BAE SYSTEMS
INSPIRED WORK

Annual Report 2015

Welcome to the BAE Systems Annual Report 2015

Further information can be found online by visiting baesystems.com

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Cover
Hawk aircraft at RAF Valley.

At BAE Systems, we provide some of the world's most advanced technology defence, aerospace and security solutions.

We employ a skilled workforce of 82,500 people[1] in over 40 countries. Working with customers and local partners, our products and services deliver military capability, protect people and national security, and keep critical information and infrastructure secure.

1. Including share of equity accounted investments.

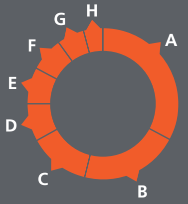
Our business

Sales[1] by domain

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

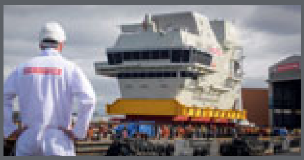
Air
53%

- Manufacture, development, upgrade and in-service support of Typhoon combat aircraft
- Design and manufacture of avionics equipment for military aircraft
- In-service support of Tornado combat aircraft
- Design and manufacture of avionics equipment for commercial aircraft
- Design and manufacture of missiles and missile systems through a 37.5% interest in MBDA
- Manufacture, development, upgrade and in-service support of Hawk trainer aircraft
- Design and manufacture of sub-assemblies and electronic systems for F-35 Lightning II combat aircraft
- Development of next-generation unmanned air systems

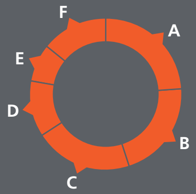


A	Typhoon	33%
B	Defence avionics	21%
C	Tornado	13%
D	Commercial avionics	8%
E	Weapon systems	8%
F	Hawk	7%
G	F-35 Lightning II	6%
H	Other	4%

Maritime
28%



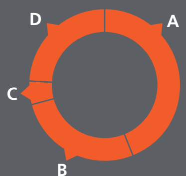
- Design and manufacture of complex warships
- Design and manufacture of submarines
- Provision of ship repair and modernisation services in the US
- Provision of in-service support to surface ships and facilities management in the UK
- Design and manufacture of naval gun systems, torpedoes, radars, and naval command and combat systems



A	Complex warships	24%
B	Submarines	21%
C	US ship repair	21%
D	UK naval support	12%
E	Weapon systems	8%
F	Other	14%

Land
13%

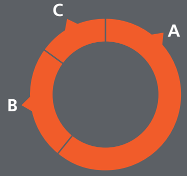
- Design, manufacture, upgrade and support of tracked and amphibious combat vehicles
- Manufacture of ammunition and precision munitions for US, UK and other armed forces
- Design and manufacture of artillery systems and missile launchers for US, UK and other armed forces



A	Combat vehicles	44%
B	Munitions	27%
C	Weapon systems	5%
D	Other	24%

Cyber
6%

- Supply of cyber, intelligence and security capabilities to US government agencies
- Supply of defence-grade cyber solutions for the commercial market
- Supply of cyber, intelligence and security capabilities to UK and other government agencies



A	US government	61%
B	Commercial	24%
C	UK and other governments	15%

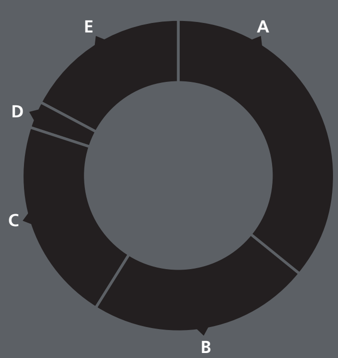
P(iv) Our key products and services

Sales[1] for 2015

£17.9bn

Sales[1] by destination

BAE Systems has leading positions in its principal markets in the US, UK, Saudi Arabia and Australia.

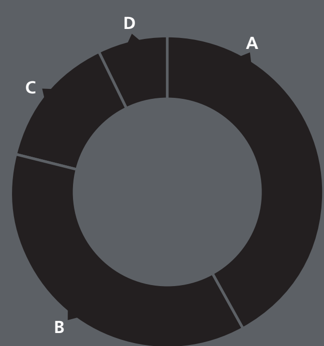


A	US	36%
B	UK	23%
C	Saudi Arabia	21%
D	Australia	3%
E	Other[2]	17%

P11 Our markets

Sales[1] by activity

BAE Systems has a diverse portfolio, broadly balanced between an enduring services and support business, long-term platforms programmes, electronic systems, and activities in cyber and intelligence.



A	Military and technical services and support	42%
B	Platforms	37%
C	Electronic systems	14%
D	Cyber	7%

P24 Segmental performance

Employees[1] by location

Employees[1]

82,500

US	
UK	
Saudi Arabia	
Australia	
Other[1]	9,900

1. Including share of equity accounted investments.
2. Includes £1.4bn (8%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

P48 Our people

Our key products and services

BAE Systems has strong, established positions supplying defence equipment, electronics and services, and cyber, intelligence and security solutions for governments. We also have a growing position in adjacent commercial markets, including avionics and cyber security.

Typhoon manufacture and development

Manufacture of major Typhoon assemblies. Aircraft assembly and expansion of the capabilities of aircraft in service with the Royal Air Force and Royal Saudi Air Force.

F-35 Lightning II design and manufacture

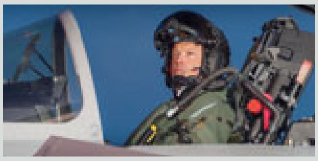
Design and manufacture of sub-assemblies, including the aft fuselage and empennage, in the UK and provision of equipment, including the electronic warfare suite, in the US. BAE Systems has a significant workshare on the world's largest defence programme.

Unmanned and future air system capabilities

Development of future air system capabilities, including unmanned air systems, with the potential for a joint unmanned combat air system programme with France.

Air support and training

Provision of support to operational capability. The Group provides maintenance, support and training for Typhoon aircraft in service with the UK and Saudi Arabian air forces. Under the Saudi British Defence Co-operation Programme, the Group has contracts to provide manpower, logistics and training, as well as training aircraft, including Hawk, and upgrades to Tornado aircraft in Saudi Arabia. The Group provides support for Hawk aircraft in service in 14 countries.

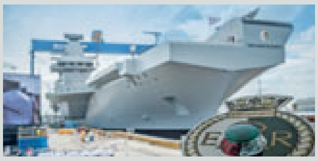


Defence avionics equipment

Design and manufacture of avionics equipment across a range of US and other Western military aircraft programmes, including a leadership position in the electronic warfare market. BAE Systems has been selected by Boeing to design and manufacture a new electronic warfare system for the US Air Force's F-15 fleet.

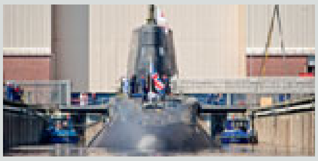
Commercial avionics equipment

Design and manufacture of avionics equipment across multiple commercial aircraft platforms, including engine and flight controls, and cabin and cockpit systems, together with aftermarket support services. BAE Systems is a major supplier to Boeing.



Complex warships

Design and manufacture of two 65,000 tonne aircraft carriers and three Offshore Patrol Vessels for the Royal Navy, together with design, and anticipated manufacture, on the Royal Navy's Type 26 frigate programme. The aircraft carriers are expected to complete sea trials in 2017 and 2019, respectively.



Submarines

Design and manufacture of seven Astute Class nuclear-powered attack submarines for the Royal Navy, together with design, and anticipated manufacture, of nuclear-powered submarines to carry the UK's Trident nuclear deterrent. The third of class Astute boat, Artful, is now being operated by the Royal Navy, with the final boat expected to enter service towards the middle of the next decade.

Ship repair and naval support

Provision of naval and commercial ship repair and modernisation services in the US, UK and Australia, together with support to the navies of the US, UK and Australia. In the US, BAE Systems has facilities located on the East, West and Gulf coasts, as well as Hawaii, and is investing in new dry dock facilities at its San Diego shipyard to support the US Navy's increased focus on Asia-Pacific operations.

Weapon systems

Design and manufacture of naval gun systems, torpedoes, radars, naval command and combat systems, artillery systems, missile launchers and, through a 37.5% interest in MBDA, missiles and missile systems.

Combat vehicles

Products and services include upgrade of US Army tracked vehicles, including Bradley Fighting Vehicles, design and manufacture of the US Army's M109 self-propelled howitzer and Armored Multi-Purpose Vehicle, design, manufacture and support of the CV90 combat vehicle for international customers, and vehicle upgrade and support to the British Army.

Cyber security

Delivery of a broad range of services to enable the US military and government to recognise, manage and defeat threats. Support to UK and other government agencies in their intelligence missions. Provision of defence-grade solutions for commercial cyber applications worldwide.

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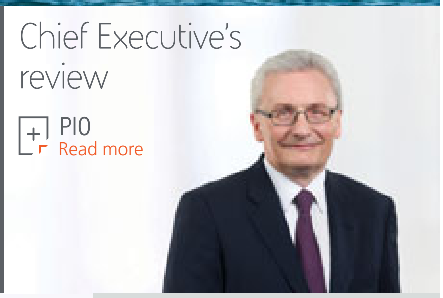

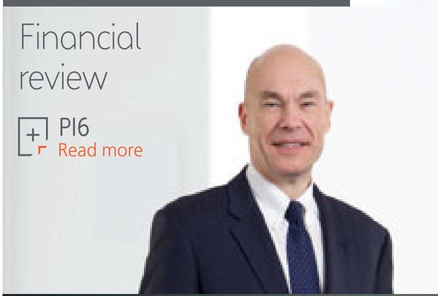

Responsible business
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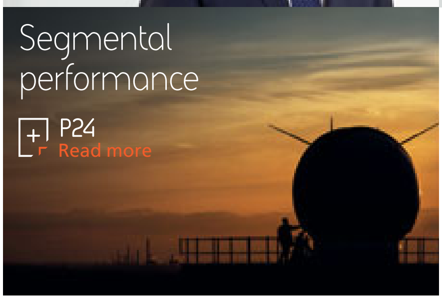


Financial and operational highlights

In 2015, BAE Systems delivered another year of solid performance

- Sales[1] increased by £1.3bn to £17.9bn, including a £0.8bn benefit to UK sales from increased aircraft deliveries to Saudi Arabia and sales from the trading of equipment on the European Typhoon programme and the increased activity across the naval business. Exchange translation added £0.2bn compared to prior year.
- Underlying EBITA[2] reduced by £19m, to £1,683m, impacted by both the previously announced Typhoon production slowdown and Australian shipyard impairment and rationalisation charges. There was an exchange translation benefit of £15m.
- Underlying earnings[3] per share was 2.2p higher than in 2014, at 40.2p, including a 2.6p benefit from the previously announced overseas tax provision release and an additional 1.7p benefit from a UK tax provision release.
- The large order backlog[1,4] of £36.8bn underpins confidence in the future prospects for the business.
- Final dividend of 12.5p per share making a total of 20.9p per share for the year (an increase of 2% over 2014).

Sales[1] KPI

£17,904m

£16,637m (2014)

Underlying EBITA[2] KPI

£1,683m

£1,702m (2014)

Underlying earnings[3] per share KPI

40.2p

38.0p (2014)

Order backlog[1,4]

£36.8bn

£40.5bn (2014)

Operating profit

£1,502m

£1,300m (2014)

Basic earnings per share[5]

29.0p

23.4p (2014)

Operating business cash flow[6] KPI

£681m

£1,191m (2014)

Net debt (as defined by the Group)[7] KPI

£(1,422)m

£(1,032)m (2014)

Dividend per share

20.9p

20.5p (2014)

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 17).
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 7 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 19).

Operational and strategic highlights for 2015 include:

Selected by Boeing to develop and manufacture the next-generation digital electronic warfare system for the US Air Force's Eagle Passive Active Warning Survivability System programme. The upgrade of up to 400 F-15 aircraft could be worth in excess of $1.0bn (£0.7bn) over the life of the programme.

Major contracts received from the Royal Navy, including an £859m Type 26 frigate demonstration contract and the full £1.3bn contract for the fifth Astute Class submarine.

Further contracts received in support of the US combat vehicle industrial base, including $104m (£71m) for the engineering and manufacturing development phase as part of the competition for the Amphibious Combat Vehicle 1.1 programme.

In Saudi Arabia, a contract was awarded for a further 22 Hawk aircraft, associated ground equipment and training aids.

Progressive expansion of the Typhoon aircraft's capabilities, including the integration of the Captor E-Scan radar and additional weapons.

Sales growth of 31% in Applied Intelligence and increased investment to support the expansion of the commercial cyber security business.

Awarded a five-year contract by the US Army for the Enhanced Night Vision Goggle III and Family of Weapon Sights – Individual programme, with a potential value of $435m (£295m).

A $100m (£68m) capital investment programme underway at our San Diego, California, shipyard.

P10 Chief Executive's review

P24 Segmental performance

Chairman's letter

In a challenging and turbulent world, the Company delivered a robust and solid performance.

Undoubtedly, in 2015, defence became an increasingly important priority for many countries as the risk from terrorism and military aggression continued to grow. In this context, the nature of our relationships as a strategic supplier to the governments of the UK, US, Kingdom of Saudi Arabia and Australia were clearly raised in importance and tempo. These relationships form the bedrock of our business and we will continue to invest in strengthening and developing them in the year ahead.

Equally, our customers' unrelenting demand for product excellence has continued to be matched by their requirement for competitive prices and unfailingly high service levels. The executive team has therefore been focused on managing our costs without compromising quality and service throughout the year. This has required an appropriate blend of seasoned experience and refreshed management endeavour, and the benefits of this approach have been evident across the organisation. By working with our customers in the spirit of partnership, with common objectives, greater transparency and constructive teamwork, our relationships have been strengthened and deepened. This style will be the hallmark of our business in the years ahead.

As we continue to develop our business and presence internationally, we have embraced the needs of our customers to establish and provide high-quality local employment and industrial capability, through partnerships and joint ventures for local manufacturing, services, procurement and product assembly. This strategy has been particularly evident in the Kingdom of Saudi Arabia and we believe that the expansion of our relationship in the Kingdom will go hand-in-hand with our commitment to developing greater local content. It is a partnership built over 50 years that we will seek to expand in both our interests. In India too, we have a long and successful record in manufacturing Hawk aircraft with Hindustan Aeronautics Limited that embodies Prime Minister Modi's 'Make in India' strategy.

During the course of the year, I visited many of our businesses across the globe and was consistently impressed by the technical capabilities of our people, their enthusiasm for supplying and supporting those that protect us, and their pride in delivering world-class products and services.

I saw at first hand the training facilities and support we provide apprentices and graduates in the United Kingdom. Following a record intake of some 1,000 new graduates and apprentices in 2015, we will have around 2,000 UK apprentices and graduates in training by the end of 2016 as we continue to build our own pipeline of talent for the future.

I witnessed the progress we have made in a number of countries encouraging young people, and in particular female students, to consider engineering as a rewarding career and in promoting a more diverse workforce overall. I saw on site visits the achievements of young people who had made that choice and were now working on technological innovations in cyber security, electronics or the next generation of complex military platforms and services from submarines to unmanned aircraft.

The value of these skills to the British economy was highlighted in an independent report produced by Oxford Economics[1] which showed that BAE Systems accounts for 1% of all UK exports, 45p in every £100 of Gross Domestic Product, with labour productivity more than double the national average. The report was clear that BAE Systems is an important British company at the heart of an important global industry.

Wherever BAE Systems people are working, their safety and welfare are our priority, and adherence to our high standards will remain a key focus and an integral part of our operating policies in every country whether in ownership or partnership.

Similarly, our commitment to ethical behaviour wherever we operate is a principle that the Board reinforces through all its interaction with our people to ensure everyone in the organisation recognises that we are performance-driven, but values-led. In measuring our success, we are clear that we should be judged not simply on what we do, but also on how we do it.

Adherence to these principles is a vital part of our business culture which we believe is important to all our stakeholders.

Reflecting on the highlights of the year, we have enjoyed strong performance in our electronic systems business, growth in cyber security and solid achievements across the Company, including in our maritime, land vehicles, military air, international and services businesses.

Our disappointments have been primarily limited to delays in some military aircraft orders, the absence of near-term Australian government orders to sustain our local shipbuilding capabilities and the identification of additional costs necessary to complete commercial ship construction contracts in the US.

Overall, we have been satisfied with our achievements in delivering sales of £17.9bn and underlying earnings per share of 40.2p, reassured by the strength of our order backlog of £36.8bn and pleased that future cash generation and robust prospects have facilitated a healthy dividend of 20.9p per share.

Looking forward, recent financial commitments to the defence sector by the governments of our major customers provide welcome clarity and stability for our core programmes. We take none of this for granted. We are very aware of our responsibilities to work with vigour and rigour in designing, developing and providing the highest quality of products and services on time and to budget, offering both value for money and unrivalled capability to those that put their trust in us. The Board and the management team will respect that trust and strive to meet our obligations as a constructive partner.

With this in mind, we look forward to delivering a strong performance in the year ahead.

1. Based on 2013 data.

"The Company delivered a robust and solid performance."

Sir Roger Carr Chairman

Dividend (pence)

20.9p
+2%

The Board and directors

In June 2015, Carl Symon resigned from the Board having completed seven years' service. Carl made a valuable contribution as both a non-executive director and chair of the Remuneration Committee, and we wish him well in his retirement. Paula Rosput Reynolds has now taken over the role of chair of the Remuneration Committee.

Elizabeth Corley has recently joined the Board as a non-executive director. Elizabeth will shortly step down from her current position as Chief Executive Officer of Allianz Global Investors. As a highly respected leader in the financial services industry and member of the Financial Reporting Council, Elizabeth will bring considerable business acumen, international perspective and strong governance credentials to the Board.

I am delighted that as part of our succession planning programme we have recently been able to announce the appointment of Charles Woodburn to the Board, in the newly-created role of Chief Operating Officer. Reporting to the Chief Executive, he will bring outstanding engineering credentials, valuable international experience and a fresh perspective to the Company's operations and the Board.

Led by our Senior Independent Director, Nick Rose, the Board has agreed to extend my term of appointment as Chairman until February 2020. I very much look forward to continuing to work with fellow directors and the executive team during this period.

Dividend

The Board has recommended a final dividend of 12.5p per share making a total of 20.9p per share for the year, an increase of 2% over 2014. Subject to shareholder approval at the 2016 Annual General Meeting, the dividend will be paid on 1 June 2016 to holders of ordinary shares registered on 22 April 2016.

Sir Roger Carr Chairman

Group strategic framework

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

Our vision is to be the premier international defence, aerospace and security company

Our mission is to safeguard and enhance our customers' vital interests and deliver sustainable growth in shareholder value

Our strategy

– Maintain and grow our defence businesses
– Continue to grow our business in adjacent markets
– Develop and expand our international business
– Inspire and develop our people to drive success
– Enhance overall financial performance and competitive positions

Strategic objectives

- Continuously improve efficiency and competitiveness
- Continue to drive value from our defence platforms and services
- Accelerate the growth of our cyber, intelligence and security business
- Continue to win new international orders
- Continue to grow our electronic systems business
- Leverage our technology and engineering capabilities

Our values are Trusted, Innovative and Bold

Our strategy is guiding us through challenging market conditions. Government spending is still under pressure and competition is high across 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. We have also continued to invest in our business and people and in the technology and skills we need to drive the business forward.

Our vision is to be the premier international defence, aerospace and security company.

