of fixed rate debt and 19% (2013 31%) of floating rate debt based on a gross debt of £3.3bn, including debt-related derivative financial assets (2013 £2.9bn).

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	2,308	–	–
Loans and overdrafts	(644)	(643)	(643)

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 2014, the Group had a total of \$1.0bn (2013 \$1.5bn) of this type of swap outstanding with a weighted average duration of 4.6 years (2013 2.3 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 10.1 years (2013 9.6 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 4.1% (2013 3.3%) on US dollars. The cost of the fixed rate debt was 5.4% (2013 5.7%).

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 (2013 £6m).

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 £9m (2013 £13m).

#### Liquidity risk

##### Contractual cash flows on financial liabilities

The contracted cash flows on loans and overdrafts, and derivative financial instruments at the reporting date are shown below, classified by maturity. The cash flows are shown on a gross basis, are not discounted and include estimated interest payments where applicable.

	31 December 2014					31 December 2013				
	Contracted cash flow					Contracted cash flow				
	Carrying amount £m	Less than one year £m	Between one and five years £m	More than five years £m	Total £m	Carrying amount £m	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
<b>Loans and overdrafts</b>	<b>(3,350)</b>	<b>(655)</b>	<b>(1,420)</b>	<b>(2,926)</b>	<b>(5,001)</b>	(2,926)	(558)	(1,129)	(2,513)	(4,200)
(Sale)/purchase contracts:										
US dollar		(39)	(41)	71	(9)		(197)	(69)	97	(169)
Euro		707	761	47	1,515		683	1,079	61	1,823
Sterling		(696)	(696)	(118)	(1,510)		(620)	(894)	(159)	(1,673)
Other		24	(27)	–	(3)		134	(122)	–	12
<b>Cash flow hedges – foreign exchange contracts</b>	<b>(107)</b>	<b>(4)</b>	<b>(3)</b>	<b>–</b>	<b>(7)</b>	(12)	–	(6)	(1)	(7)
Purchase/(sale) contracts:										
US dollar		1,399	(9)	–	1,390		809	–	–	809
Euro		507	–	–	507		551	–	–	551
Sterling		(2,044)	9	–	(2,035)		(1,591)	–	–	(1,591)
Other		138	–	–	138		233	–	–	233
Interest rate contracts		4	(4)	–	–		8	(5)	(3)	–
<b>Other foreign exchange/interest rate contracts</b>	<b>(5)</b>	<b>4</b>	<b>(4)</b>	<b>–</b>	<b>–</b>	(11)	10	(5)	(3)	2
<b>Debt-related derivative financial instruments</b>	<b>10</b>	<b>6</b>	<b>2</b>	<b>23</b>	<b>31</b>	6	6	–	–	6
<b>Other financial assets and liabilities</b>	<b>(102)</b>	<b>6</b>	<b>(5)</b>	<b>23</b>	<b>24</b>	(17)	16	(11)	(4)	1

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.



**28. FINANCIAL RISK MANAGEMENT** continued**Borrowing facilities**

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2014, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2013 £2bn). The RCF is contracted until 2018 at £2bn and from 2018 to 2019 at £1.8bn. The RCF was undrawn throughout the year.

**Cash management**

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.

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 2014 of £2,308m (2013 £2,222m) was invested with 30 (2013 27) 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 counterparty credit risk through this process.

**Currency risk**

The Group's objective is to reduce its exposure to transactional 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 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 statements or balance sheets of foreign subsidiaries and equity accounted investments it regards as long-term investments.

**Credit risk**

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, a provision for bad debts has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk, and no one counterparty constitutes more than 7% of the balance (2013 5%).