Our mission recognises the important role we play in protecting and enhancing our customers' vital interests, from defence and national security to critical infrastructure and commercial information.

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.

We define our strategic objectives, which set near-term priorities and help employees to align their personal objectives to the Group's strategy.

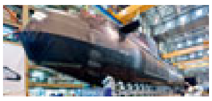
Each year, the Group has an overall objective to meet its financial targets and each Executive Committee member has specific annual objectives in support of the Group's strategy.

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

Our strategy in action

Throughout this report, we use case studies to demonstrate performance against our strategic objectives.

Continuously improve efficiency and competitiveness



P13 Major investments in naval facilities

P41 World-class manufacturing facilities

Continue to drive value from our defence platforms and services

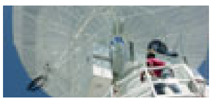
P14 Global footprint of the F-35 programme

P36 Amphibious Combat Vehicle 1.1 contract award

P38 HM Naval Base Portsmouth modernisation

Accelerate the growth of our cyber, intelligence and security business

P30 Commercial cyber security



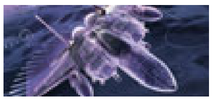
P32 Maintaining space radars

Continue to win new international orders

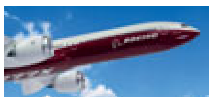
P42 Saudi training partnership

P45 MBDA export success

Continue to grow our electronic systems business



P28 Innovation in electronic warfare



P29 Commercial flight control electronics

Leverage our technology and engineering capabilities

P26 Advancing future solutions

P34 Naval weapon technology

P44 F-35 missile collaboration

How our business works

How we create value for our shareholders

We identify opportunities with customers…

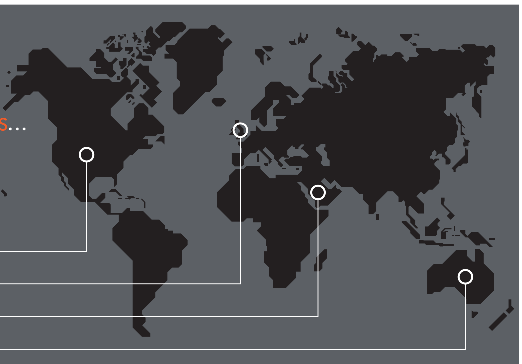
– We deliver advanced defence, aerospace and security solutions to many governments and customers around the world.

– 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…



…and, increasingly, in international export markets.

P(iii) Sales by destination

Our value chain

Bidding and contracting

– We assess opportunities and risk rigorously before deciding to bid.

– 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 services.

– We engineer and manufacture some of the world's most technologically advanced platforms, products and systems.

Support and sustainment

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

– 42% of our sales are services-related contracts.

– Many of our platforms stay in service for decades.

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.

P(iii) Sales by activity

We report through five principal reporting segments

Electronic Systems

P26 See more

Cyber & Intelligence

P30 See more

Platforms & Services (US)

P34 See more

Platforms & Services (UK)

P38 See more

Platforms & Services (International)

P42 See more

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 and only when the return from doing so is in excess of the Group's Weighted Average Cost of Capital

– investing in value-enhancing acquisitions

P16 Financial review

Our business is enabled by our outstanding resources...

Our people

We:

- have 82,500 employees[1] worldwide
- have a diverse range of talented people
- invest in education and training for our existing workforce
- work with education sectors to help shape the workforce of the future

Our technology and engineering

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 £1,263m (2014 £1,343m) in 2015 on R&D, of which £168m (2014 £137m) was funded by the Group

Our project management

We:

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

Our key relationships

Our policies and procedures require that we:

- work with suppliers who share our values and embrace our standards
- set clear expectations for all suppliers
- assess supplier performance and compliance with local legislation
- work only with approved advisers

...supported by strong governance processes,...

Operational Framework

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

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

We manage our operations responsibly and conduct our business in an ethical way to earn and maintain our stakeholders' trust.

...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

To improve safety standards, we focus on raising awareness of our employees' role in identifying, managing and reducing safety risks.

P48 Our people

Diversity

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

P48 Our people

Resource efficiency

We proactively manage the impact of our operations on the environment, with targets for the efficient use of resources set, and monitored, locally.

P51 Resource efficiency

Community investment

We invest in the communities in which we operate through local recruitment, using local suppliers and supporting local charities.

P50 Community investment

1. Including share of equity accounted investments.

Chief Executive's review

Overview and key business attributes

We have delivered another year of solid performance. BAE Systems has continued to demonstrate resilience in markets constrained by wider economic pressures.

Over the past several years, the Group has navigated through a period of constrained defence budgets. Where sales volumes have been challenged, we have taken actions to protect earnings and deliver attractive shareholder returns. The overall business environment is now improving and the Group is well positioned as we enter this phase.

Our business benefits from a number of distinct attributes which underpin performance and prospects.

Geographic diversity

BAE Systems has a broader geographic presence than many of its defence industry peers, with its largest markets in the US, UK, Saudi Arabia and Australia. Growing our international business further remains a key strategic objective.

Customer focus

Our businesses continue to focus on operational excellence to deliver on customer commitments. In addition to the design and production of platforms and equipment, we have established extensive support services delivering long-term capability to customers beyond the manufacturing phase of products. In 2015, support and service activities generated approximately 42% of sales.

Ethical business

As a leading defence company operating in international markets, we take pride in our culture of responsible behaviour and recognise that ethical behaviour in all aspects of our business is essential for our ongoing success.

Technology and innovation

BAE Systems has developed some of the world's most innovative technologies and we continue to invest in research and development to generate future products and capabilities. This company-funded research and development often leads to customer-funded development activity as requirements mature.

Company-funded research and development investment is more relevant in some areas of the Group's activities and is, therefore, disproportionately focused in areas such as defence and commercial aerospace electronics, military aircraft and cyber security.

Approximately 7% of sales is invested in customer and company-funded research and development activities.

"Another year of solid performance."

Ian King Chief Executive

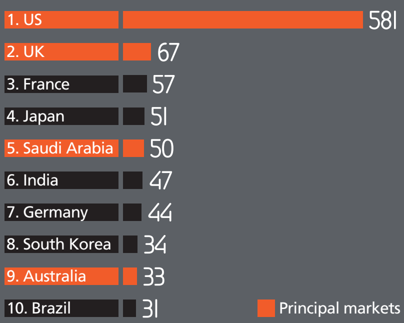
Our markets

BAE Systems is well positioned to support its diverse customer base.

The Group operates in four principal markets, identified as having a significant and sustained commitment to defence and security. These principal markets, the US, the UK, the Kingdom of Saudi Arabia and Australia, encourage investment to develop and sustain a domestic defence industrial capability. Through such investment, BAE Systems has established long-term and trusted customer relationships and is an established part of the defence industrial capability in each of those countries.

The Group's strategy continues to focus on the importance of winning international business. BAE Systems has a strong international market presence with well-established relationships in key accessible markets.

Accessible global defence markets ($bn)



Source: 2014 US defence budget as shown in the Department of Defense Fiscal Year 2016 Budget Request and, outside the US, IHS Jane's Defence Budgets (based on 2014 total defence budgets and constant 2015 US dollars).

P(iii) Sales by destination

US

The US remains the largest single defence market in the world, with fiscal year 2016 defence spending expected to be $581bn (£394bn).

Whilst BAE Systems expects budget challenges to continue, further clarity regarding potential market improvement was gained after Congress reached agreement on a new budget deal that provides for defence and domestic programme spending above the Budget Control Act caps through 2017.

In addition to progressing US defence market programmes, the US business remains focused on delivering capabilities for application in the growing commercial aviation market, and continues to pursue near- and long-term US Foreign Military Sales and direct international sales opportunities.

UK

BAE Systems has a key role in supporting the UK armed forces across the air, maritime and land domains, and the nation's security and intelligence capabilities in both government and commercial markets.

The UK government's actions to address programme priorities and its commitment to increase defence spending to 2% of Gross Domestic Product (GDP) have provided greater certainty and stability for core programmes. This has been reinforced by the 2015 Strategic Defence and Security Review announced in November, which provided further clarity on the UK government's strategic priorities.

Saudi Arabia

Regional challenges continue to dictate that defence and security remain a high priority for Saudi Arabia.

The planned re-organisation 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 capability.

Australia

BAE Systems is the largest defence company in Australia spanning the air, maritime, land and cyber domains.

As part of the Australian Federal Budget announcements in May, the Australian government restated its commitment to increase defence spending to 2% of GDP within a decade.

Other key international markets

Oman and India remain key markets building on BAE Systems' established relationships.

BAE Systems is developing its position in Oman, building on a long history of relationships with the Omani armed forces.

In India, BAE Systems continues to build on its long-standing relationship with Hindustan Aeronautics Limited and is working to develop its 40% interest in the BAeHAL software joint venture.

BAE Systems will continue to target opportunities in other international markets, including Asia and the Middle East.

Chief Executive's review
continued

2015 performance

US

In the US, President Obama signed the Bipartisan Budget Act of 2015, which lifts defence budget caps for fiscal years 2016 and 2017 by $33bn (£22bn) and $23bn (£16bn), respectively. This is expected to enhance the funding environment for the Group's US businesses through 2017.

The Group's electronics businesses have performed well and remain well positioned to address current and evolving priority programme requirements. As a major supplier of electronics equipment on the F-35 Lightning II aircraft, including the electronic warfare system, BAE Systems is positioned to benefit from the commitment to progressive increases in production output over coming years to meet the requirements of US and international customers.

Important new business wins in key technology areas in 2015 included the Eagle Passive Active Warning Survivability System (EPAWSS) electronic warfare upgrade for US Air Force F-15 aircraft and electronics upgrades to US Special Operations Command C-130J aircraft.

We have a strong position in the Intelligence, Surveillance and Reconnaissance domain, providing customers with high-technology sensing solutions, including advanced geospatial intelligence capabilities.

We continue to perform in commercial electronics through our broadly-based flight and engine controls activities. Company-funded investment in innovative commercial aircraft cabin systems took an important step forward with the signing of the first IntelliCabin® in-flight entertainment system airline customer.

The US Navy is redeploying some ships consistent with its stated strategy, to include expanding operations in the Asia-Pacific region. As a leading supplier of ship repair services to the US Navy, BAE Systems is responding to these changes with a reduction in workforce at its Norfolk, Virginia, facility on the Atlantic coast and by investing in additional capacity at its San Diego shipyard. In 2016, the Group expects to deliver the remaining commercial ships currently under construction in Jacksonville, Florida, and Mobile, Alabama.

Whilst much of the Group's US-based activity has proven resilient over recent years through the downturn in US defence spending, land programmes and manpower services have been disproportionately impacted. Both activities performed well in 2015, supporting expectations for an improved outlook going forward.

In land, we continued to make good progress building on the award in 2014 of the Armored Multi-Purpose Vehicle (AMPV) programme and further order intake for M109A7 (Paladin) tracked artillery systems. These two programmes draw on commonality with the Bradley family of vehicles and underpin our strong franchise in tracked combat vehicles. The Group was also down-selected as one of two companies awarded a contract for the engineering and manufacturing development phase of a competition for the US Marine Corps' Amphibious Combat Vehicle programme.

Beyond the US market, FNSS, the Turkish land systems business in which BAE Systems holds a 49% interest, secured further international armoured vehicle orders in the year.

Following external interest in the Group's US-based manpower and services activities, BAE Systems undertook a strategic review of the business. Recognising the performance of the business and its good order intake, the review concluded, in November, that greater value could be derived from retaining the businesses. Throughout the period, Intelligence & Security remained focused on providing leading-edge products and services to customers and delivered solid financial performance, winning re-compete awards and a number of new, multi-year service contracts.

UK

The Group's UK businesses continued to perform well, benefiting from good programme execution and continuity in UK customer requirements. UK government commitments in July 2015 to protect defence and security spend, in a still tightly constrained UK economic environment, were helpful.

In November, the UK government published its Strategic Defence and Security Review (SDSR). The SDSR identified defence and security priorities and set out a plan to spend £178bn on defence equipment and support over the next ten years.

A number of important SDSR commitments for BAE Systems included continued investment in expanding Typhoon capabilities and an extension of the aircraft's expected service life until at least 2040. There was also a commitment to continued joint investment with France in the development of a future unmanned combat air capability. Also in the air domain, the SDSR identified an accelerated UK procurement of F-35 Lightning II aircraft. BAE Systems is a major participant in the F-35 programme, supplying airframe assemblies and electronics equipment.

Our strategy in action
Continuously improve efficiency and competitiveness

Major investments in naval facilities

BAE Systems has agreed with the UK government an investment of more than £300m at its Barrow-in-Furness site to transform the UK's submarine manufacturing facilities to accommodate build of the successor to the current Vanguard Class nuclear deterrent boats. It will involve the construction of new state-of-the-art facilities and the refurbishment of existing infrastructure, including an extension to the Devonshire Dock Hall in which the Astute Class submarines (pictured) are currently assembled.

The construction of the first new building, a £23m logistics facility, started in August and a £90m contract was placed at the end of 2015 to build a new central yard complex where sections of new submarines will be outfitted.

In the US, BAE Systems is investing approximately $100m (£68m) to expand and complement its capabilities at its San Diego, California, shipyard to support the US Navy's changing requirements resulting from its workload rebalancing from the Atlantic to the Pacific coasts.

The Group's investment will enhance its ship repair, maintenance and modernisation services through the purchase of a new 55,000-ton lifting capacity dry dock and a range of infrastructure improvements.

More online
baesystems.com

In the maritime domain, the SDSR included a continued commitment to seven Astute Class submarines and the replacement of the four Vanguard Class submarines. The UK government reaffirmed its commitment to shipbuilding continuity providing clarity and future opportunities for the Group's shipbuilding facilities and workforce in Scotland. A fleet of at least 19 frigates and destroyers is expected to be maintained, including eight Type 26 frigates. The government's SDSR commitments also include a concept study followed by the design and build of a new class of lighter, flexible, general purpose frigates, in addition to two new Offshore Patrol Vessels.

In September, an agreement between Kuwait and Italy was announced relating to the supply of 28 Typhoon aircraft to the Kuwait Air Force. We continue to support the campaign, led by Finmeccanica, to achieve a formal contract. In November, BAE Systems announced a reduction in its build rate for Typhoon assemblies to ensure production continuity at competitive costs over the medium term. We also announced a proposal to reduce the workforce of the Military Air & Information business.

The UK government continues to provide strong support for Typhoon and other export campaigns. Although there can be no certainty as to the timing of orders, discussions with current and prospective operators of the Typhoon aircraft continue to support our expectations for additional Typhoon contract awards.

Consistent with the Group's focused investment in research and technology, in November, BAE Systems announced an agreement to acquire a 20% interest in Reaction Engines Limited (REL). REL is working on a radical new aerospace engine concept, SABRE™, which combines rocket and jet engine functions, made possible by exciting new heat exchanger technology. We expect our involvement to expedite transition of the concept to a working demonstration engine.

Chief Executive's review
continued

Our strategy in action
Continue to drive value from our defence platforms and services

Global footprint of the F-35 programme

BAE Systems is a principal subcontractor on the world's largest defence programme, the F-35 Lightning II, with high-technology manufacturing, development and support activities carried out in the US, the UK and Australia.

In the US, BAE Systems is delivering significant elements of the F-35 programme, including the aircraft's electronic warfare suite, vehicle management computer and active inceptor systems.

At BAE Systems' advanced manufacturing facility in the UK (see page 41), the Group has several workshare areas, including manufacture of the aft fuselage, and vertical and horizontal tails. We are also providing integration support to enable operations from the UK's new Queen Elizabeth Class aircraft carriers.

BAE Systems Australia produces titanium components for the F-35's vertical tails, as well as specialist electronic warfare equipment for customers in the US.

More online
baesystems.com

International
We continued to deliver Typhoon aircraft to the Kingdom of Saudi Arabia during 2015 and the Group's extensive in-Kingdom training and support activities are at a high tempo. The Royal Saudi Air Force has achieved high utilisation and aircraft availability across its Typhoon and Tornado fleets, operating under demanding conditions.

We reached agreement with the Saudi customer for the provision of a further 22 Hawk Advanced Jet Trainer aircraft, associated ground equipment and training aids for the Royal Saudi Air Force, which form part of an enhancement to the Kingdom's pilot training capacity.

As the 50th anniversary of the relationship approaches, BAE Systems continues to address current and potential new requirements as part of the long-standing agreements between the UK government and the Kingdom.

In Australia, the second of the two Landing Helicopter Dock (LHD) ships was successfully delivered into service with the Royal Australian Navy. Whilst we welcomed the Australian government's announcement of its intention to launch a naval shipbuilding strategy, the viability of the Williamstown, Melbourne, shipyard remains uncertain. With no near-term prospect of work beyond the LHD programme and Air Warfare Destroyer block manufacture, we announced further headcount reductions in November, together with other cost reduction measures across the Australian businesses. In addition, a non-cash impairment charge has been taken against the carrying value of the Williamstown facility.

In India, BAE Systems has a long-standing relationship with Hindustan Aeronautics Limited (HAL). Delivery of a second batch of HAL-assembled Hawk aircraft continues and negotiations are underway to agree a third batch. The Group has also commenced discussions with HAL for further co-development of Indian Hawk aircraft to meet potential requirements for new capabilities.

The Group continues to discuss the potential sale of M777 howitzers, including prospective local arrangements for assembly, integration and testing, to address India's large requirement for new-generation artillery systems.

BAE Systems is a 37.5% shareholder in the MBDA guided weapons business. MBDA continues to win significant order intake, including naval weapon systems and weapons awards in support of multiple combat aircraft types. The business expects to win further orders from recently announced, and anticipated, international sales of European combat aircraft. MBDA is expected to generate strong growth in later years from this rising order book.

Cyber security
A substantial expansion of the Group's Applied Intelligence business into commercial markets is underway, with significant recruitment and product development alongside integration of the former SilverSky business, acquired at the end of 2014. Sales growth is expected to continue, underpinned by continued good order intake as cyber security becomes an increasingly important part of government security and a core element of stewardship for commercial enterprises.

Acquisitions and disposals
In April, BAE Systems completed the sale of its 75% holding in BAE Systems Land Systems South Africa (Pty) Limited to Denel (SOC) Limited for cash consideration of 655 million Rand (£36m).

In June, we acquired Eclipse Electronic Systems, Inc. from Esterline Corporation. The Texas-based business provides advanced Intelligence, Surveillance and Reconnaissance products and services to the US defence and intelligence community.

Balance sheet and capital allocation
The Group's balance sheet continues to be managed conservatively in line with its policy to retain its investment grade credit rating and to ensure operating flexibility. Consistent with this approach, the Group meets 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 and only when the return from doing so is in excess of the Group's Weighted Average Cost of Capital. Investment in value-enhancing acquisitions is considered where market conditions are right and where they deliver on the Group's strategy.

The Group continues to fund the pension deficits of the UK schemes under funding agreements determined following the last UK valuations in 2014. The next valuations of the UK pension schemes are expected to begin in April 2017.

In February 2013, we initiated a share repurchase programme of up to £1bn over three years. As at 31 December 2015, a total of 120.5 million shares had been purchased for £502m under the programme.

Responsible business
BAE Systems continues to instil responsible behaviour across the Group by supporting employees in making the right ethical decisions. During 2015, a revised Code of Conduct was launched and cascaded to employees via face-to-face briefings.

The safety of our employees, and anybody who works on, or visits, our sites, is a key priority. We provide training and tools to employees to help them understand the importance of a safe workplace. Senior leadership plays a key role in maintaining the focus on safety and leading through example.

We are saddened to report that, during 2015, there were two air incidents that resulted in seven fatalities, four of our employees and three from other companies. We have been supporting investigations with air accident authorities in Saudi Arabia and the US, and are carrying out internal reviews into the incidents.

Engaging and developing the skills and talent of our employees and future workforce to address our customers' complex and challenging projects remained a key focus during 2015, including continuing to develop an inclusive and diverse work environment to help drive innovation.

Looking forward
BAE Systems has a large order backlog generated by a well-balanced portfolio of businesses serving the needs of customers in many of the world's larger accessible markets.

Many contracts are multi-year and our current order backlog will deliver a significant proportion of our sales over the next five years, providing long-term visibility of revenues.

Having demonstrated good resilience through an extended period of economic challenge in many of its markets, the Group is well placed to continue to generate attractive returns for shareholders as defence budgets increase.

Ian King Chief Executive

Financial review

Peter Lynas Group Finance Director

Financial Key Performance Indicators

Sales[1] (£bn)
P17

£17.9bn
+8%

2015	17.9
2014	16.6
2013	18.2

Order intake[1] (£bn)
P18

£14.9bn

2015	14.9
2014	15.1
2013	19.3

Target[6] not achieved
15% UK executive directors' annual bonus[7]

Underlying EBITA[2] (£m)
P17

£1,683m
-1%

2015	1,683
2014	1,702
2013	1,925

Underlying earnings[3] per share (pence)
P18

40.2p
+6%

2015	40.2
2014	38.0
2013	42.0

Target[6] achieved
40% UK executive directors' annual bonus[7]

Operating business cash flow[4] (£m)
P19

£681m

2015	681
2014	1,191
2013	147

Net debt (as defined by the Group)[5] (£m)
P19

£(1,422)m

2015	(1,422)
2014	(1,032)
2013	(699)

Target[6] achieved
25% UK executive directors' annual bonus[7]

Income statement

Sales[1] increased by £1.3bn to £17.9bn, including a £0.8bn benefit to UK sales from increased aircraft deliveries to Saudi Arabia and sales from the trading of equipment on the European Typhoon programme and the increased activity across the naval business. Exchange translation added £0.2bn compared to prior year.

Underlying EBITA[2] decreased by £19m to £1,683m (2014 £1,702m), giving a return on sales of 9.4% (2014 10.2%), impacted by both the previously announced Typhoon production slowdown and Australian shipyard impairment and rationalisation charges. There was an exchange translation benefit of £15m.

Non-recurring items in 2015 of £26m includes research and development expenditure credits relating to 2013 and 2014 (£50m), partly offset by a loss on the disposal of the Group's 75% shareholding in the Land Systems South Africa business (£24m).

Amortisation of intangible assets[1] reduced to £108m (2014 £184m) due to acquired intangible assets fully amortising in 2014.

Impairment of intangible assets mainly comprises the impairment of goodwill in the US Intelligence & Security business reflecting lower growth assumptions. In 2014, goodwill impairment charges were taken against the carrying value of the US Support Solutions (£87m) and South African (£74m) businesses.

Finance costs[1] were £409m (2014 £448m). The underlying interest charge, excluding pension accounting, and fair value and foreign exchange adjustments on financial instruments and investments, reduced to £194m (2014 £204m) primarily from a lower level of net present value adjustments. Net interest expense on the Group's pension deficit was higher at £200m (2014 £155m) mainly reflecting the increase in the deficit at the beginning of 2015.

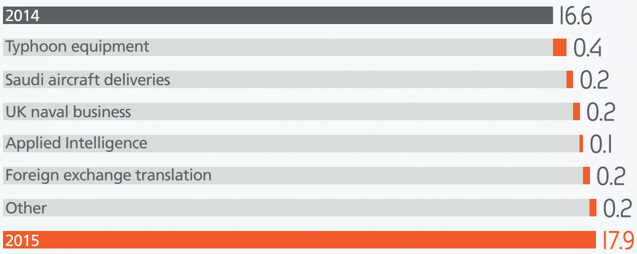
Taxation expense[1] reflects the Group's underlying effective tax rate for the year of 21%, which excludes the change in accounting for UK research and development credits and the benefit of £134m arising from the adjustment of certain tax provisions. Including these items, the underlying effective tax rate is 14%. The calculation of the underlying effective tax rate is shown in note 6 to the Group accounts on page 120. The underlying effective tax rate for 2016 is expected to be around 22%, with the final rate dependent on the geographical mix of profits.

Looking beyond 2016, the effective tax rate will depend principally on whether there are any changes in tax legislation in the Group's most significant countries of operation, the geographical mix of profits and the resolution of open issues. The Group does not expect the future rate to be materially impacted by the changes to the international tax landscape resulting from the package of measures developed under the OECD/G20 Base Erosion and Profit Shifting project and the investigations and proposals of the European Commission. However, the details of those are yet to be finalised and the Group will keep these under review.

Income statement

		2015 £m	2014 £m
Sales[1]	KPI	17,904	16,637
Underlying EBITA[2]	KPI	1,683	1,702
Return on sales		9.4%	10.2%
Non-recurring items		26	–
EBITA		1,709	1,702
Amortisation of intangible assets[1]		(108)	(184)
Impairment of intangible assets		(78)	(170)
Finance costs[1]		(409)	(448)
Taxation expense[1]		(171)	(148)
Profit for the year		943	752

Sales[1] bridge (£bn)



P112 Note 1 to the Group accounts

Exchange rates

Average	2015	2014
£/$	1.528	1.647
£/€	1.377	1.241
£/A$	2.036	1.827

Sensitivity analysis

Estimated impact on sales[1] of a ten cent movement in the average exchange rate	£m
$	400
€	50
A$	30

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 7 to the Group accounts).
4. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.
5. Comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account (see page 19).
6. The target is the Group's budget for the year, which represents the first year of the five-year Integrated Business Plan (see page 64).
7. 85% (including 5% relating to safety objectives – see page 46) 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 (see page 76).

Financial review
continued

Order intake

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

Order intake[1] of £14.9bn was broadly similar to 2014 (£15.1bn). Key awards included the UK Type 26 demonstration phase contract (£0.9bn), weapons package agreements for Egypt and Qatar in MBDA as part of agreed export contracts for Rafale aircraft (£0.8bn), and further Hawk aircraft and associated equipment for Saudi Arabia.

Earnings per share

Underlying earnings[3] per share for the year was 2.2p higher than in 2014, at 40.2p (2014 38.0p), including a 2.6p benefit from the previously announced overseas tax provision release and an additional 1.7p benefit from a UK tax provision release.

Basic earnings per share, in accordance with International Accounting Standard 33, Earnings per Share, was 29.0p (2014 23.4p).

Earnings per share

		2015	2014
Underlying earnings[3] per share	KPI	**40.2p**	38.0p
Basic earnings per share		**29.0p**	23.4p

Underlying earnings[3] per share bridge (pence)

P122 Note 7 to the Group accounts

1. Including share of equity accounted investments.
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 7 to the Group accounts).

Cash flow

Operating business cash flow[4]

Cash inflow from operating activities was £924m (2014 £913m), which includes cash contributions in respect of pension deficit funding, over and above service costs, for the UK and US schemes totalling £274m (2014 £391m).

The major advances received in 2012 on the Omani Typhoon and Hawk order, and the Saudi training aircraft contract, continue to be consumed. Advances were also utilised in the year on European Typhoon production. Costs are being incurred against provisions created in previous years, including the US commercial shipbuilding programmes and on UK rationalisation. The second of the two payments under the Salam price escalation settlement was received.

Net capital expenditure and financial investment was £284m. In 2014, there was a net cash inflow of £215m, which included the receipt of £418m in respect of the sale and leaseback of two properties in Saudi Arabia.

Dividends received from equity accounted investments reduced by £22m to £41m (2014 £63m) reflecting a lower dividend from MBDA.

Interest payments were £28m higher at £173m (2014 £145m) primarily reflecting the timing of interest payments on US dollar bonds and interest receipts in the UK.

The net cash inflow in respect of **acquisitions and disposals** of £16m includes £21m received in respect of the sale of the Group's 75% shareholding in the Land Systems South Africa business, less £5m paid in respect of the acquisition of Eclipse Electronic Systems, Inc. In 2014, there was a net cash outflow of £230m comprising the acquisition of SilverSky (£147m) and Signal Innovations Group (£12m), together with an additional 59% shareholding in Saudi Development and Training Company (£71m).

During 2015, there was a cash outflow of £7m (2014 £283m) under the **share repurchase programme** representing shares purchased and cancelled under the programme announced in February 2013. The return on investment from buying back the Group's own shares reduces as the share price rises and, as a result, activity on the programme has been minimal in the year.

Equity dividends paid in 2015 includes payments in respect of the 2014 final (£389m) and 2015 interim (£266m) dividends.

Dividends paid to non-controlling interests increased to £40m (2014 £14m) reflecting higher dividends paid by both the Group's 75%-owned South African business prior to disposal and a 51%-owned Saudi portfolio company.

Foreign exchange translation, primarily in respect of the Group's US dollar-denominated borrowing, increased reported net debt by £165m.

Cash flow

		2015 £m	2014 £m
Cash inflow from operating activities		**924**	913
Capital (expenditure)/proceeds (net) and financial investment		**(284)**	215
Dividends received from equity accounted investments		**41**	63
Operating business cash flow[4]	KPI	**681**	1,191
Interest		**(173)**	(145)
Taxation		**(116)**	(92)
Free cash flow		**392**	954
Acquisitions and disposals		**16**	(230)
Cash classified as held for sale		**–**	(6)
Share repurchase programme		**(7)**	(283)
Other net sale of own shares		**8**	2
Equity dividends paid		**(655)**	(642)
Dividends paid to non-controlling interests		**(40)**	(14)
Cash flow from matured derivative financial instruments		**12**	8
Movement in cash collateral		**3**	10
Movement in cash received on customers' account[8]		**–**	1
Total cash outflow		**(271)**	(200)
Foreign exchange translation		**(165)**	(146)
Other non-cash movements		**46**	13
Increase in net debt (as defined by the Group)		**(390)**	(333)
Opening net debt (as defined by the Group)		**(1,032)**	(699)
Net debt (as defined by the Group)		**(1,422)**	(1,032)
Debt-related derivative financial instrument assets		**53**	10
Cash and cash equivalents		**2,537**	2,314
Less: Cash classified as held for sale		**–**	(6)
Cash (as defined by the Group)		**2,590**	2,318
Loans – non-current		**(3,775)**	(2,868)
Loans and overdrafts – current		**(237)**	(482)
Debt (as defined by the Group)		**(4,012)**	(3,350)
Net debt (as defined by the Group)	KPI	**(1,422)**	(1,032)

4. Net cash inflow from operating activities after capital expenditure (net), financial investment and dividends from equity accounted investments.
8. Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance. It is included within trade and other payables in the Consolidated balance sheet.

Financial review
continued

Balance sheet

The £134m increase in **intangible assets** to £10.1bn (2014 £10.0bn) mainly reflects exchange translation (£257m), partly offset by amortisation and impairment (£182m).

Property, plant and equipment, and investment property increased to £1.8bn (2014 £1.7bn), including £32m of exchange translation.

Equity accounted investments and other investments increased to £256m (2014 £236m) reflecting the Group's share of profit for the year (£110m), partly offset by exchange translation (£45m) and dividends received (£41m).

The £0.9bn reduction in the Group's share of the pre-tax **net pension deficit** mainly reflects a decrease in liabilities due to a 0.3 percentage point increase in the real discount rate to 0.7% in the UK and a 0.4 percentage point increase in the nominal discount rate to 4.5% in the US.

In December 2015, BAE Systems, Airbus and the scheme trustees agreed to work towards the creation of a separate Airbus section of the BAE Systems Pension Scheme (Main Scheme) in 2016 with the allocation of the deficit to the BAE Systems and Airbus sections based on each member's last employer. This allocation methodology has been reflected in the allocation of the IAS 19 pension deficit in the Main Scheme at 31 December 2015. The impact of this change on the amounts allocated at 31 December 2015 is an increase of £187m (£153m post-tax) in the Group's share of the reported IAS 19 deficit.

Details of the Group's pension schemes are provided in note 20 to the Group accounts on page 139.

A net deferred tax asset of £0.9bn (2014 £1.2bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

There was a £0.6bn increase in **working capital** mainly reflecting a net reduction in advance contract funding and utilisation of provisions.

The Group expects to complete the disposal of Aircraft Accessories and Components Company during 2016 and, accordingly, it is classified as **held for sale** at 31 December 2015 (£12m). The disposal of the Group's 75% shareholding in the Land Systems South Africa business, which was held for sale at 31 December 2014 (£41m), was completed during 2015.

The Group's **net debt**[5] at 31 December 2015 is £1,422m, a net increase of £390m from the net debt position of £1,032m at the start of the year.

A $750m (£481m) 5.2% bond was repaid at maturity in August.

In December, BAE Systems issued $1.5bn (£1.0bn) of bonds in the US capital market comprising a $500m five-year bond at a 2.85% coupon, a $750m ten-year bond at a 3.85% coupon and a $250m 30-year bond maturing in 2044 at a 4.75% coupon.

Cash and cash equivalents of £2,537m (2014 £2,314m) are held primarily for the repayment of debt securities, pension deficit funding, payment of the 2015 final dividend and management of working capital.

5. Comprises cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments) and cash received on customers' account (see page 19).

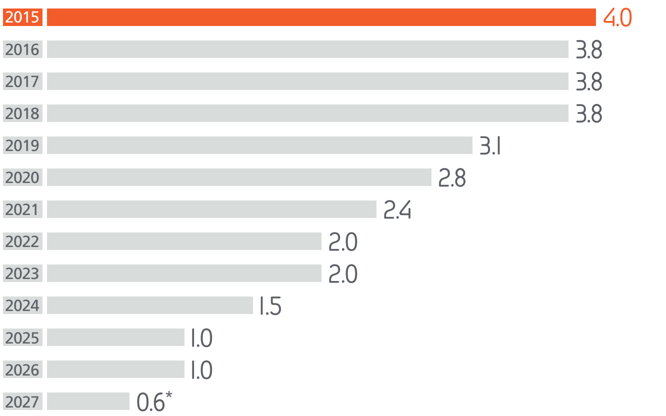
Balance sheet

	2015 £m	2014 £m
Intangible assets	**10,117**	9,983
Property, plant and equipment, and investment property	**1,818**	1,718
Equity accounted investments and other investments	**256**	236
Other financial assets and liabilities, net	**(43)**	(112)
Pension deficit, net (see below)	**(4,501)**	(5,368)
Tax assets and liabilities, net	**661**	865
Working capital	**(3,896)**	(4,466)
Net assets held for sale	**12**	53
Net debt (as defined by the Group)	**(1,422)**	(1,032)
Net assets	**3,002**	1,877
Pension deficit, net (see above)	**4,501**	5,368
Add back: Amounts allocated to equity accounted investments and other participating employers	**1,053**	1,444
Total IAS 19 deficit, net	**5,554**	6,812

Pension deficit bridge (£bn)

P139 Note 20 to the Group accounts

Maturity of the Group's borrowings (£bn)



*Repayable in 2041 (£268m) and 2044 (£363m).

P137 Note 18 to the Group accounts

Exchange rates

Year end	2015	2014
£/$	**1.474**	1.559
£/€	**1.357**	1.287
£/A$	**2.027**	1.908

Critical accounting policies

Certain of the Group's significant 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	
Revenue	£16.8bn (year ended 31 December 2015) See note 1 to the Group accounts
Carrying value of intangible assets	
Intangible assets	£10.1bn (at 31 December 2015) See note 8 to the Group accounts
Valuation of retirement benefit obligations	
Group's share of IAS 19 deficit, net	£4.5bn (at 31 December 2015) See note 20 to the Group accounts

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For more information

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 only when the return from doing so is in excess of the Group's Weighted Average Cost of Capital; 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+	Negative	Investment grade
Fitch Ratings	BBB+	Negative	Investment grade

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Note 22 to the Group accounts

Treasury

The Group's treasury activities are overseen by the Treasury Review Management Committee (TRMC). Two executive directors are members of the TRMC, including the Group Finance Director who chairs the Committee. The TRMC also has representatives with legal and tax expertise. The Group operates a centralised treasury department that is accountable to the TRMC for managing treasury activities in accordance with the treasury policies approved by the Board.

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 £1.9bn contracted from December 2018 to December 2020 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.

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Note 27 to the Group accounts

Financial review
continued

Tax strategy

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.

The Group promotes collaborative professional working with tax authorities in order to build open, transparent and trusted relationships. As part of this, the Group engages in open and early dialogue to discuss tax planning, strategy, risks and significant transactions, and discloses any significant uncertainties in relation to tax matters. Queries and information requests by tax authorities are responded to in a timely fashion and the Group ensures that tax authorities are kept informed about how issues are progressing. The Group seeks to resolve issues in real-time and before returns are filed where possible. Fair, accurate and timely disclosures are made in tax returns, reports and documents that the Group files with, or submits to, tax authorities. Where disagreements over tax arise, the Group works proactively to seek to resolve all issues by agreement (where possible) and reach reasonable solutions.

Whilst the Group aims to maximise the tax efficiency of its business transactions, it does not use structures in its tax planning that are contrary to the intentions of the relevant legislature. The Group interprets relevant tax laws in a reasonable way and ensures that transactions are structured in a way that is consistent with a relationship of co-operative compliance with tax authorities. It also actively considers the implications of any planning for the Group's wider corporate reputation.

The Group is open and transparent with regards to decision-making, governance and tax planning in its business, keeping tax authorities informed of who has responsibility, how decisions are reached, how the business is structured and where different parts of the business are located.

BAE Systems operates internationally and is subject to tax in many different jurisdictions. The Group employs professional tax managers and takes appropriate advice from reputable professional firms. The Group is routinely subject to tax audits and reviews which can take a considerable period of time to conclude. Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The assessment and management of tax risks are regularly reviewed by the Audit Committee, as is the Group's tax strategy.

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 in relation to 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).

+ P119
Note 6 to the Group accounts

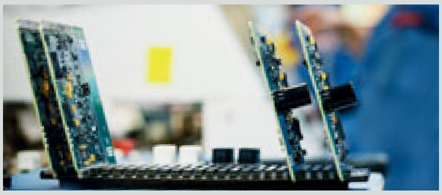
Guidance for 2016

Group guidance

In 2016, the Group's underlying earnings[1] per share are expected to be approximately 5% to 10% higher than the adjusted underlying earnings[1] per share of 36.6p* in 2015.

*Reported underlying earnings[1] per share of 40.2p excluding the previously announced 2.6p per share earnings benefit from an overseas tax provision release and an additional 1.7p per share earnings benefit from a UK tax provision release, and adjusting for a 0.7p per share benefit to an assumed US$1.45 to sterling translation rate.

Segmental guidance



Electronic Systems

- Low single-digit sales[2,3] growth is expected in 2016 with margins around the middle of an increased 13% to 15% guidance range.