The ageing of trade receivables is detailed below:

	2014			2013		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due and not impaired	611	–	611	919	–	919
Up to 180 days overdue and not impaired	266	–	266	153	–	153
Up to 180 days overdue and impaired	–	–	–	1	(1)	–
Past 180 days overdue and not impaired	58	–	58	66	–	66
Past 180 days overdue and impaired	28	(28)	–	26	(26)	–
	963	(28)	935	1,165	(27)	1,138

Movements on the provision for bad debts are as follows:

	2014 £m	2013 £m
At 1 January	27	31
Created	15	14
Utilised	(4)	(2)
Released	(11)	(16)
Foreign exchange adjustments	1	–
<b>At 31 December</b>	<b>28</b>	<b>27</b>

# NOTES TO THE GROUP ACCOUNTS

## CONTINUED

### 29. SHARE-BASED PAYMENTS

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.

Details of the terms and conditions of each share-based payment plan are given in the Annual Remuneration Report on pages 69 to 82.

#### Expense in year

	2014			2013		
	Equity-settled £m	Cash-settled £m	Total £m	Equity-settled £m	Cash-settled £m	Total £m
Executive Share Option Plan	4	–	4	3	3	6
Performance Share Plan	5	–	5	8	–	8
Restricted Share Plan	5	–	5	7	–	7
	<b>14</b>	<b>–</b>	<b>14</b>	<b>18</b>	<b>3</b>	<b>21</b>

The Group also incurred a charge of £28m (2013 £31m) in respect of the equity-settled all-employee free shares and matching Partnership Shares elements of the Share Incentive Plan.

#### Executive Share Option Plan

	2014		2013	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
<b>Equity-settled options</b>				
Outstanding at the beginning of the year	30,959	3.52	23,014	3.24
Granted during the year	10,578	4.12	12,293	3.90
Exercised during the year	(1,644)	3.07	(1,918)	2.37
Expired during the year	(4,299)	3.71	(2,430)	3.62
Outstanding at the end of the year	35,594	3.70	30,959	3.52
Exercisable at the end of the year	3,633	4.30	5,674	3.95
<b>Cash-settled share appreciation rights</b>				
Outstanding at the beginning of the year	1,802	2.38	4,063	2.20
Exercised during the year	(1,078)	2.19	(2,125)	2.03
Expired during the year	(30)	2.07	(136)	2.30
Outstanding at the end of the year	694	2.69	1,802	2.38
Exercisable at the end of the year	694	2.69	1,802	2.38

	2014		2013	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	2.64 – 4.79	2.64 – 3.56	2.01 – 4.79	2.01 – 3.58
Weighted average remaining contracted life (years)	8	–	8	1
Weighted average fair value of options granted (£)	0.64	–	0.61	–

**29. SHARE-BASED PAYMENTS** continued**Performance Share Plan, Share Matching Plan and Restricted Share Plan**

	Performance Share Plan		Share Matching Plan		Restricted Share Plan	
	<b>2014</b> Number of shares '000	2013 Number of shares '000	<b>2014</b> Number of shares '000	2013 Number of shares '000	<b>2014</b> Number of shares '000	2013 Number of shares '000
Outstanding at the beginning of the year	<b>21,693</b>	26,834	<b>11,201</b>	13,334	<b>6,070</b>	7,519
Granted during the year	<b>8,678</b>	5,753	–	2,766	<b>1,205</b>	1,373
Exercised during the year	<b>(637)</b>	(1,097)	–	–	<b>(2,872)</b>	(1,887)
Expired during the year	<b>(10,866)</b>	(9,797)	<b>(5,583)</b>	(4,899)	<b>(643)</b>	(935)
Outstanding at the end of the year	<b>18,868</b>	21,693	<b>5,618</b>	11,201	<b>3,760</b>	6,070
Exercisable at the end of the year	<b>266</b>	720	–	–	–	–
	<b>2014</b>	2013	<b>2014</b>	2013	<b>2014</b>	2013
Weighted average remaining contracted life (years)	<b>5</b>	5	<b>1</b>	1	<b>5</b>	5
Weighted average fair value of awards granted (£)	<b>3.01</b>	3.51	–	3.89	<b>4.12</b>	3.90

All awards are equity-settled.