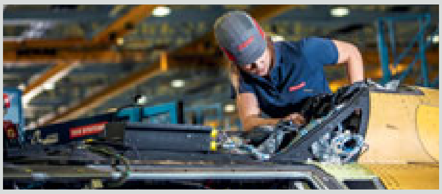
Cyber & Intelligence

Comprising the US Intelligence & Security sector (70%[3] of Cyber & Intelligence sales in 2015) and Applied Intelligence:

- Low single-digit sales[2] growth is expected in 2016 with stable sales in Intelligence & Security and good double-digit growth in Applied Intelligence.
- Margins are expected to improve to within a 7% to 9% range, following the high product development investment in the Applied Intelligence business in 2015.

Platforms & Services (US)

- Sales[2] are expected to be some 10% lower, including a reduction in naval ship repair activity as the pivot of the fleet to the West coast takes place.
- Another year of margin improvement, to a range of 7% to 8%, is expected in 2016, absent further charges on commercial shipbuilding contracts.

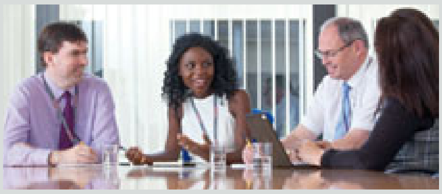


Platforms & Services (UK)

- Sales[2] are expected to be slightly lower in line with planned lower Typhoon deliveries. Increased submarine programme activity is expected to offset reducing aircraft carrier sales.
- Margins are expected to be at the lower end of a 10% to 12% range.

Platforms & Services (International)

- Sales[2] are expected to grow around 5% in 2016 with increased Typhoon aircraft support.
- Margins are expected to be at the lower end of a 10% to 12% range.



HQ

- HQ costs are expected to be similar to those in 2015. Underlying finance costs are expected to increase by £35m in 2016. The underlying effective tax rate remains dependent on the geographical mix of profits, but is expected to increase slightly to around 22%.

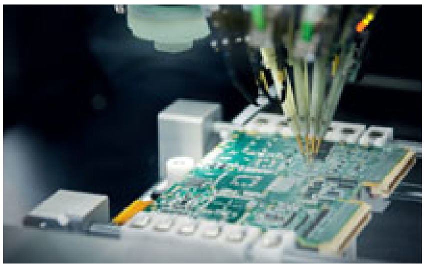
1. Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items and, in 2014, a credit in respect of the re-assessment of existing tax provisions (see note 7 to the Group accounts).
2. Including share of equity accounted investments.
3. Adjusted for the transfer of the GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance) business to Electronic Systems.

For further information visit investors.baesystems.com

Segmental performance

We report our performance through five principal reporting segments:

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



P26
Electronic Systems

P30
Cyber & Intelligence

P34
Platforms & Services (US)

P38
Platforms & Services (UK)

P42
Platforms & Services (International)

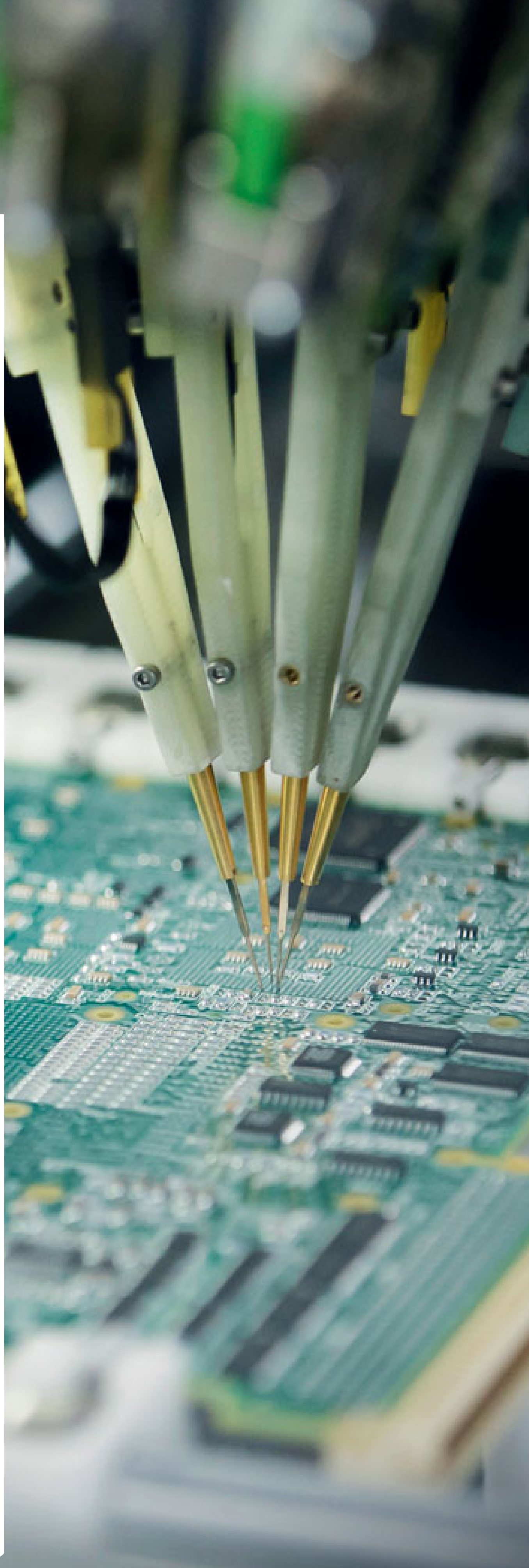
Segmental performance at a glance

	Number of employees[1]	KPI Sales[1] £m	KPI Underlying EBITA[2] £m	Return on sales %	KPI Cash flow[3] £m	KPI Order intake[1] £m	Order backlog[1,4] £bn
Electronic Systems	12,400	2,638	396	15.0	323	2,523	4.2
Cyber & Intelligence	12,900	1,848	145	7.8	93	2,029	2.4
Platforms & Services (US)	11,500	2,779	177	6.4	100	2,737	3.9
Platforms & Services (UK)	29,600	7,405	721	9.7	220	4,944	17.8
Platforms & Services (International)	13,600	3,742	335	9.0	164	3,046	10.2
HQ*	2,500	237	(91)		(219)	231	–
Less: Intra-group		(745)				(589)	(1.7)
Total	82,500	17,904	1,683	9.4	681	14,921	36.8

*HQ comprises the Group's head office activities, together with a 49% interest in Air Astana.

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 17).
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.

Segmental performance



Electronic Systems

Electronic Systems, with 12,400 employees[1], comprises the US and UK-based electronics activities, including electronic warfare systems, 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.

Electronic Combat includes the Electronic Protection, Electronic Warfare and Electronic Attack product lines, and provides a depth of capability in integrated electromagnetic systems for airborne applications, mission planning and battle management solutions, secure networked communications and navigation systems, radio frequency communication and data links.

Survivability, Targeting & Sensing exploits the electro-optical and infrared spectrum to provide leading threat warning and infrared countermeasures systems, precision guidance and seeker solutions, advanced targeting solutions, head-up displays and state-of-the-art tactical imaging systems.

Intelligence, Surveillance & Reconnaissance addresses the market for actionable intelligence through innovative technical solutions for airborne persistent surveillance, identification systems, signals intelligence, underwater and surface warfare solutions, and space products.

Controls & Avionics addresses the military and commercial aircraft electronics markets, including fly-by-wire flight controls, full authority digital engine controls, flight deck systems, cabin management systems and mission computers.

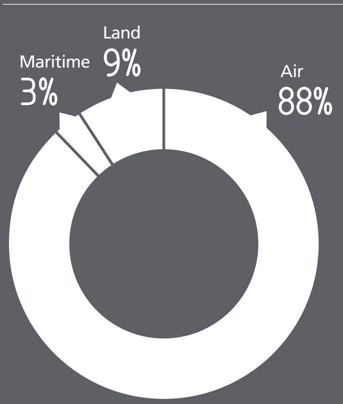
HybriDrive® Solutions delivers electric propulsion and power management performance, with innovative products and solutions that advance vehicle mobility, efficiency and capability in the transit, military, marine and rail markets.

Our strategy in action
Leverage our technology and engineering capabilities

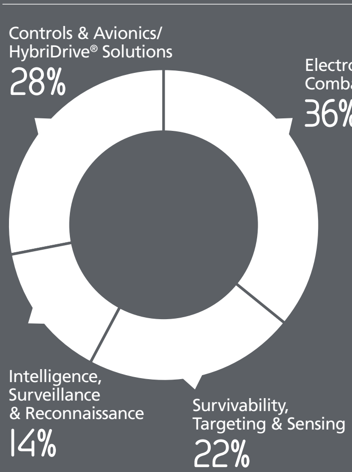
Advancing future solutions

Electronic Systems' research and advanced technology arm develops agile, innovative solutions to solve mission-critical customer challenges. The majority of the 150 active programmes are funded by the Defense Advanced Research Projects Agency (DARPA) and other US Department of Defense research laboratories. The focus is to develop innovative concepts and transition them to support programmes of record, such as the Long-Range Anti-Ship Missile programme, which uses BAE Systems' advanced long-range sensors as the missile's eyes and ears to enable the attack of targets within a group of enemy ships protected by sophisticated air defence systems.

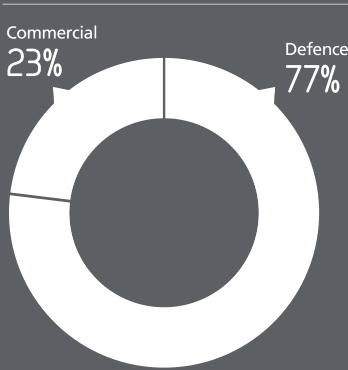
Sales[1] by domain (%)



Sales[1] by line of business (%)



Sales[1] analysis: Defence and commercial (%)



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. 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.

Operational and strategic highlights

- Selected for the Eagle Passive Active Warning Survivability System programme with Boeing, potentially worth over $1.0bn (£0.7bn) over the life of the programme, to upgrade up to 400 US Air Force F-15 aircraft
- Delivered the first international order for the Advanced Precision Kill Weapon System (APKWS™)
- Awarded a five-year contract for the US Army's Enhanced Night Vision Goggle III and Family of Weapon Sights – Individual programme, with a potential value of $435m (£295m)
- Acquired Eclipse Electronic Systems, Inc., a provider of leading-edge communications intelligence receivers and services
- Selected by Boeing to provide the entire flight control electronics suite on the next-generation 777X aircraft programme following the award, in 2015, for the remote electronic units
- Opened a state-of-the-art aviation technology manufacturing facility in Fort Wayne, Indiana

Financial performance

		2015	2014
Sales[1]	KPI	**£2,638m**	£2,415m
Underlying EBITA[2]	KPI	**£396m**	£373m
Return on sales		**15.0%**	15.4%
Cash inflow[3]	KPI	**£323m**	£246m
Order intake[1]	KPI	**£2,523m**	£2,341m
Order backlog[1,4]		**£4.2bn**	£3.9bn

- Sales[1] compared to 2014 increased marginally to $4.0bn (£2.6bn). The commercial areas of the business now amount to 23% having seen sales growth in the year of 7%. On the defence side, sales were stable with growth on the F-35 Lightning II programme offsetting contracts completing in 2014.
- The return on sales achieved of 15.0% benefited from continued strong programme execution and risk retirement. Last year's return on sales of 15.4% included a 0.5 percentage point non-recurring gain from a contract pricing settlement.
- Cash[3] conversion of underlying EBITA[2] for the year was at 89%, excluding pension deficit funding.
- Order backlog[1,4] was sustained at $6.1bn (£4.2bn) benefiting from awards for Enhanced Night Vision Goggles, F-15 electronic warfare upgrades, production of P-8A Poseidon mission computers and F-35 Lightning II Low-Rate Initial Production Lots 9 to 11.

Segmental performance
Electronic Systems

Operational performance

Electronic Combat

Electronic Systems has sustained its leadership position in the US electronic warfare market and production is ramping up across a number of programmes. Low-Rate Initial Production hardware deliveries on the F-35 Lightning II programme continue with Lot 8 and 9 deliveries, and Lot 10 deliveries expected to commence in 2016. The business has received initial funding for Lot 11, with negotiations anticipated in 2016.

The business is under contracts, from Boeing and Warner Robins Air Logistics Complex, totalling over $1.0bn (£0.7bn) to install the Digital Electronic Warfare System (DEWS) on 84 new F-15 aircraft, upgrade 70 existing F-15 aircraft with DEWS and provide spare units and modules for an international customer. Hardware and software deliveries, and system verification testing remain on schedule.

BAE Systems has been selected by Boeing to develop and manufacture the next-generation digital electronic warfare system for the US Air Force's Eagle Passive Active Warning Survivability System programme to upgrade up to 400 F-15 aircraft. The programme could be worth over $1.0bn (£0.7bn) over its life.

BAE Systems was selected by the US Special Operations Command to develop a new electronic warfare system for its fleet of C-130J aircraft. The initial contract, worth more than $20m (£14m), is the first phase of a multi-phase programme to provide product development and platform integration work over the next 12 months. The lifecycle value of the contract could exceed $400m (£271m).

Due to the sensitive nature of electronic combat systems and technology, many of the business's programmes are classified. As a world leader in electronic warfare systems, the business continues to experience growth in this increasingly important area.

Survivability, Targeting & Sensing

The US Army continues to field the third-generation upgrade to its Common Missile Warning Systems and has placed its first Foreign Military Sales orders for systems to Qatar, the Republic of Korea, Indonesia and Turkey.

Our strategy in action
Continue to grow our electronic systems business

Innovation in electronic warfare

More online
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BAE Systems has an extensive electronic warfare heritage, with more than 60 years' experience integrating and fielding some of the most advanced US electronic warfare technologies.

BAE Systems has been selected to develop and manufacture an all-digital electronic warfare system, the Eagle Passive Active Warning Survivability System, for the US Air Force's F-15 aircraft. It will replace the aircraft's legacy-1980s Tactical Electronic Warfare Suite, and leverages the technology and capabilities of the Digital Electronic Warfare System and the F-35 Lightning II programmes.

Electronic Systems continues to deliver on Advanced Precision Kill Weapon System (APKWS™) Full-Rate Production Lots 3 and 4, now worth a total of $115m (£78m) with the US Navy. BAE Systems received customer recognition for the completion of the 5,000th production unit during September and the first Foreign Military Sales order of 110 systems for Jordan was completed in October. The US Army acquired an initial quantity of APKWS™ laser-guided rockets from the US Navy for use in ongoing operations.

The business continues to perform on the Terminal High-Altitude Area Defence Full-Rate Production contract, valued at $340m (£231m), for 307 infrared missile seekers supporting both the US government and Foreign Military Sales.

A five-year, Indefinite Delivery, Indefinite Quantity (IDIQ) contract to support the US Army's Enhanced Night Vision Goggle III and Family of Weapon Sights – Individual programme was awarded to BAE Systems in March. The contract has a potential value of approximately $435m (£295m). The programme has commenced initial deliveries to support user evaluation and reliability testing.

The next-generation Striker® II helmet-mounted display has completed initial flight trials, successfully demonstrating the performance of the integrated digital night vision camera.

The business was unsuccessful in bidding for the US Army's Common Infrared Countermeasures programme.

Intelligence, Surveillance & Reconnaissance

The business 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 28,000 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 35 mission computer and display systems during the year. Four systems were purchased by Australia in 2015.

Electronic Systems continues to provide Signals Intelligence capability for the US Army and other US Department of Defense customers. BAE Systems was awarded $28m (£19m) for additional enhancements to the existing two-year contract valued in excess of $95m (£64m) to provide Tactical Signals Intelligence Payloads and associated equipment for the US Army's Gray Eagle unmanned aircraft. Deliveries of pods and ground stations have commenced.

In June, BAE Systems completed the acquisition of Eclipse Electronic Systems, Inc., a Texas-based provider of highly-advanced Intelligence, Surveillance and Reconnaissance products and services to the US defence and intelligence community.

Controls & Avionics

BAE Systems is a major supplier to Boeing for flight controls, and cabin and flight deck systems. In February, the Group was selected to provide the remote electronic units on Boeing's next-generation 777X aircraft programme. With this new award, BAE Systems will now provide the entire flight control suite for 777X aircraft. Delivery of subsystems for the first 737 MAX test aircraft was completed on schedule.

FADEC Alliance, a joint venture between FADEC International (the Group's joint venture with Sagem) and GE Aviation, completed certification of the full authority digital engine controls on the Leap engine for the Airbus A320neo aircraft.

The business completed certification of the flight control electronics for the Embraer Legacy 500 and Bombardier CSeries aircraft, and its flight control electronics enabled first flights of the Gulfstream G500 and Embraer KC-390 aircraft.

Vistara, an Indian airline, became the launch customer for BAE Systems' IntelliCabin® wireless in-flight entertainment system. The first installation of the system was certified in January 2016.

A new state-of-the-art manufacturing facility in Fort Wayne, Indiana, officially opened in September for the production of commercial aircraft electronics.

On the F-35 Lightning II programme, BAE Systems completed Low-Rate Initial Production (LRIP) Lot 7 deliveries of 38 production shipsets, plus spares, of the vehicle management computer and active inceptor system equipment to Lockheed Martin. Both systems are currently in production for LRIP Lot 8 and under contract for LRIP Lot 9.

HybriDrive® Solutions

With the recent delivery of its 5,000th hybrid propulsion system, the business is continuing to meet the needs of an environmentally-conscious global transit bus market with its new anti-idling technology and zero-emission drive modes. Cities including London, Paris, Boston and Seattle are now using engine-off technology to save fuel, reduce noise and improve local air quality.

Other

In July, the Communications & Control line of business was realigned across the three remaining defence businesses.

From 2016, Cyber & Intelligence's Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance business will be reported in Electronic Systems.

Our strategy in action

Continue to grow our electronic systems business

Commercial flight control electronics

More online
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Electronic Systems is both a supplier of high-technology equipment for defence electronics capabilities and is growing in adjacent commercial aerospace markets.

BAE Systems is a leading supplier of engine controls, including for GE engines, and, through a joint venture, for the CFM family of engines. The Group has a strong franchise position, providing flight control electronics for many Boeing and other aircraft platforms.

In 2015, BAE Systems was selected by Boeing to provide the remote electronic units for the 777X aircraft. In combination with the prior year award to provide the integrated flight control electronics on the 777X, BAE Systems will be providing the complete suite of flight control electronics for the next-generation platform's fly-by-wire system.