The exercise price for the Performance Share Plan and Restricted Share Plan is £nil (2013 £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:

Executive Share Option Plan – Binomial model

Performance Share Plan – Monte Carlo

Restricted Share Plan – Dividend valuation model

	<b>2014</b>	2013
Range of share price at date of grant (£)	<b>4.12 – 4.51</b>	3.89 – 4.40
Expected option/award life (years)	<b>3 – 10</b>	3 – 10
Volatility (%)	<b>21 – 24</b>	24 – 25
Risk free interest rate (%)	<b>1.0 – 1.2</b>	0.2 – 0.9

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £4.33 (2013 £4.07).

## NOTES TO THE GROUP ACCOUNTS CONTINUED

### 30. RELATED PARTY TRANSACTIONS

The Group has a related party relationship with its directors and key management personnel (see below), equity accounted investments (note 12) and pension schemes (note 21).

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:

Related party	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party <sup>1</sup>		Management recharges <sup>1</sup>	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Advanced Electronics Company Limited	9	1	56	50	–	–	–	–	–	–
CTA International SAS	3	1	–	–	2	1	–	–	–	–
Eurofighter Jagdflugzeug GmbH	1,087	1,048	11	–	64	30	77	92	–	–
FADEC International LLC	74	61	–	–	–	–	–	–	–	–
Gripen International KB	–	–	–	–	15	17	14	16	–	–
MBDA SAS	22	17	90	134	6	6	403	454	17	17
Panavia Aircraft GmbH	34	39	44	64	5	2	–	–	–	–
Saudi Development and Training Company Limited (SDT) <sup>2</sup>	–	1	8	15	n/a	–	n/a	1	–	–
	<b>1,229</b>	1,168	<b>209</b>	263	<b>92</b>	56	<b>494</b>	563	<b>17</b>	17

In October, the Group sold a freehold property to MBDA SAS for cash consideration of £12m.

- Also relates to disclosures under Financial Reporting Standard 8, Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2014, £453m (2013 £560m) was owed by BAE Systems plc and £41m (2013 £3m) by other Group subsidiaries.
- For the period from 1 January 2014 to 15 September 2014 when the Group accounted for its share of the results of SDT under the equity method, in accordance with IAS 28, Investments in Associates and Joint Ventures (revised 2011).

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 Annual Remuneration Report on pages 69 to 82. Total emoluments for directors and key management personnel charged to the Consolidated Income Statement were:

	2014 £'000	2013 £'000
Short-term employee benefits	14,383	13,418
Post-employment benefits	1,678	1,676
Termination benefits	1,702	611
Share-based payments	3,320	4,163
	<b>21,083</b>	19,868

### 31. 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 and regards these as insurance contracts. 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:

	2014 £m	2013 £m
Payments due:		
Not later than one year	213	166
Later than one year and not later than five years	678	506
Later than five years	810	630
	<b>1,701</b>	1,302
Total of future minimum sublease income under non-cancellable subleases	<b>159</b>	166

#### Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2014 £m	2013 £m
Property, plant and equipment	142	91
Intangible assets	3	18
	<b>145</b>	109

## NOTES TO THE GROUP ACCOUNTS CONTINUED

### 32. GROUP ENTITIES

Principal subsidiary undertakings	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
BAE Systems (Operations) Limited <i>(Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)</i>	Defence and commercial aerospace activities	100% ordinary	UK	England and Wales
BAE Systems Controls Inc. <i>(Held via BAE Systems, Inc.)</i>	Designs, develops and manufactures electronic systems for commercial and military applications	100% common	US	US
BAE Systems Information and Electronic Systems Integration Inc. <i>(Held via BAE Systems, Inc.)</i>	Designs, develops and manufactures electronic systems and subsystems	100% common	US	US
BAE Systems Information Solutions Inc. <i>(Held via BAE Systems Technology Solutions &amp; Services Inc.)</i>	Full-service information technology solution provider	100% common	US	US
BAE Systems Land & Armaments LP 2000 North 15th Street, 11 <sup>th</sup> Floor, Arlington, VA 22201, USA <i>(Partners: BAE Systems Land &amp; Armaments Inc. and BAE Systems Land &amp; Armaments Holdings Inc.)</i>	Manufactures and supports military vehicles	100%	US	US
BAE Systems Surface Ships Limited <i>(Held via BAE Systems Surface Ships (Holdings) Limited)</i>	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<sup>1</sup>. A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2014 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.

# COMPANY BALANCE SHEET

## AS AT 31 DECEMBER

	Notes	2014 £m	2013 £m
<b>Fixed assets</b>			
Intangible assets		10	–
Tangible assets		9	10
Investments in subsidiary undertakings	2	8,169	8,057
		<b>8,188</b>	8,067
<b>Current assets</b>			
Debtors due within one year	3	3,257	3,662
Debtors due after one year		9	22
Other financial assets due within one year	4	128	126
Other financial assets due after one year	4	105	80
Cash at bank and in hand		1,792	1,732
		<b>5,291</b>	5,622
<b>Liabilities falling due within one year</b>			
Loans and overdrafts	5	(1)	(100)
Creditors	6	(7,690)	(8,223)
Other financial liabilities	4	(134)	(141)
		<b>(7,825)</b>	(8,464)
<b>Net current liabilities</b>			
		<b>(2,534)</b>	(2,842)
<b>Total assets less current liabilities</b>			
		<b>5,654</b>	5,225
<b>Liabilities falling due after one year</b>			
Loans	5	(1,197)	(1,159)
Creditors	6	(25)	(21)
Other financial liabilities	4	(98)	(86)
		<b>(1,320)</b>	(1,266)
<b>Provisions for liabilities and charges</b>			
	7	(120)	(52)
<b>Net assets</b>			
		<b>4,214</b>	3,907
<b>Capital and reserves</b>			
Issued share capital	9	87	89
Share premium account	11	1,249	1,249
Statutory reserve	11	202	202
Other reserves	11	100	88
Profit and loss account	11	2,576	2,279
<b>Equity shareholders' funds</b>			
		<b>4,214</b>	3,907

Approved by the Board on 18 February 2015 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 UK (UK GAAP). The going concern basis has been applied in these accounts.

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 total recognised gains or losses is presented.

### 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.

### Intangible assets

Software development costs that are directly associated with the production of identifiable and unique software products controlled by the Company, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets.

### 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	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 note 14 to the Group accounts 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 note 21 to the Group accounts. 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 funding 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 of awards granted to employees of the Company 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. The cost of awards to employees of subsidiary undertakings is accounted for as an additional investment in the employing subsidiary.

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

Dividends received and receivable are credited to the Company's profit and loss account.

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.

### Changes in accounting policies in 2015

A new financial reporting framework in the UK was effective on 1 January 2015. As a result, BAE Systems plc has adopted FRS 101 Reduced Disclosure Framework for the year ending 31 December 2015.



**2. INVESTMENTS IN SUBSIDIARY UNDERTAKINGS**

	£m
<b>Cost</b>	
At 1 January 2014	8,118
Additions <sup>1</sup>	153
Disposals	(88)
<b>At 31 December 2014</b>	<b>8,183</b>
<b>Impairment provisions</b>	
At 1 January 2014	61
Disposals	(47)
<b>At 31 December 2014</b>	<b>14</b>
<b>Net carrying value</b>	
<b>At 31 December 2014</b>	<b>8,169</b>
At 31 December 2013	8,057

1. Principally additional capital contributions into BAE Systems (Holdings) Limited in respect of the SilverSky acquisition.

**3. DEBTORS**

	2014 £m	2013 £m
<b>Due within one year</b>		
Corporation tax recoverable	32	32
Amounts owed by subsidiary undertakings	3,182	3,585
Amounts owed by Group joint ventures	5	5
Prepayments and accrued income	23	24
Other debtors	15	16
	<b>3,257</b>	3,662

**4. OTHER FINANCIAL ASSETS AND LIABILITIES**

	2014 Assets £m	2014 Liabilities £m	2013 Assets £m	2013 Liabilities £m
<b>Due within one year</b>				
Cash flow hedges – foreign exchange contracts	2	–	–	(2)
Other foreign exchange/interest rate contracts	126	(134)	126	(139)
	<b>128</b>	<b>(134)</b>	126	(141)
<b>Due after one year</b>				
Cash flow hedges – foreign exchange contracts	4	–	–	(2)
Other foreign exchange/interest rate contracts	95	(98)	80	(84)
Debt-related derivative financial instruments – assets <sup>1</sup>	6	–	–	–
	<b>105</b>	<b>(98)</b>	80	(86)

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 notes 14, 27 and 28 to the Group accounts.