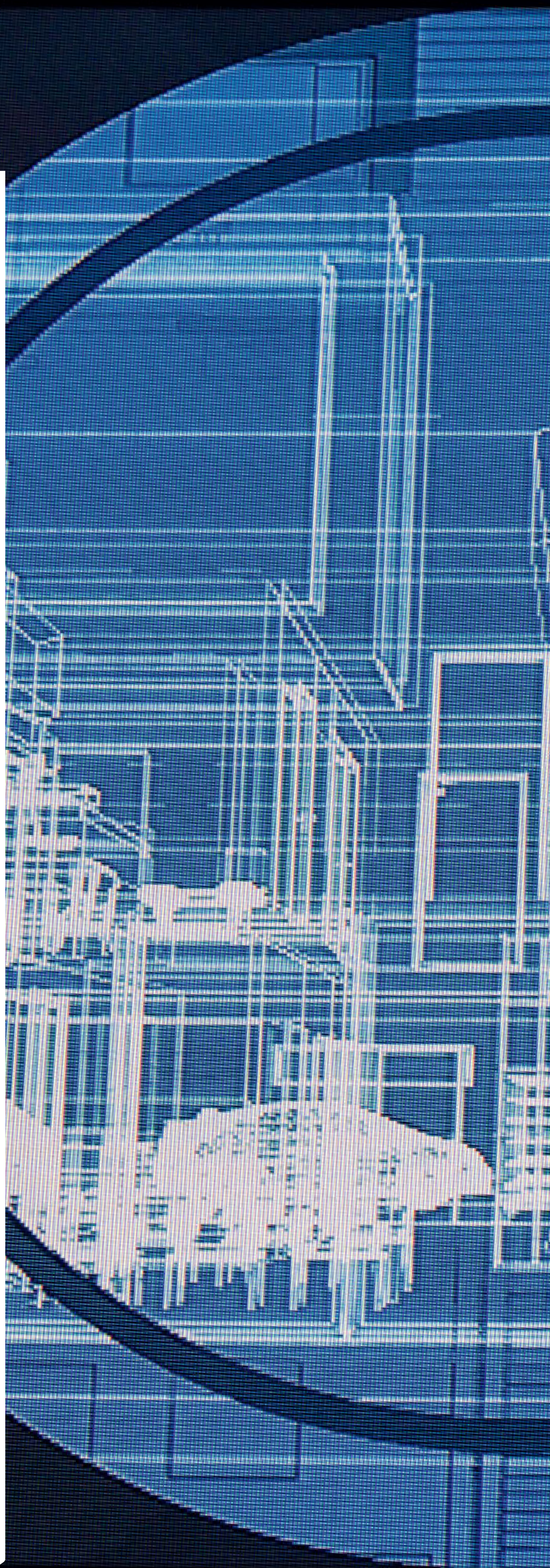
Looking forward

In the US, further clarity regarding potential market improvement was gained after Congress reached agreement on a new budget deal that provides for defence and domestic programme spending above the Budget Control Act caps through 2017.

Whilst the longer-term outlook retains some uncertainty, 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 for US and international customers, while sustaining its emphasis on cost reduction, and research and development.

The business expects to benefit from its franchise positions, particularly on the F-35 Lightning II and F-15 programmes, and its ability to apply innovative technology solutions that meet defence customers' changing requirements. In the commercial aviation market, Electronic Systems' technology innovations are enabling the business to renew long-standing customer positions and win new business.

Segmental performance



Cyber & Intelligence

Cyber & Intelligence, with 12,900 employees[1], comprises the US-based Intelligence & Security business and UK-headquartered Applied Intelligence business, and covers the Group's cyber security, secure government, and commercial and financial security activities.

Intelligence & Security delivers a broad range of services to the US military and government.

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

Global Analysis & Operations provides innovative, mission-enabling analytic solutions and support to the US government.

Integrated Electronics & Warfare Systems provides systems engineering, integration and through-life support services for US defence and coalition partner customers.

IT Solutions delivers operational secure solutions that enable US national security customers to perform operations and protect their data and networks.

Applied Intelligence collects, manages and exploits information to provide intelligence enabling government and commercial customers to 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 services and solutions integration to commercial customers, with a focus on financial services, telecommunications, and energy and utility companies.

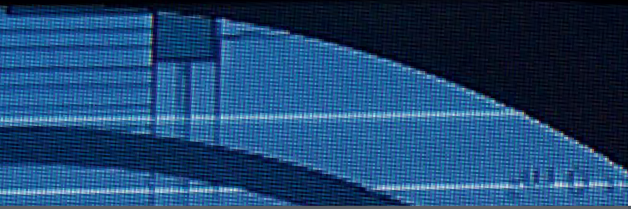
Primary operations are located in the UK, Denmark, Ireland, Australia, Malaysia and the US.

Our strategy in action
Accelerate the growth of our cyber, intelligence and security business

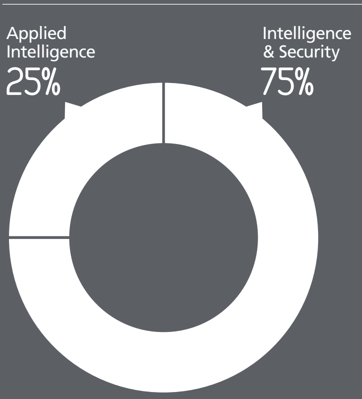
Commercial cyber security

Growth in the cyber security domain has been achieved by accelerating technology and market positions through targeted acquisitions. The core of this strategy was the acquisition in 2008 of Detica plc to complement and expand the Group's capabilities in cyber security for governments. Whilst this continues to be a growth activity, with high technical barriers to entry, commercial markets offer higher growth opportunities.

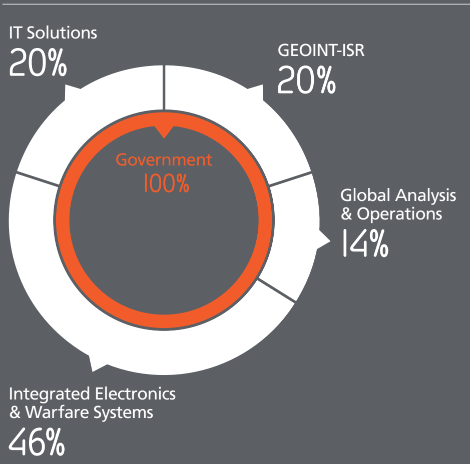
BAE Systems has developed a range of product and service offerings, building on our capabilities in the secure-government environment and establishing channels to take defence-grade cyber solutions to commercial customers.



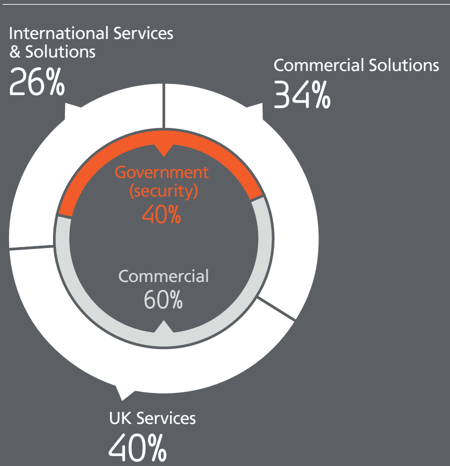
Sales[1] by business (%)



Sales[1] analysis: Intelligence & Security (%)



Sales[1] analysis: Applied Intelligence (%)



1. Including share of equity accounted investments.
2. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.
3. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
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.

Operational and strategic highlights

Intelligence & Security

– Strategic review of manpower and services businesses determined that retaining the businesses delivers greater value

– Secured a ten-year contract with an expected value of over $1.0bn (£0.7bn) to provide information technology services to high-priority US government agencies

– Secured a five-year, $278m (£189m) re-compete award to provide logistics and sustainment engineering services for radar, optical and telemetry systems

Applied Intelligence

– Integration of the acquired SilverSky business substantially completed

– Significant investment in engineering capabilities and product development

– Strong performance in commercial cyber security products, with multi-year contracts awarded

– Launch and initial take-up of cloud-based cyber security products in Europe, Canada and Asia-Pacific

– Continued growth of security and digital services projects in government and critical national infrastructure in the UK and internationally

Financial performance

		2015	2014[2]
Sales[1]	KPI	**£1,848m**	£1,658m
Underlying EBITA[3]	KPI	**£145m**	£153m
Return on sales		**7.8%**	9.2%
Cash inflow[4]	KPI	**£93m**	£125m
Order intake[1]	KPI	**£2,029m**	£1,784m
Order backlog[1,5]		**£2.4bn**	£2.0bn

– In aggregate, sales[1] increased by 3% to $2.8bn (£1.8bn). The US business saw just a 1% decrease largely in government IT services. Growth in the Applied Intelligence business was at 31%, of which 13% came from the acquisition of SilverSky and 18% organically, largely from non-UK government customers.

– The return on sales reduced to 7.8% (2014 9.2%) due to a higher level of costs expensed in Applied Intelligence as the business focuses on further growth.

– Cash[4] conversion of underlying EBITA[3] for the year was at 82%, excluding pension deficit funding.

– In aggregate, order backlog[1,5] increased to $3.5bn (£2.4bn). Order backlog in the US business grew by 13% largely on imagery analysis and cyber support awards. In the Applied Intelligence business, order backlog increased by 21% over the year driven mainly by international and commercial awards.

Segmental performance
Cyber & Intelligence

Operational performance

Intelligence & Security

GEOINT-ISR (Geospatial Intelligence – Intelligence, Surveillance and Reconnaissance)
Intelligence & Security continues to mature its capabilities in software-based data analytics with an emphasis on big data, production, automation and efficiencies to help the intelligence and defence communities transform data into actionable intelligence.

The business continues to build on its legacy of support to the National Geospatial-Intelligence Agency. Under the Consolidated Library programme, the business was awarded a 15-month, $18m (£12m) contract for a Flexible Content Management System that provides new flexible and adaptable capabilities that can be deployed to enhance intelligence collection and tradecraft.

Since winning the Geospatial Data Services Foundational GEOINT Content Management programme in 2014, the business has been awarded orders valued at over $104m (£71m).

The business is performing well on two new contracts awarded in 2015 to assist new US intelligence community customers with the development of advanced GEOINT data processing and next-generation geospatial intelligence data collection solutions.

The Mobility Air Force Automated Flight Planning Service programme is developing advanced mission planning software for US Air Force non-combat aircraft. The software generates four-dimension optimised flight plans to minimise fuel consumption and take advantage of new and evolving air space regulations. The latest software version has been delivered to the customer for formal qualification testing and is on track to be operational in 2016.

Signal Innovations Group, Inc., acquired in 2014, has been integrated into the Geospatial eXploitation Products business. The new organisation is combining enhanced full motion video imagery capabilities with existing geospatial analytic software products to pursue new opportunities in the US intelligence and defence communities.

From 1 January 2016, the GEOINT-ISR business will be managed and reported within Electronic Systems.

Global Analysis & Operations
In full motion video and intelligence, surveillance and reconnaissance analysis, the business has more than 500 analysts globally sustaining mission critical activities on programmes worth over $400m (£271m).

The business secured a five-year re-compete contract worth up to $145m (£98m) to provide counter-terrorism analysis services.

Integrated Electronics & Warfare Systems
The business secured a five-year, $278m (£189m) re-compete award to provide logistics and sustainment engineering services for US Department of Defense radar, optical and telemetry systems used by the Department of Defense, Department of Energy and NASA, as well as international government agencies.

On the US Air Force's Intercontinental Ballistic Missile Integration Support Contractor programme, the business has been awarded $174m (£118m) in additional engineering scope change proposals in 2015. Since assuming control of the programme in 2014, the team has supported five successful missile test launches.

The business was awarded a five-year US Marine Corps Air Traffic Control and Landing Systems re-compete contract, with a potential total value of $77m (£52m).

The US Army awarded BAE Systems a five-year contract, potentially worth $76m (£52m), to test Command, Control, Communications, Computers and Intelligence (C4i) systems for tactical vehicles, and then prototype, engineer and upgrade more than 2,000 vehicles per year.

IT Solutions
Intelligence & Security was selected to provide information technology services to the US government in a single-award contract with a potential value of over $1.0bn (£0.7bn) over a ten-year period.

The business secured a five-year re-compete award with a potential ceiling value of $47m (£32m) to continue its support of the US Department of Homeland Security Office of Biometric Identity Management with large-scale, mission-critical fingerprint analysis and verification services.

The business was selected for three important Indefinite Delivery, Indefinite Quantity (IDIQ) contracts in the year. Under the Network Operations and Infrastructure and Application Services Full and Open multiple-award contracts, the business is pursuing task orders to expand its IT services footprint with the US Air Force. The third IDIQ contract award positions the business to pursue task orders for mission support services to the Federal Bureau of Investigation.

Applied Intelligence

Applied Intelligence's markets are highly competitive with fast-changing customer requirements. It typically faces competition from multiple vendors. Whilst it has won positions on a number of framework agreements, business tendered under these contracts is still competitive. Whilst continuing to grow in the UK market, it was disappointing to note the loss in the Metropolitan Police Service Integration and Applications Management competition this

Our strategy in action
Accelerate the growth of our cyber, intelligence and security business

Maintaining space radars

More online
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The US Air Force has awarded BAE Systems a five-year contract for the Instrumentation Radar Support Programme (IRSP) to provide multiple agencies with a wide range of radar support services. IRSP, a government-administered co-op programme that BAE Systems has managed since 1985, was established to provide support to several agencies with similar radar, telemetry and optical tracking systems, as well as compatible missions. Currently, IRSP supports more than 500 systems with work ranging from logistical upgrades to complete depot-level overhauls.

year. The business continues to focus on delivering a value-for-money service to all its current and prospective customers in this area of government business.

The strategy for the Applied Intelligence business is to create market-leading positions in the commercial cyber security market and increasing the scale of systems and service integration contracts to the UK government and for government customers overseas.

The integration of the SilverSky business in the US, acquired in 2014 to accelerate the drive into the commercial cyber security market, has been a success and is substantially completed.

During the year, the business has invested in engineering and product development and the sales team to support growth. In 2015, Applied Intelligence recruited 1,200 employees, including 700 engineers.

Commercial Solutions

Commercial Solutions focuses on the provision of cyber security, counter-fraud and compliance software and solutions, primarily to commercial organisations.

The sale of products and services which provide multi-year or recurring revenue streams has continued to grow. Applied Intelligence's cloud-based e-mail protection products, launched in Europe, Canada and Asia-Pacific during the year, have been deployed by a leading international airline and a leading UK media producer and broadcaster.

New managed security services awards include a three-year contract to provide advanced threat detection services to an international law firm and a three-year networking security monitoring services contract with one of the main national UK television broadcasters.

The CyberReveal™ threat analytics solution, which defends organisations against sophisticated cyber attacks, continues to receive orders from both new and existing customers, including major financial institutions in Europe and North America.

During the year, new NetReveal® wins included Metro Bank in the UK to provide a range of anti-money laundering services and a large credit union in the US to provide an enterprise fraud solution. Growth in existing accounts has included the procurement of a trade finance fraud solution by a large financial institution. The year also saw the successful implementation of a managed fraud analytics platform for Canadian National Insurance Crime Services (CANATICS), the largest insurance consortium in Canada.

UK Services

UK Services is a provider of systems integration and consulting services to UK government, national security customers and critical national infrastructure providers, with a particular focus on digital, data analytics and cyber security. The business has continued to grow.

The business has strengthened its relationship with Network Rail, being awarded a three-year contract for its business intelligence IT portfolio, winning a contract to provide cyber security systems integration services to help mitigate the cyber threats to the UK's national rail network and winning a contract to support the digital enablement of the UK rail network as part of Network Rail's Digital Railway Initiative.

Demand for Applied Intelligence's cyber security services continues, with contracts awarded for a cyber security and information assurance managed service at the Ministry of Justice, for digital identity and fraud analytics at the Department for Work and Pensions and to provide cyber threat intelligence strategy consulting services for a major international financial services group. The business has also been awarded a position on the UK government's Defence Science and Technology Laboratory framework for electronic warfare and cyber research.

Applied Intelligence's digital and data transformation business continues to grow, with new contracts including a data migration strategy project for the Atomic Weapons Establishment, a secure, cloud-based, open-source IT platform for Lloyd's Register and a digital capability assessment project for a leading UK television and broadband provider in support of its digital transformation programme.

International Services & Solutions

International Services & Solutions focuses on cyber and communications intelligence services and solutions for international governments and communications service providers, pulling through Applied Intelligence's commercial product-based solutions where relevant.

The business continues to see demand in Asia-Pacific and the Middle East in support of protection against national threats. In Europe, the business was awarded a contract to provide a long-term government partner with a solution to investigate new concepts for situational awareness using the IntelligenceReveal™ all-source analysis solution.

In the second half of the year, the business won major contracts to provide integrated intelligence solutions to support the missions of South European and Asian customers. It also won a substantial cyber security services contract in Asia to build an advanced Security Operations Centre.

Looking forward

Intelligence & Security

In the US, further clarity regarding potential market improvement was gained after Congress reached agreement on a new budget deal that provides for defence and domestic programme spending above the Budget Control Act caps through 2017.

In April, BAE Systems announced that it had engaged advisers to support a strategic assessment of the Intelligence & Security sector's Global Analysis & Operations, Integrated Electronics & Warfare Systems and IT Solutions businesses. The review determined that retaining the businesses within BAE Systems, Inc. delivers greater value.

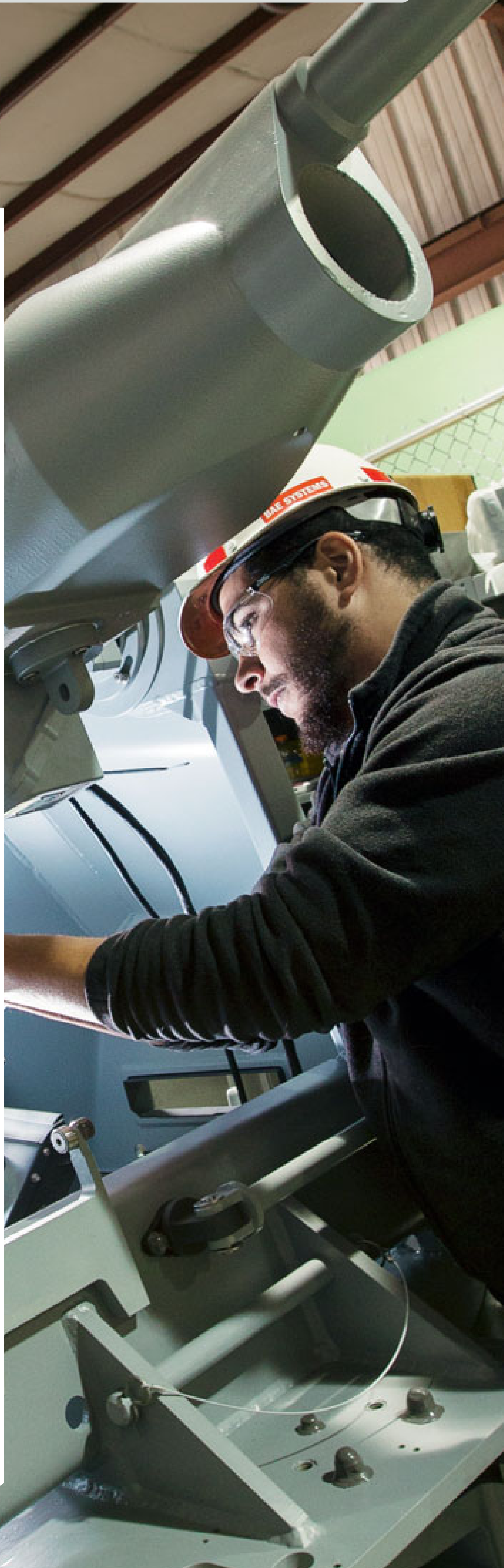
Following a period of market contraction in the US government services sector, the Group believes the outlook is now stabilising.

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

Applied Intelligence

Applied Intelligence has invested in engineering and product development and the sales team to grow further its order backlog and pipeline of opportunities from commercial and government customers in North America, Europe, Asia-Pacific and the Middle East.

Segmental performance



Platforms & Services (US)

Platforms & Services (US), with 11,500 employees[1] and operations in the US, UK and Sweden, produces combat vehicles, weapons and munitions, and delivers US-based services and sustainment activities, including ship repair and the management of government-owned munitions facilities.

US Combat Vehicles focuses on a portfolio of tracked combat vehicles, amphibious vehicles, accessories, protection systems and tactical support services for the US military and international customers.

Weapon Systems and Munition Operations focuses on naval weapons, artillery, advanced weapons, precision munitions, high explosives and propellants for US, UK and international customers.

Services include complex munition site management for the US Army's Holston and Radford facilities.

US Ship Repair and Modernisation is a major provider of non-nuclear ship repair, modernisation, overhaul and conversions to the US Navy, government and commercial maritime customers. It has operations in seven US shipyards on the Atlantic, Gulf of Mexico and Pacific coasts, as well as in Hawaii.

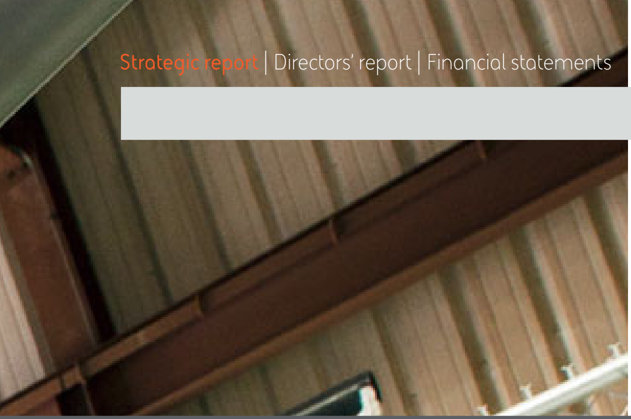
BAE Systems Hägglunds focuses on the tracked vehicle market for Swedish and international customers.

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

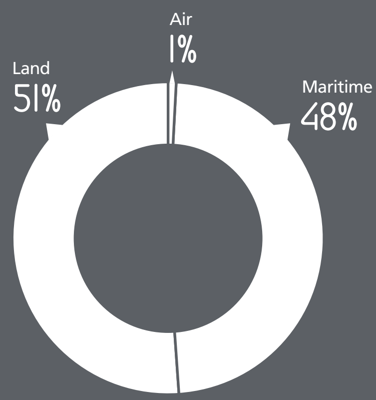
Our strategy in action
Leverage our technology and engineering capabilities

Naval weapon technology

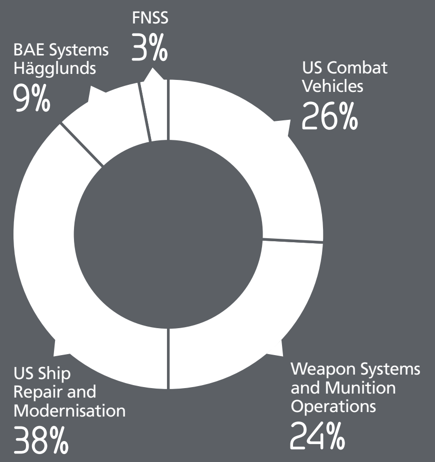
BAE Systems today produces a comprehensive range of naval armaments providing capabilities for US and overseas navies. In addition to these current systems, the Group is developing new technologies, such as the Hyper Velocity Projectile and the Electromagnetic Railgun in partnership with the US Navy. The Electromagnetic Railgun is a revolutionary, long-range weapon technology that uses high-power electromagnetic energy instead of explosive chemical propellants, reducing the hazards of high explosives on the ship and unexploded ordnance on the battlefield.



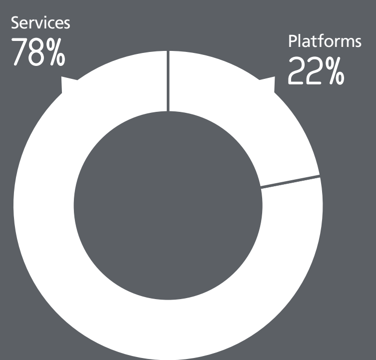
Sales[1] by domain (%)



Sales[1] by line of business (%)



Sales[1] analysis: Platforms and services (%)



1. Including share of equity accounted investments.
2. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.
3. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
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.

Operational and strategic highlights

- Award of a five-year contract worth up to $332m (£225m) to perform technical support for the US Army's Bradley Fighting Vehicle and M113 family of vehicles
- Low-Rate Initial Production contract options awarded, worth $245m (£166m), for US Army M109A7 (Paladin) self-propelled howitzers
- Contract worth $104m (£71m) awarded for the engineering and manufacturing development phase of the competition for the Amphibious Combat Vehicle 1.1 programme
- Secured naval gun system contracts with the US, Canada and Brazil
- FNSS received a new export order for the PARS wheeled armoured vehicle
- Continued challenges on commercial shipbuilding programmes
- Workforce reductions announced in commercial shipbuilding, ship repair and BAE Systems Hägglunds
- Sale of 75% interest in Land Systems South Africa completed

Financial performance

		2015	2014[2]
Sales[1]	KPI	**£2,779m**	£2,689m
Underlying EBITA[3]	KPI	**£177m**	£117m
Return on sales		**6.4%**	4.4%
Cash inflow[4]	KPI	**£100m**	£147m
Order intake[1]	KPI	**£2,737m**	£2,565m
Order backlog[1,5]		**£3.9bn**	£4.7bn

- Sales[1] reduced by 4% to $4.2bn (£2.8bn), or by just 1% on a like-for-like basis after adjusting for exchange translation and the South African business disposal. Higher than expected sales were seen on both ship repair activity and munitions volume.
- The business has delivered an improved return on sales of 6.4% (2014 4.4%). Whilst further charges had to be taken in the year on the commercial shipbuilding programmes, these were partly offset by improvements to the Radford munitions contract.
- Cash[4] conversion of underlying EBITA[3] was impacted by the utilisation of provisions on commercial shipbuilding programmes and of customer advances on the CV90 Norway contract, as well as the investment in the new floating dry dock facilities in San Diego.
- Order backlog[1,5] reduced to $5.8bn (£3.9bn) largely for the trading out of the five-year Multi-Ship, Multi-Option contracts in the ship repair business and the CV90 Norway programme.

Segmental performance
Platforms & Services (US)

Operational performance

As the US defence market stabilises, the business retains its focus on sustaining its franchise programmes and building a strong domestic and international pipeline, whilst optimising competitiveness by shaping and scaling operations.

US Combat Vehicles

In May, the US Army awarded BAE Systems a contract worth $110m (£75m) to convert 36 M88A1 recovery vehicles to the M88A2 Heavy Equipment Recovery Combat Utility Lift Evacuation System (HERCULES) configuration. The M88 plays an important role in maintaining the combat vehicle industrial base, with the first vehicle delivery scheduled for 2017. In October, BAE Systems received awards worth $31m (£21m) from the US Army to produce six M88A2 HERCULES vehicles and associated spare parts for the Australian government, as well as an additional vehicle and parts for the US Marine Corps.

Work has commenced on the US Army's Armored Multi-Purpose Vehicle (AMPV) programme and a preliminary design review was completed in June. BAE Systems is producing 29 vehicles under the engineering and manufacturing development phase. The total potential contract value for the initial programme phases is $1.2bn (£0.8bn), including options to produce 289 vehicles under Low-Rate Initial Production (LRIP). Anticipated full-rate production is expected to approach 3,000 vehicles.

The business was awarded a $29m (£20m) follow-on contract for trade studies and analysis related to the future infantry fighting vehicle. Under the contract, BAE Systems will develop concepts that span from modernising the Bradley vehicle to a new design, and will capitalise on technology created under the Ground Combat Vehicle programme.

In July, the US Army awarded BAE Systems a five-year contract worth up to $332m (£225m) to support ongoing service and improvements for the Bradley Fighting Vehicle and the M113 family of vehicles.

The business was notified in August that the Lockheed Martin Joint Light Tactical Vehicle team, of which BAE Systems was a member, was not selected for the LRIP contract. This competition outcome is currently in litigation.

In October, the business was awarded the final LRIP contract options, worth $245m (£166m), for the M109A7 self-propelled howitzers (Paladin) and their associated ammunition carriers. In March, the business delivered the first vehicles to the US Army under the previously awarded $335m (£227m) LRIP contract. The US Army's total acquisition objective is for 581 vehicle sets.

Our strategy in action
Continue to drive value from our defence platforms and services

Amphibious Combat Vehicle 1.1 contract award

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BAE Systems' solution for the Amphibious Combat Vehicle 1.1 programme has been designed to fulfil the complex mission of deploying US Marines from ship to shore to complete their mission objectives.

BAE Systems and IVECO Defence have joined forces to present an 8x8 platform capable of performing open-ocean ship launch and recovery operations, while offering a unique mix of true open-ocean amphibious capability, land mobility, survivability, payload and growth potential to accommodate evolving operational needs.

In 2015, BAE Systems was awarded a contract for the engineering and manufacturing development phase of the programme as one of two competitive bids down-selected.

During the fourth quarter, BAE Systems completed contractor testing of six Bradley Engineering Change Proposal (ECP) 2 vehicles. Efforts are now underway to build an additional ten vehicles for US Army testing, with deliveries to begin in 2016. The Bradley ECP 2 programme helps to restore automotive performance to the Bradleys with a modified engine and transmission, and an upgraded generator and power distribution system.

In November, the US Marine Corps awarded BAE Systems, along with partner IVECO Defence, a contract worth $104m (£71m) for the engineering and manufacturing development phase of the Amphibious Combat Vehicle 1.1 programme. The award is one of two contracts for this phase, during which the BAE Systems team will produce 16 prototypes for Marine Corps testing. This competition outcome is currently being protested.

In 2015, BAE Systems was awarded two international Assault Amphibious Vehicle (AAV) contracts: an $82m (£56m) contract for the Brazilian Marine Corps under the US government's Foreign Military Sales programme to upgrade 23 vehicles, with deliveries expected in 2017; and an award from another international customer for advance work related to an expected production order for AAVs in 2016.

Weapon Systems and Munition Operations

In May, BAE Systems was awarded a contract for five Bofors 40 Mk4 naval guns for the Brazilian Navy. Series production of the guns has commenced, including local content in Brazil. Deliveries are scheduled to begin in 2016.

BAE Systems continues to work with the governments of India and the US to secure an award for M777 155mm lightweight howitzers. BAE Systems has proposed the establishment of an assembly, integration and test facility in partnership with an Indian company, which supports the Indian prime minister's 'Make in India' initiative.

In August, the business was awarded a contract to deliver up to six modified 25mm Mk 38 machine gun systems for the Royal Canadian Navy's Arctic Offshore Patrol Ship programme. Also in August, the US Navy awarded BAE Systems an $80m (£54m) contract to upgrade six Mk 45 naval guns to the Mod 4 configuration, with an option for four additional guns for an additional $50m (£34m) expected to be exercised in 2016.

In September, the business confirmed its selection by the UK Ministry of Defence as the preferred bidder to provide the gun system, known as the Maritime Indirect Fires System, for the Type 26 frigate. Subject to contract award, the business will provide the integrated gunnery system, which includes the Mk 45 Mod 4 naval gun system, along with an automated ammunition handling system, gun fire control system and qualified ammunition.

BAE Systems is executing on the re-baselined Archer artillery system for the Swedish government. The business delivered the first system in September, with deliveries planned to continue at a rate of two guns per month during 2016.

BAE Systems continues its partnership with the US Navy on the development of the Hyper Velocity Projectile and an Electromagnetic Railgun.

BAE Systems continues to manage operations at the Holston and Radford Army ammunition plants, receiving a $50m (£34m) contract for the continued production of MK 90 propellant grains, as well as a $30m (£20m) contract to modernise the Insensitive Munitions ingredient facility at Holston. In September, the business received $35m (£23m) in closing an historical pricing agreement. The business remains focused on enhancing performance under major facility modernisation contracts.

US Ship Repair and Modernisation

In the first quarter of 2015, BAE Systems announced a $100m (£68m) capital improvement programme at its San Diego, California, shipyard, principally for the construction of a new dry dock in anticipation of increased activity to support the US Navy's re-balance to the Pacific coast (see page 13).

In the second half of 2015, the business received a number of fixed-price orders as the US Navy began to transition its contracting strategy for ship modernisation and repair. For over a decade, the Navy had awarded Multi-Ship, Multi-Option cost-plus contracts, which effectively bundled the maintenance of a class of ships into one multi-year contract. Starting on the East coast in the first half of 2016, the Navy is expected to award Indefinite Delivery, Indefinite Quantity repair orders with fixed-price terms on a ship-to-ship basis. During the year, the ship repair business received a total of $1.2bn (£0.8bn) in orders from the US Navy.

The Jacksonville, Florida, shipyard delivered its third Platform Support Vessel (PSV) during the summer for service in the Gulf of Mexico. In early 2016, the business delivered the fourth and final ship of the PSV class to the customer. Four additional ships are in various stages of construction in Jacksonville, Florida, and Mobile, Alabama, and the business expects to deliver these ships in 2016. The commercial shipbuilding business continued to experience challenges in the year, taking a $73m (£48m) charge against ongoing contracts, principally driven by the Mobile shipbuilding programmes.

The business is responding to lower demand due to declining US Navy ship repair and commercial shipbuilding and repair work by reducing workforce numbers. Redundancies initiated in 2015 could impact approximately 1,100 employees in Norfolk, Virginia, and Jacksonville, Florida, through the first quarter of 2016.

BAE Systems Hägglunds

Series production has commenced on the $865m (£587m) contract for CV90 Infantry Fighting Vehicles to Norway. The business completed BvS10 vehicle deliveries to Sweden in 2015 and will continue to execute retrofitting and provide spare parts and documentation.

In September, the business launched a new vehicle based on the BvS10 called the BvS10 BEOWULF, a highly mobile, modular and fully-amphibious vehicle with an impressive payload.

At the September Defence and Security Equipment International trade show in London, BAE Systems launched its BattleView 360 system that employs cutting-edge display and sensor technology to improve situational awareness for soldiers inside combat vehicles.

In 2015, the business completed 130 redundancies related to the unsuccessful CV90 Armoured Personnel Carrier bid in Denmark. With two major production programmes winding down, in the first quarter of 2016, the business initiated an additional redundancy notification that could impact up to 150 employees during the second half of the year.

FNSS

FNSS, the Turkish land systems joint venture, has continued production under the $524m (£356m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army.

FNSS received a new export order for the PARS wheeled armoured vehicle. Under this new contract, FNSS will deliver the PARS vehicle to its new customer in multiple configurations.

Production is underway on a contract to upgrade M113 tracked armoured personnel carriers for the Royal Saudi Land Forces.

Four competitive proposals have been submitted for combat vehicle programmes in Turkey and the Middle East, with award decisions expected in 2016 or 2017.

Business disposal

In April, the Group completed the sale of its shareholding in Land Systems South Africa.

Looking forward

In the US, further clarity regarding potential market improvement was gained after Congress reached agreement on a new budget deal that provides for defence and domestic programme spending above the Budget Control Act caps through 2017.

The business is underpinned by strong positions on key franchise programmes. These include, in the land domain, the US Army's AMPV, Bradley and Paladin programmes, and the CV90 for Norway. In the maritime domain, the Group has a strong position on naval gun programmes and US Navy ship repair. Some near-term reduction in ship repair and construction activity is anticipated as commercial shipbuilding contracts are completed and with expected changes to the basing of US Navy ships. Actions to address reduced workload at the Group's US East and Gulf coast shipyards are underway alongside measures to support anticipated subsequent expansion of ship repair operations in San Diego, California.

The business continues to pursue a range of domestic and international opportunities in combat vehicles, weapon systems and maritime support services.

Segmental performance

Platforms & Services (UK)

Platforms & Services (UK), with 29,600 employees[1], comprises the Group's UK-based air, maritime, combat vehicle, munitions and shared services activities.

Military Air & Information includes programmes for the production of Typhoon combat and Hawk trainer aircraft, F-35 Lightning II 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 five-year contract secured in 2014 for the delivery of services at HM Naval Base Portsmouth.

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

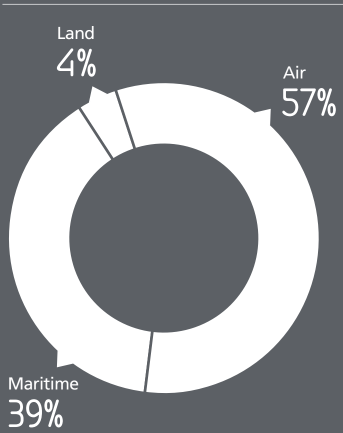
Munitions focuses on the design, development and manufacture of a comprehensive range of products, servicing its main customer, the UK Ministry of Defence, as well as international customers. Munitions also develops and manufactures cased-telescoped weapons and ammunition through its CTA International joint venture. The business is a principal supplier of general munitions to the British armed forces.

Our strategy in action
Continue to drive value from our defence platforms and services

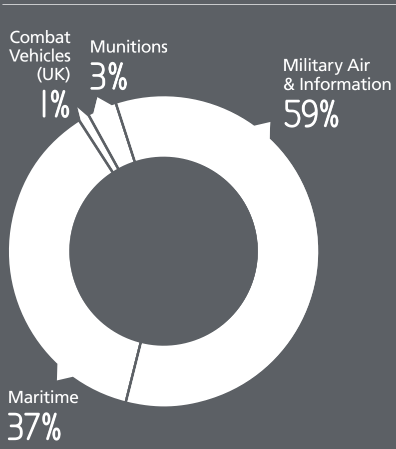
HM Naval Base Portsmouth modernisation

HM Naval Base Portsmouth is undergoing a 15-year transformation. As part of the Maritime Support Delivery Framework contract, BAE Systems will deliver service improvements and modernise the base. The business is working with the Royal Navy to prepare for the arrival of the UK's two new aircraft carriers and future platforms. The two 65,000-tonne ships, which are currently under construction, will be based in Portsmouth and will be the largest vessels in service with the Royal Navy.

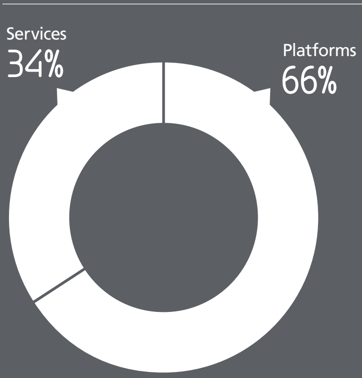
Sales[1] by domain (%)



Sales[1] by line of business (%)



Sales[1] analysis: Platforms and services (%)



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

Operational and strategic highlights

- The Strategic Defence and Security Review announced in November 2015 provided clarity, continuity and stability for the UK business
- Contracts awarded for the expansion of Typhoon's capabilities
- £203m of F-35 Lightning II Lot 9 Low-Rate Initial Production orders received
- £859m demonstration phase contract awarded for the Type 26 frigate programme
- Full £1.3bn contract awarded for the fifth Astute Class submarine
- Artful, the third Astute Class submarine, accepted by the Royal Navy in November
- Third and final Khareef Class corvette accepted by the Royal Navy of Oman
- €188m (£139m) contract award for 515 cased-telescopic cannons for the Ministry of Defence secured by our 50% joint venture, CTA International

Financial performance

		2015	2014
Sales[1]	KPI	**£7,405m**	£6,623m
Underlying EBITA[2]	KPI	**£721m**	£772m
Return on sales		**9.7%**	11.7%
Cash inflow[3]	KPI	**£220m**	£173m
Order intake[1]	KPI	**£4,944m**	£5,386m
Order backlog[1]		**£17.8bn**	£20.1bn

- Sales[1] of £7.4bn were 12% higher than 2014. The increase came from a higher number of Saudi aircraft deliveries, trading of Radar and Defensive Aids Sub-System equipment on the European Typhoon Tranche 3 programme and the increasing activity in the Submarines business.
- The return on sales was at 9.7% (2014 11.7%). An impact from lower pension discount rates has been that the service cost charged to the income statement increases and, in 2015, that amounted to 0.5 percentage points of margin compared with 2014. In addition, the 2015 result includes the in-year impact from the announced Typhoon production slowdown decision.
- Cash performance was as expected with a cash inflow[3] of £220m (2014 £173m). Consumption of customer advances occurred on the Omani, Saudi and European Typhoon contracts. There have also been rationalisation costs charged against provisions created in prior years.
- Order backlog[1] reduced to £17.8bn (2014 £20.1bn) primarily from trading on the Typhoon aircraft and aircraft carrier programmes.