# NOTES TO THE COMPANY ACCOUNTS CONTINUED

## 5. LOANS AND OVERDRAFTS

	2014 £m	2013 £m
<b>Due within one year</b>		
Euro-Sterling £100m 10¾% bond, repayable 2014	–	100
Overdrafts	<b>1</b>	–
	<b>1</b>	100
<b>Due after one year</b>		
US\$350m 3.5% bond, repayable 2016	<b>224</b>	211
US\$500m 4.75% bond, repayable 2021	<b>320</b>	301
£400m 4.125% bond, repayable 2022	<b>398</b>	397
US\$400m 5.8% bond, repayable 2041	<b>254</b>	238
Debt-related derivative financial instruments – liabilities	<b>1</b>	12
	<b>1,197</b>	1,159

## 6. CREDITORS

	2014 £m	2013 £m
<b>Due within one year</b>		
Amounts owed to subsidiary undertakings	<b>7,035</b>	7,338
Amounts owed to Group joint ventures	<b>453</b>	560
Accruals and deferred income	<b>46</b>	45
Other creditors	<b>156</b>	280
	<b>7,690</b>	8,223
<b>Due after one year</b>		
Other creditors	<b>25</b>	21
	<b>25</b>	21

## 7. PROVISIONS FOR LIABILITIES AND CHARGES

	Contracts and other £m
At 1 January 2014	52
Created	2
Transfer from other balance sheet categories	84
Utilised	(16)
Released	(7)
Net present value adjustments	5
<b>At 31 December 2014</b>	<b>120</b>

The Company holds provisions for 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 £2,146m (2013 £1,661m) 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		Nominal value £m
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	
<b>Issued and fully paid</b>					
At 1 January 2013	3,588	90	1	1	90
Repurchased and cancelled	(52)	(1)	–	–	(1)
At 31 December 2013	3,536	89	1	1	89
Repurchased and cancelled	(67)	(2)	–	–	(2)
<b>At 31 December 2014</b>	<b>3,469</b>	<b>87</b>	<b>1</b>	<b>1</b>	<b>87</b>

**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.

**Share buyback**

In 2014, 67,417,000 (2013 51,595,000) ordinary shares of 2.5p were repurchased under the buyback programme.

**Treasury shares**

As at 31 December 2014, 315,826,614 (2013 327,644,952) ordinary shares of 2.5p each with an aggregate nominal value of £7,895,665 (2013 £8,191,124) were held in treasury. During 2014, 11,818,338 (2013 9,169,044) treasury shares were used to satisfy awards and options under the Share Incentive Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan.

# NOTES TO THE COMPANY ACCOUNTS

## CONTINUED

### 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 Annual Remuneration Report on pages 69 to 82.

	Executive Share Option Plan			
	2014		2013	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	<b>11,709</b>	<b>3.57</b>	9,601	3.30
Granted during the year	<b>3,692</b>	<b>4.12</b>	3,798	3.90
Exercised during the year	<b>(1,022)</b>	<b>2.93</b>	(1,056)	2.06
Expired during the year	<b>(594)</b>	<b>3.86</b>	(634)	3.92
Outstanding at the end of the year	<b>13,785</b>	<b>3.75</b>	11,709	3.57
		<b>2014</b>		2013
Weighted average remaining contracted life (years)		<b>7</b>		7
Weighted average fair value of options granted (£)		<b>0.59</b>		0.59
Range of exercise price of outstanding options (£)		<b>2.64 – 4.79</b>		2.01 – 4.79
Expense recognised for the year (£m)		<b>2</b>		1