Segmental performance
Platforms & Services (UK)

Operational performance

Military Air & Information

In the year, 18 Typhoon aircraft were delivered from the UK final assembly facility, of which 12 were delivered to Saudi Arabia. Cumulative aircraft deliveries to the UK, Germany, Italy and Spain total 227 of the contracted 236 Tranche 2 aircraft and 22 of the contracted 88 Tranche 3 aircraft. The 2014 issues delaying acceptance of Typhoon Tranche 3 aircraft from the Group's partners in Germany, Italy and Spain were resolved.

The Oman Typhoon and Hawk aircraft programme continues to meet all contractual milestones and is on track for commencement of deliveries in 2017.

In order to meet existing and anticipated orders and delivery schedules, BAE Systems is reducing the rate of Typhoon major unit production. This will help reduce production discontinuity and provide a more sustainable and competitive position for Typhoon manufacturing in the years ahead. The action involves a proposed workforce reduction of up to 371 roles.

Typhoon's capabilities continue to expand with the integration of the Captor E-Scan radar and Brimstone 2 missile.

BAE Systems continues to successfully support its UK and European customers' Typhoon and Tornado aircraft in delivering their operational commitments. The business supports its UK customer through availability-based service contracts, and contract extensions totalling £147m were received in the year.

On the F-35 Lightning II programme, BAE Systems completed delivery of 43 aft fuselage assemblies for the Low-Rate Initial Production (LRIP) Lot 8 contract. A £203m contract on LRIP Lot 9 for 57 aircraft sets was received in the year, with 11 aft fuselage assemblies completed. The forward price for LRIP Lot 10 for 94 aircraft sets has been agreed, with full contract award for both Lots 9 and 10 anticipated during 2016. A proposal for LRIP Lot 11 has been submitted to Lockheed Martin in advance of negotiations commencing in 2016.

Support continues to be provided to users of Hawk trainer aircraft around the world. In 2015, the Indian Navy and Air Force received five and 15 Hawk aircraft, respectively, built under the Batch 2 licence for 57 aircraft by Hindustan Aeronautics Limited. An order for a further 20 Hawk aircraft from the Indian Air Force is currently being negotiated.

Orders for £255m were received in the year for continued support to the RAF advanced jet training facility in North Wales.

Working jointly with Dassault Aviation, progress is being made in maturing and demonstrating critical technology and operational aspects for an unmanned combat air system.

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 further phases of flight trials in the year.

During 2015, the business concluded 236 management redundancies following the announcement in October 2014, with a further 204 potential redundancies mitigated through redeployment within either the business or the wider Group.

In October, BAE Systems agreed to invest £20.6m in Reaction Engines Limited (REL) to acquire 20% of its share capital and also enter into a working partner relationship. REL is a privately-held company based in the UK developing the technologies needed for SABRE™ (Synergetic Air-Breathing Rocket Engine), a new aerospace engine class.

Maritime

The consolidation of BAE Systems' UK shipbuilding operations into Glasgow concluded in 2015.

Following completion of the assessment phase contract for the Type 26 frigate in March, an £859m demonstration phase contract was secured, covering detailed design activities and enabling BAE Systems to subcontract for key equipment with companies throughout the supply chain. The programme continues to employ over 1,000 employees.

The government's reaffirmed commitment to shipbuilding continuity in November's UK Strategic Defence and Security Review provides clarity and future opportunities for the Group's shipbuilding facilities and workforce in Scotland. This includes maintaining a fleet of 19 frigates and destroyers, including eight Type 26 frigates and a planned concept study followed by the design and build of a new class of lighter, flexible, general purpose frigates. There is also a commitment to build two additional Offshore Patrol Vessels.

On the aircraft carrier programme, HMS Queen Elizabeth commenced the commissioning of its key systems, which will continue through to the second half of 2016. Construction of HMS Prince of Wales continued, with the integration of the bow, forward island and bridge during the year. The final manufacturing block was delivered to Rosyth in December.

HMS Forth, the first of a second batch of River Class Offshore Patrol Vessels for the Royal Navy, is planned for delivery in 2017. The construction of HMS Medway, the second ship, commenced in June and the third ship, HMS Trent, in October. This programme supports shipbuilding skills and provides the springboard to transform the business between the carrier programme and the start of manufacture for the Type 26 frigate programme.

Following successful sea trials, final acceptance of the third and final Khareef Class corvette for the Royal Navy of Oman was achieved during the second half of the year.

Under the five-year, £600m Maritime Support Delivery Framework contract, secured in 2014, the business provides services at HM Naval Base Portsmouth and support to half of the Royal Navy's surface fleet. The provision of services under the contract progresses well with cost savings remaining on target.

BAE Systems manages the support, maintenance and upgrade of the Royal Navy's fleet of Type 45 destroyers.

Successful completion of the first in-water trials was achieved on the £270m Spearfish torpedo upgrade programme. The demonstration phase of the contract is planned to complete in 2019 prior to full manufacture.

The first phase of the joint UK and French Maritime Mine Counter Measures demonstrator programme, which may form the basis of a future Royal Navy unmanned system to combat the threat of underwater sea mines, progresses.

Following handover and customer acceptance in November, Artful, the third Astute Class attack submarine, is now being operated by the Royal Navy. Good progress continues on the remaining four boats. The full £1.3bn contract for the fifth boat was secured in November and further limit of liability funding of £30m for the seventh boat was also received.

Our strategy in action
Continuously improve efficiency and competitiveness

World-class manufacturing facilities

More online
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During recent years, as part of its commitment to the largest defence programme in the world, over £500m has been invested at Samlesbury, UK, (of which over £150m has been contributed by the Group) in the latest technology, facilities and people to deliver aircraft sets for the F-35 Lightning II programme.

The investment includes a titanium machining facility for complex parts, extended manufacturing facilities, state-of-the-art production lines and a new office building.

In December, work began on the final phase of the F-35 assembly facility at Samlesbury. The 4,300m² expansion is due to be completed in 2017 and will enable the manufacture of up to 160 aircraft sets per annum, an increase of approximately 250% from current levels.

The Successor submarine, the replacement for the Vanguard Class fleet, continues to advance functional and spatial design as the programme approaches its production stage. Preparations include a major programme of building works to ensure the Barrow site will be ready to begin manufacturing when the anticipated UK Ministry of Defence's investment decision is approved in 2016 (see page 13). At 31 December, BAE Systems has almost 8,000 employees and contractors in the Submarines business.

Combat Vehicles (UK)
The final five Terrier combat engineering vehicles were completed in the year.

A £7m contract for the assessment phase of the upgrade to the British Army land bridging system was secured in December.

Other orders totalling £50m for ongoing support to the previously supplied armoured and bridging vehicles were received in the year.

Munitions
Negotiations on the pricing for the next five years of the 15-year Munitions Acquisition Supply Solution partnering agreement with the Ministry of Defence, secured in 2008, continue.

A €188m (£139m) contract for 515 cased-telescopic cannons for the Ministry of Defence was secured in March by CTA International, a 50% joint venture between BAE Systems and Nexter.

Looking forward

Platforms & Services (UK) has a strong order backlog of long-term committed programmes and an enduring support business. The Strategic Defence and Security Review announced in November 2015 provided clarity, continuity and stability for the UK business.

In Military Air & Information, sales are underpinned by Typhoon and F-35 Lightning II aircraft production and in-service support. There are opportunities to secure future Typhoon export sales, supported by the announcement made in September relating to the supply of 28 aircraft for the Kuwait Air Force.

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, River Class Offshore Patrol Vessels and Astute Class submarines. The through-life support of existing and new platforms, together with their associated command and combat systems, provides a sustainable business in technical services and mid-life upgrades.

Combat Vehicles (UK) continues to pursue obsolescence management and upgrade programmes.

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

With the aim of continuously improving business delivery and efficiency, the Combat Vehicles (UK) and Munitions businesses, with effect from 1 January 2016, merged to form one business, BAE Systems Land (UK).

Segmental performance

Platforms & Services (International)

Platforms & Services (International), with 13,600 employees[1], 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 through 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, maritime and land domains. Services contracts include the provision of sustainment, training solutions and upgrades.

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. Business generated in Oman is executed through the Group's relevant reporting segments.

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

Our strategy in action
Continue to win new international orders

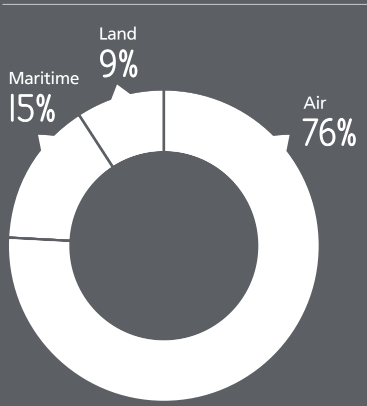
Saudi training partnership

The Royal Saudi Air Force continues to invest in training and associated equipment. The Group provides technician, officer and aircrew training both in Saudi Arabia and the UK, and is delivering new training equipment to the latest standard. As at 31 December, a total of 46 of the 55 Pilatus PC-21 aircraft had been delivered to replace the ageing Pilatus PC-9 aircraft. Production of the 22 Hawk Advanced Jet Trainer aircraft, ordered in 2012, is currently in the advanced stages with deliveries commencing in 2016.

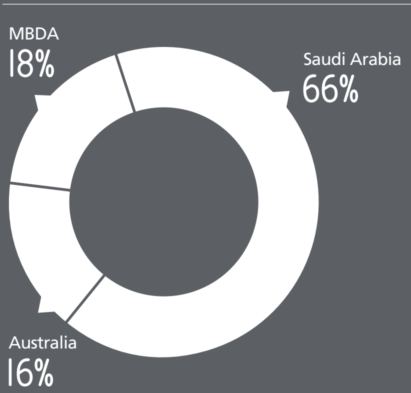
An order for an additional 22 Hawk Advanced Jet Trainer aircraft, associated ground equipment and training aids was secured during the year, and is the latest example in the Group's long-term partnership to meet the Kingdom of Saudi Arabia's future aircrew training needs.

The Hawk trainer aircraft gives trainee fast jet pilots access to the very latest in advanced emulation for radar, weapons and defensive aids training to enable a smooth transition to front-line aircraft, including Typhoon.

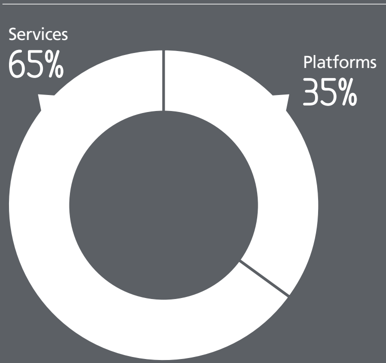
Sales[1] by domain (%)



Sales[1] by line of business (%)



Sales[1] analysis: Platforms and services (%)



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

Operational and strategic highlights

- 12 Typhoon aircraft delivered to Saudi Arabia in the year
- Continued support to the operational capabilities of the Royal Saudi Air Force and Royal Saudi Naval Forces
- Contract awarded in Saudi Arabia for a further 22 Hawk aircraft
- Re-organisation of portfolio of interests in industrial companies in Saudi Arabia progressed
- Customer acceptance of the second of two Landing Helicopter Dock ships in Australia
- Headcount reductions and an impairment of assets at the Williamstown shipyard
- Announced a consolidation of Australian operating divisions to reduce management costs and remain competitive
- The UK and French governments signed a treaty relating to complex weapons technology
- MBDA secured weapons package orders with Egypt and Qatar worth €1.1bn (£0.8bn) as part of agreed export contracts for Rafale aircraft

Financial performance

		2015	2014
Sales[1]	KPI	**£3,742m**	£3,572m
Underlying EBITA[2]	KPI	**£335m**	£366m
Return on sales		**9.0%**	10.2%
Cash inflow[3]	KPI	**£164m**	£881m
Order intake[1]	KPI	**£3,046m**	£3,398m
Order backlog[1]		**£10.2bn**	£11.6bn

- Sales[1] of £3.7bn were 5% up over 2014, or 9% on a constant currency basis, due to higher levels of support to the Salam Typhoon aircraft now in service and higher volumes of weapon systems.
- Underlying EBITA[2] of £335m (2014 £366m) is after charges totalling £53m in respect of the impairment and rationalisation in the Australian business.
- There was an operating cash inflow[3] of £164m (2014 £881m) which includes the second payment under the Salam Variation of Price agreement. However, some £200m of receivables were collected in December 2014, ahead of the contracted 2015 dates. In addition, customer advances were utilised against the Saudi aircraft training programme.
- Order backlog[1] continues to reduce as the 2013 awards of the five-year support contracts in Saudi Arabia trade out.

Segmental performance
Platforms & Services (International)

Operational performance

Saudi Arabia

On the Salam Typhoon programme, 12 aircraft were delivered in the year and, as at 31 December, 57 aircraft had been delivered to the Royal Saudi Air Force. Work on enhancing Typhoon's air-to-ground capability is progressing to schedule.

The Typhoon support contracts are operating well with all Key Performance Indicators meeting contractual levels.

Through the Saudi British Defence Co-operation Programme, the business continues to support the operational capabilities of the Royal Saudi Air Force (RSAF) and Royal Saudi Naval Forces. The modernisation of the RSAF's training aircraft fleet has been extended with an agreement for the supply of a further 22 Hawk aircraft, associated ground equipment and training aids. The original contract continues on schedule, with all 22 Hawk aircraft in advanced stages of production and the first aircraft having flown in September. Deliveries are due to commence in 2016. As at 31 December, a total of 46 of the 55 Pilatus PC-21 aircraft had been delivered. Training and support under five-year contracts continues.

The upgrade of Tornado aircraft and associated equipment procurement continues.

Under the Royal Saudi Naval Forces' Minehunter mid-life update programme, acceptance of the second ship is now expected in 2016 following the delayed completion of sea trials during the year. The third ship is due to be initiated into the upgrade programme in 2016. However, delivery timescales will be impacted by previous programme delays.

The planned re-organisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia continues. Riyadh Wings Aviation Academy LLC has contracted to acquire a 49% shareholding in a Group subsidiary, Overhaul and Maintenance Company. The re-organisation supports BAE Systems' strategy to expand the customer base of its In-Kingdom Industrial Participation programme, promoting training, development and employment opportunities in line with the Saudi National Objective. As part of the re-organisation, the business plans to transfer a material proportion of its Saudi-based workforce to one of the local Saudi industrial companies. Work is ongoing to secure the necessary regulatory and stakeholder approvals to allow this to commence.

Our strategy in action
Leverage our technology and engineering capabilities

F-35 missile collaboration

Image courtesy of Kongsberg Defence & Aerospace AS

BAE Systems Australia is supporting Norway's Kongsberg Defence & Aerospace AS to develop guidance technology for the Joint Strike Missile being designed for the F-35A Joint Strike Fighter.

The Passive RF Sensor, developed by BAE Systems' Advanced Technologies team in Adelaide, with the support of the Australian government, will increase the survivability of the missile and the aircraft by increasing the range at which targets can be engaged. The production of sensors is expected to provide long-term work for the business.

More online
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The In-Kingdom Industrial Participation programme continues to progress, with the Al Salam Aircraft Company being accredited as a repair agent for Typhoon windscreens and transparencies. Advanced Electronics Company, in which BAE Systems has a 50% shareholding, has secured further accreditations as a repair agent for Typhoon avionics equipment and produced critical avionics for use on the Hawk trainer aircraft. These capability transfer successes demonstrate BAE Systems' long-standing commitment to the development and growth of the Saudi Arabian aerospace industry, which plays a significant and increasing role in the delivery of its contracts in the country.

Australia

The second and final Landing Helicopter Dock warship, HMAS Adelaide, was accepted by the Australian customer in October and was commissioned into the fleet in December. In-service support to both Landing Helicopter Dock ships is provided by BAE Systems under a four-year contract.

Construction of ship blocks for the Air Warfare Destroyer (AWD) programme at the Williamstown shipyard continues, with production complete and acceptance achieved on 18 of the 21 contracted blocks at 31 December.

There is no contracted shipbuilding programme for the Williamstown shipyard following completion of the Landing Helicopter Dock programme in 2015 and delivery of the remaining AWD blocks in early 2016. As a result, BAE Systems announced, on 12 November, workforce reductions of up to 340 shipbuilding roles, of which 200 had been completed as at 31 December, with the remainder in the first half of 2016. Rationalisation and restructuring charges relating to these workforce reductions totalling A$37m (£18m) have been taken. In addition, a non-cash impairment charge of A$48m (£24m) has been taken against the carrying value of the Williamstown facility.

The fourth of the seven Anzac Class frigates to be modernised under the current Anti-Ship Missile Defence programme was accepted in September as planned. The fifth and sixth ships are undergoing their refits at the Henderson shipyard and are scheduled for acceptance during 2016.

BAE Systems has been selected as the Asia-Pacific regional prime contractor to undertake airframe maintenance, repair and overhaul for the F-35 Lightning II programme. This represents a significant growth opportunity and is expected to underpin the Group's aerospace sustainment activities in Australia over the next decade and beyond.

Negotiations have been completed with the Commonwealth on a revised delivery schedule for the delayed JP 2008 Phase 3F programme for enhanced satellite communications services to the Australian Defence Force.

In September, the business submitted its proposal for the multi-billion Australian dollar Land 400 Phase 2 Combat Reconnaissance Vehicle programme to the Commonwealth. The successful tenderers are participating in funded risk mitigation trials during 2016.

On 12 November, further headcount reductions were announced as part of a restructuring to improve efficiency and management costs that reduced the number of operating divisions from three to two.

Oman

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

The Typhoon and Hawk programme continues to meet all contracted milestones.

The third of three Khareef Class corvettes achieved final acceptance during the year.

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

The business continues to fulfil its industrial participation obligations in Oman through delivery of an agreed training and knowledge transfer programme. An expansion of this programme has been contracted and, when delivered, will satisfy all of the Group's outstanding industrial participation obligations.

MBDA

Following completion of the Meteor development programme at the end of 2014, deliveries of production-standard missiles ordered by the six partner nation customers and first export customer continue to plan.

MBDA has secured a contract, worth £89m to BAE Systems, for the UK Advanced Short Range Air-to-Air Missile (ASRAAM) development and production programme.

The German government has announced its intention to buy the Medium Extended Air Defence System (MEADS) missile defence system being developed by MBDA in partnership with Lockheed Martin. Contract signature is expected in 2016, subject to German political approval. This decision provides an opportunity for MEADS to compete for significant export opportunities worldwide.

In November, a treaty was signed between the UK and French governments under which both countries committed to principles of inter-dependency and joint sovereignty in the field of key complex weapons technology.