	Performance Share Plan		Share Matching Plan		Restricted Share Plan	
	2014 Number of shares '000	2013 Number of shares '000	2014 Number of shares '000	2013 Number of shares '000	2014 Number of shares '000	2013 Number of shares '000
Outstanding at the beginning of the year	<b>8,281</b>	10,519	<b>5,167</b>	5,690	<b>29</b>	101
Granted during the year	<b>3,710</b>	1,798	–	1,446	<b>9</b>	10
Exercised during the year	<b>(375)</b>	(500)	–	–	<b>(9)</b>	(53)
Expired during the year	<b>(3,974)</b>	(3,536)	<b>(1,946)</b>	(1,969)	<b>(1)</b>	(29)
Outstanding at the end of the year	<b>7,642</b>	8,281	<b>3,221</b>	5,167	<b>28</b>	29
	<b>2014</b>	2013	<b>2014</b>	2013	<b>2014</b>	2013
Weighted average remaining contracted life (years)	<b>5</b>	5	<b>1</b>	1	<b>5</b>	5
Weighted average fair value of awards granted (£)	<b>2.73</b>	3.18	–	3.89	<b>4.12</b>	3.89
Expense recognised for the year (£m)	<b>3</b>	3	–	–	–	–

The exercise price for the Performance Share Plan, Share Matching Plan and Restricted Share Plan is £nil (2013 £nil).

Information on options/awards granted in the year can be found in note 29 to the Group accounts.

**11. RESERVES**

	Share premium account £m	Statutory reserve £m	Other reserves £m	Profit and loss account £m
At 31 December 2013	1,249	202	88	2,279
Profit for the year	–	–	–	1,183
Dividends paid	–	–	–	(642)
Share-based payments	–	–	–	37
Purchase of own shares	–	–	2	(281)
Movements in hedging reserve	–	–	10	–
<b>At 31 December 2014</b>	<b>1,249</b>	<b>202</b>	<b>100</b>	<b>2,576</b>

**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 (2013 £24m); hedging reserve £6m credit (2013 £4m debit); capital redemption reserve £3m (2013 £1m) and non-distributable reserve arising from property disposals to other Group undertakings £67m (2013 £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 £1,183m (2013 £758m). The non-distributable portion of the profit and loss account is £196m (2013 £196m).

**Own shares held**

Own shares held, including treasury shares and shares held by BAE Systems Employee Share Option Plan (ESOP) Trust, are recognised as a deduction from retained earnings.

**BAE Systems ESOP Trust**

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2014.

At 31 December 2014, the ESOP held 1,509,844 (2013 1,451,631) ordinary shares of 2.5p each with a market value of £7m (2013 £6m). 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.

Dividend waivers were in operation for the dividends paid in June and December 2014 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants. A dividend waiver was also in operation for the dividends paid in June and December 2014 over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants.

**12. OTHER INFORMATION****Employees**

The total number of employees of the Company at 31 December 2014 was 1,189 (2013 831). Total staff costs, excluding charges for share-based payments, were £128m (2013 £102m).

**Directors' emoluments**

Under Schedule 5 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (Schedule 5), total directors' emoluments, excluding Company pension contributions, were £6,601,189 (2013 £6,289,295); these amounts are calculated on a different basis to emoluments in the Annual Remuneration Report which are calculated under Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (Schedule 8 (2013)). These emoluments were paid for their services on behalf of the BAE Systems Group. No emoluments related specifically to their work for the Company. Under Schedule 5, the aggregate gains made by directors from the exercise of share options in 2014 as at the date of exercise was £739,401 (2013 £1,909,962) and the net aggregate value of assets received by directors in 2014 from Long-Term Incentive Plans as calculated at the date of vesting was £nil (2013 £129,722); these amounts are calculated on a different basis from the valuation of share plan benefits under Schedule 8 (2013) in the Annual Remuneration Report.

**Company audit fee**

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,669,000 (2013 £1,621,000).

**Related party transactions**

Details of related party transactions are detailed in note 30 to the Group accounts.

The Company also has a related party relationship with its directors and key management personnel, and pension schemes.

# SHAREHOLDER INFORMATION

## Registered office

6 Carlton Gardens  
London  
SW1Y 5AD  
United Kingdom

Telephone: +44 (0)1252 373232

Company website: [www.baesystems.com](http://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 email form, which will help 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 the above number are charged at 8p per minute plus network extras. Lines are open from 8.30am to 5.30pm Monday to Friday.

In addition, the following services are offered to shareholders:

- **Shareview** – online access to your shareholding, including balance movements, indicative share prices and information on recent payments
- **Dividend mandates** – have your dividends paid directly into either your UK bank/building society account or an overseas bank account
- **Dividend reinvestment plan (DRIP)** – have your dividend reinvested in shares purchased on the stock market

More information on all these services can be found on Equiniti's website ([www.shareview.co.uk](http://www.shareview.co.uk)).

## American Depositary Receipts

BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares.

JPMorgan Chase Bank, N.A. is the depository. 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](mailto:jpmorgan.adr@wellsfargo.com)

Telephone number for general queries: (800) 990 1135

Telephone number from outside the US: +1 651 453 2128

## 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](http://www.sharegift.org), by telephone on 020 7930 3737 or by email: [help@sharegift.org](mailto:help@sharegift.org)

## Share price information

The middle market price of the Company's ordinary shares on 31 December 2014 was 472.0p and the range during the year was 376.0p to 481.7p.

## For more information

Visit the Shareholder information section of our website: [www.baesystems.com/investors](http://www.baesystems.com/investors)

## FINANCIAL CALENDAR

Financial year end	31 December
Annual General Meeting	7 May 2015
2014 final ordinary dividend payable	1 June 2015
2015 half-yearly results announcement	30 July 2015
2015 interim ordinary dividend payable	30 November 2015
2015 full-year results:	
– preliminary announcement	February 2016
– Annual Report	March 2016
2015 final ordinary dividend payable	June 2016

## BEWARE OF SHARE FRAUD

Fraudsters use persuasive and high-pressure tactics to lure investors into scams.

They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment. While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

5,000 people contact the Financial Conduct Authority about share fraud each year, with victims losing an average of £20,000.

### How to avoid share fraud

1. Keep in mind that firms authorised by the FCA are unlikely to contact you out of the blue with an offer to buy or sell shares.
2. Do not get into a conversation, note the name of the person and firm contacting you and then end the call.
3. Check the Financial Services Register from [www.fca.org.uk](http://www.fca.org.uk) to see if the person and firm contacting you is authorised by the FCA.
4. Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details.
5. Use the firm's contact details listed on the Register if you want to call it back.
6. Call the FCA on **0800 111 6768** if the firm does not have contact details on the Register or you are told they are out of date.
7. Search the list of unauthorised firms to avoid at [www.fca.org.uk/scams](http://www.fca.org.uk/scams)
8. Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme.
9. Think about getting independent financial and professional advice before you hand over any money.
10. **Remember:** if it sounds too good to be true, it probably is!

### Report a scam

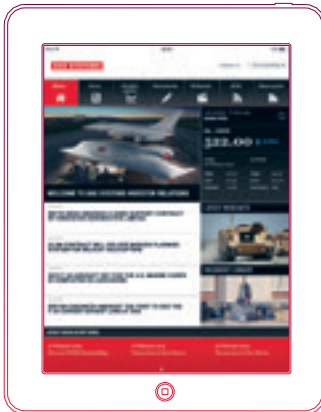
If you are approached by fraudsters please tell the FCA using the share fraud reporting form at [www.fca.org.uk/scams](http://www.fca.org.uk/scams), where you can find out more about investment scams.

You can also call the FCA Consumer Helpline on **0800 111 6768**.

If you have already paid money to share fraudsters you should contact Action Fraud on **0300 123 2040**.

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Designed and produced by Radley Yeldar.

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