MBDA has been awarded weapons package orders, worth €1.1bn (£0.8bn) to BAE Systems, as part of agreed export contracts for Rafale aircraft in Egypt and Qatar.

A significant number of ground-based air defence export campaigns continue to be pursued in central Europe and the Gulf region.

Our strategy in action
Continue to win new international orders

MBDA export success

BAE Systems holds a 37.5% interest in MBDA. Formed in 2001, MBDA is today one of the world's largest guided weapons producers.

The business aligns pan-European government requirements and harnesses some of the highest technology to achieve programmes of sufficient scale to compete successfully across multiple international markets. MBDA produces a wide range of defence systems for air, naval and land force applications. Many of these systems have applications across multiple competing defence platforms.

MBDA has been awarded significant weapons package orders as part of agreed export contracts for Rafale aircraft in Egypt and Qatar.

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Looking forward

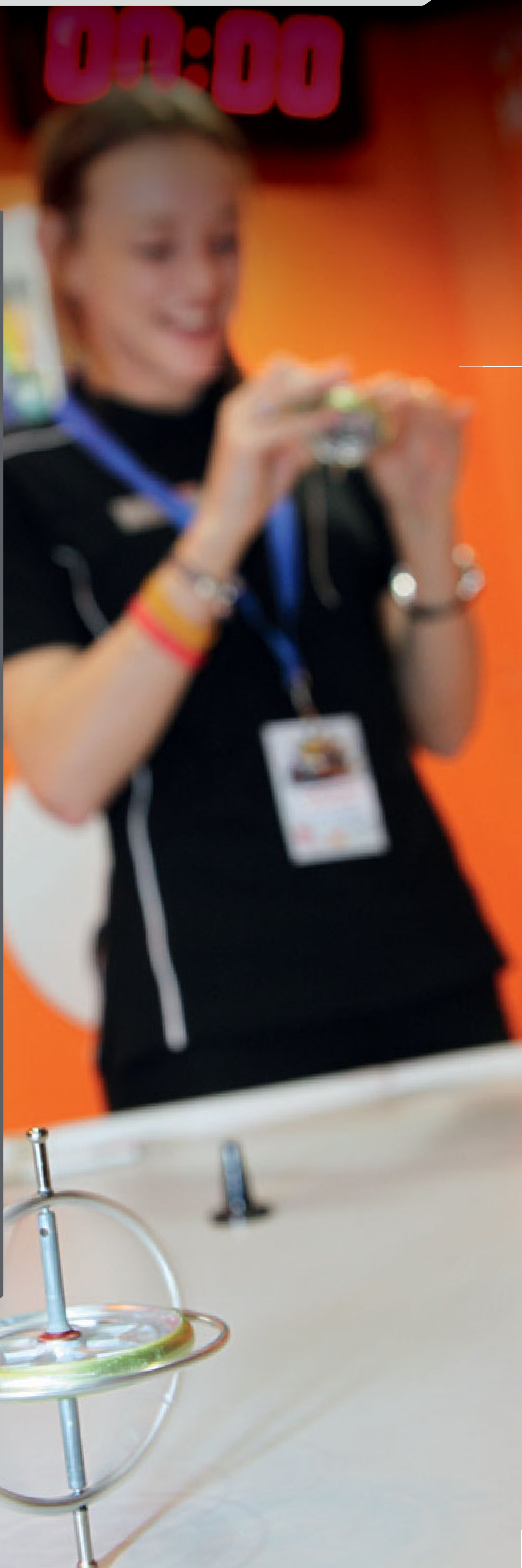
In the Kingdom of Saudi Arabia, the Group expects to sustain its long-term presence through delivering current programmes and industrialisation, and developing new business in support of the Saudi military forces. The planned re-organisation of the Group's portfolio of interests in a number of industrial 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 2015 Federal Budget statement confirmed the government's commitment to increasing annual defence expenditure to 2% of Gross Domestic Product within a decade of the budget. The Group continues to reinforce its commitment to Australia and is exploring further opportunities to provide leading defence capabilities across all domains.

In Oman, the business continues to provide support to its products in service to position for future requirements. The Typhoon and Hawk aircraft programme is on track for commencement of deliveries in 2017.

MBDA continues to build on the effective partnerships it has established with its domestic customers and has secured export opportunities that underpin future growth.

Responsible business



Non-financial Key Performance Indicators

Trust and integrity P48

Ethics enquiries[1]

1,148

Dismissals for reasons relating to unethical behaviour[1]

2015	257
2014	286

Our people P48

Safety

732 Recordable Accident Rate (per 100,000 employees)[1]

15% improvement

2015	732
2014	863

Target achieved
5% UK executive directors' annual bonus[2]

Diversity

Total employees[1,3]
75,000

Male
60,000

Female
15,000

Resource efficiency P51

Total greenhouse gas emissions (tonnes CO_2e)[1]

1,352,200
+1%

2015	1,352,200
2014	1,336,751

Total greenhouse gas emissions per employee[3] (tonnes CO_2e)

18
0%

2015	18
2014	18

1. See summary of Deloitte LLP assurance on page 51.
2. 85% (including 80% relating to financial objectives – see page 16) 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 (see page 76).
3. Excluding share of equity accounted investments.

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

Responsible business priorities

2015 priorities	2015 progress	2016 direction
Trust and integrity 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.	Refreshed Code of Conduct rolled out across the Group via face-to-face briefings. Continued to progress Ethical Leadership Group (NAVEX Global) recommendations to drive continuous improvement of business conduct programme. Integrated business conduct training and reporting with Human Resources, Legal and Internal Audit departments.	Roll out Code of Conduct refresher training across the Group. Continue to instil responsible behaviour across the Group. Further integrate the business conduct programme across Group functions.
Our people 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.	Sadly, during 2015, there were two air incidents that resulted in seven fatalities, four of our employees and three from other companies. The Group achieved a 15% reduction in the Recordable Accident Rate[1]. The number of major injuries[1] across the Group increased by 21% (see page 49). All businesses set diversity and inclusion plans to address specific issues or strategic aims.	Continue to drive towards a world-class level of safety performance. Achieve a 10% reduction in the Recordable Accident Rate. Continue to focus on 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.
Resource efficiency All businesses to continue to drive improvements in management of materials and resources.	All businesses set and met improvement targets for energy, water and waste, except where additional work opportunities and extremes of climate impacted.	All businesses to continue to drive improvements in management of materials and resources.

For further information, see our Corporate responsibility summary www.baesystems.com/crsummary

Responsible business in action
Increasing the recruitment talent pool

Global support for STEM education

Engineering skills are vital to BAE Systems and companies in the global supply chain. The Group is reliant on a pipeline of young talent having studied Science, Technology, Engineering and Mathematics (STEM) subjects. BAE Systems has introduced a number of initiatives which support the promotion of STEM subjects and careers for young people in the markets in which it operates.

In 2015, the US businesses continued to support the National Math and Science Initiative and invested in hands-on activities to engage and inspire students, including ongoing support of FIRST Robotics team competitions.

In the UK, BAE Systems has committed £80m a year to skills development and is supporting the 'Your Life' campaign, a partnership between educators, industry and government to boost female participation in technology and engineering. In addition, over the last two years, the Group has taken its schools roadshow into 500 schools, engaging with 120,000 young people aged 10 to 13.

In Saudi Arabia, BAE Systems has developed close ties with King Saud University, working with it to create an extensive scholarship programme. We also sponsor a graduation award for engineering students and support a lecture series on advanced manufacturing led by our engineers.

In Australia, BAE Systems is a major sponsor of two FIRST Robotics teams. As well as technical skills, students develop teamwork, problem solving and critical thinking skills through the programme.

In the United Arab Emirates, BAE Systems recently formed a five-year Student Co-operative Agreement with Mubadala to offer Emirati students an intensive 18-week aerospace and security internship programme in the UK. In Oman, Qatar and Bahrain, groups of our graduates and apprentices have been leading STEM workshops with schools and universities.

More online
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1. See summary of Deloitte LLP assurance on page 51.

Responsible business
continued

Introduction

The Group views Corporate Responsibility (CR) as an important enabler in achieving sustainable growth in shareholder value by:

- instilling responsible behaviour to be a trusted partner;
- supporting customer confidence in our business by continuously improving standards of safety for employees and those using our products;
- developing an inclusive, diverse workplace to drive innovation and performance; and
- proactively managing the environmental impacts of our facilities and products to improve efficiencies and cost savings.

These key enablers are supported by good relationships with our customers, business partners and communities.

The Group also has programmes in place to support sustainable long-term performance by managing non-financial risks that can impact delivery of contracts, reputation and shareholder value.

We set CR priorities for the Group, which are enacted at local level. These translate into business conduct, safety, diversity and environment objectives.

Trust and integrity

Managing our operations responsibly and conducting our business in an ethical way supports the Group in earning and maintaining our customers' trust. Our governance system is fundamental to how we do business and guides the Group in how to conduct business responsibly.

We continue to instil responsible behaviour across the Group by supporting employees to make the right ethical decisions. The launch, in early 2015, of our revised Code of Conduct gave managers an opportunity to engage directly with employees on ethical dilemmas that can take place every day. The Code was rolled out to employees via face-to-face briefings. Employees also received compliance training throughout the year appropriate to their job role, including training on export controls.

We expanded our Ethics Officer network, which supports our Ethics Helpline by providing employees across our sites with guidance and support or somewhere to report concerns. During 2015, we received 1,148 ethics queries via our Ethics Officer network and helpline[1], with the number of queries being raised face-to-face via our Ethics Officer network at 51%. The total number of queries raised is a good indicator that policies and processes are working and highlight awareness created via the Code of Conduct and compliance training. The number of queries raised directly with Ethics Officers and the Group's anonymity rate indicates that employees feel more comfortable raising concerns and that they have trust in the Group's system for addressing concerns.

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. Our Procurement Policy specifically addresses ethical standards in the Group's supply chain.

During 2015, the Group continued to progress recommendations from NAVEX Global's 2014 independent assessment of our business conduct programme, focusing on supporting middle managers in developing the right culture to drive responsible behaviours and integrating functional programmes on responsible behaviour to leverage engagement opportunities with employees.

BAE Systems is committed to respecting the human rights of our employees in the workplace. We will encourage our suppliers and business partners to adopt the same or similarly high standards of ethical behaviour.

Our people

The diversity, skills and innovation of our people drives performance across the Group.

We are committed to creating a diverse and inclusive work environment where a diverse range of talented people can work together to ensure business delivery. We are creating this environment by striving to build a diverse workforce from entry level to senior management which reflects the populations that we recruit from.

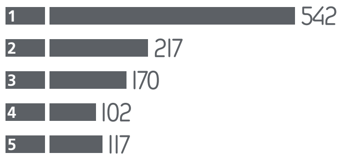
Engaging and developing our workforce for current and future business is key to successfully delivering our strategy and customer commitments. We are continuously looking to attract, recruit, develop and reward people of the highest calibre.

We want every employee to fulfil their potential while contributing to the success of the Group. We do this through our career frameworks, comprehensive development programmes and the breadth of our operations around the world that enable employees to make the most of their talents. Our focus is on continuous professional development that supports personal and professional growth.

Enquiries to Ethics Helpline[1]

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.

2015 enquiries to Ethics Helpline[1]



1 Guidance and advice
2 Employee relations and conduct
3 Management practices
4 Accounting charges practices
5 Other

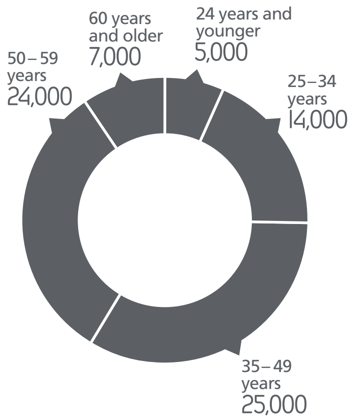
Almost half of the ethics contacts received are requests for guidance and advice. We encourage employees to contact us as early as possible when a potential incident can still be prevented by timely advice.

Anonymity rate

26%

The percentage of employees raising ethics queries anonymously compares favourably with peer companies.

Age diversity[1,2]



Our workforce demographic is similar to comparable business sectors. We sustain our workforce capabilities by attracting high-calibre people with a diverse range of experience, growing their skills and knowledge.

The Group has a number of programmes in place to improve diversity and inclusion across the business, including Executive Committee sponsored work streams to foster a culture of inclusion, accelerate the development of high-potential women and increase leadership diversity. This is underpinned by activities across the Group to improve diversity and inclusion locally.

To support our operations and the industry sectors, we partner with the education system in countries to ensure the future workforce has the core skills and capabilities to develop careers and support industrial strategies. We place particular emphasis on encouraging young people to pursue careers in Science, Technology, Engineering and Mathematics (STEM) (see page 47).

The safety of our employees, and anybody who works on, or visits, our sites, remains a priority for the Group. During 2015, the Group continued to focus on raising awareness of employees' role in identifying, managing and reducing safety risks. Throughout the year, employees were encouraged to review work processes to design out potential accidents and suggest improvements to drive standards of safety across the Group.

The Group uses the Recordable Accident Rate to measure workplace injuries. This metric, along with the number of major injuries, is used to determine an element of executive bonus (see page 76). During 2015, the Recordable Accident Rate[1] decreased by 15%, consistent with the stretch target set.

This progress represents the eighth consecutive year of improvement. However, major injuries are not decreasing at the same rate, with the severity of injuries increasing. During 2015, the number of major injuries[1] increased by 21%. The Group is reviewing root cause analysis of major injuries and will continue to focus on risk reduction and embedding safety culture to drive improvements.

We are saddened to report that, during 2015, there were two air incidents that resulted in seven fatalities, four of our employees and three from other companies. We have been supporting investigations with air accident authorities in Saudi Arabia and the US, and are carrying out internal reviews into the incidents.

We are committed to creating environments that enable employees to contribute to improving business performance through our engagement activities, including regular feedback to support their success, and drive responsible behaviour and safe working practices. We seek to listen to employees' views and opinions, and keep them informed about what is happening across the business through a variety of media, including e-enabled channels, leadership blogs, newsletters, management and team meetings, monthly team briefs, and the intranet. Employees also have the opportunity to provide feedback via our engagement surveys.

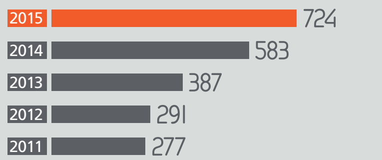
The Group welcomes employees becoming shareholders in BAE Systems and offers a number of employee share plans to support this.

Responsible business in action
Increasing the recruitment talent pool

Investing in skills in the UK

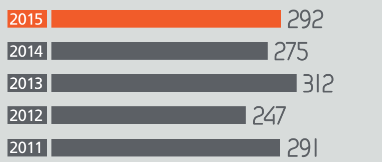
During 2015, we recruited 724 apprentices and higher-level apprentices, and 292 graduates to support the talent pipeline in the UK.

UK apprentice and higher-level apprentice recruitment



There has been significant growth in the last two years in apprentice recruitment. This relates in particular to growth in apprentice recruitment at our Submarines business linked to the Successor submarine programme and growth in higher/degree apprenticeships (which comprised 123 of our record 724 intake in 2015).

UK graduate recruitment



BAE Systems' graduate recruitment has remained relatively stable over the last five years, with our Applied Intelligence business taking approximately half our intake each year.

More online
baesystems.com

Gender diversity data as at 31 December 2015

	Number of males	Number of females	Total number	Male %	Female %
Board	7	2	**9**	78	22
Executive Committee	9	2	**11**	82	18
Senior managers[3]					
Employees in senior executive positions[4]	244	38	**282**	87	13
Directors of subsidiary companies (excluding employees in senior executive positions)	79	12	**91**	87	13
Total senior managers[4]	323	50	**373**	87	13
Total employees[1,2]	**60,000**	**15,000**	**75,000**	80	20

1. See summary of Deloitte LLP assurance on page 51.
2. Excluding share of equity accounted investments and rounded to the nearest thousand employees.
3. 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.
4. Excludes executive directors.

Responsible business
continued

Responsible business in action
Improving environmental performance

Cost and energy saving initiatives

More online
baesystems.com

Almost 12,000 solar panels are now live at three BAE Systems sites in the UK and Sweden, reducing the Group's carbon footprint and delivering savings for customers.

In Portsmouth, UK, almost 2,000 solar panels have been installed as part of a project to create an energy-efficient base for the Royal Navy. The solar panel system will transform buildings into clean energy producing facilities and is expected to generate energy savings of more than £1m over the next 20 years.

In Samlesbury, UK, where components for Typhoon, Hawk and F-35 Lightning II aircraft are manufactured, nearly 9,000 solar panels have been installed.

The panels will provide nearly a fifth of the facility's peak electrical consumption and will eliminate 1,500 tonnes of carbon emissions each year. The panels are part of an extensive programme of investment in renewable technology that has gone into the development of the advanced manufacturing centre.

Solar panels have transformed the new headquarters of the Swedish business at Örnsköldsvik into a powerful solar generator. At 2,500m^2, it is the largest façade-mounted solar plant in Scandinavia. The 1,465 solar panels will generate an estimated 370 kW at peak production, thus annually producing an estimated 312 MWh of energy and reducing carbon emissions by 187 tonnes.

Key relationships

Strong business relationships with suppliers, business partners and local communities are key to our success.

We depend on almost 27,000 suppliers to support our business and provide innovative and cost-effective products. Our relationships with suppliers are often long term due to the length of our product lifecycles, so we aim to build relationships with suppliers who share our values and who embrace standards of ethical behaviour consistent with our own. The Group sets expectations for its suppliers within contracts and within its Supplier Principles – Guidance for Responsible Business being launched in 2016, including standards on ethical conduct, health and safety, environment, and human rights.

We also require our suppliers to comply with local legislation. Compliance to required standards is evaluated during the supplier selection process and, for existing suppliers, as part of ongoing quality and approvals assurance.

Our policies and procedures require that we only work with advisers who have been approved via our due diligence process and authorised by an external panel. Advisers with whom the Group has an ongoing relationship go through this process every two years. We continue to work with peers across the defence industry to improve ethical standards. During 2015, we continued to participate in the International Forum on Business Ethical Conduct's industry working group.

We continue to strengthen relationships and invest 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 £11m[1] during 2015 to local, national and international charities and not-for-profit organisations.

1. See summary of Deloitte LLP assurance on page 51.

Resource efficiency

The Group is committed to minimising the environmental impact of our operations, whilst innovating to strive to minimise the environmental impact of our products.

We have 82,500 employees[1], across over 500 sites internationally, so our focus is to proactively manage the impact of our operations on the environment. Our primary impacts relate to energy used for heating and lighting of our facilities. We do not manufacture raw materials, so have relatively few energy-intensive processes.

Each of our businesses sets clear targets to use resources efficiently with a focus on reducing energy and water consumption, and waste generated. Environmental management systems are used to monitor and manage targets and impacts. Reducing these impacts will reduce the Group's environmental footprint and cut costs from purchased energy, raw materials and waste.

During 2015, businesses across the Group identified projects to improve environmental performance, including the installation of solar energy panels (see page 50), new LED lighting and water efficiency systems.

The majority of our greenhouse gas emissions come from the energy we use across our facilities. The Group's greenhouse gas emissions[2] increased by 1% in 2015 largely due to increased activity at some of our larger sites. This includes the bi-annual running of a high-energy test facility at Barrow-in-Furness, UK, and diesel usage for sea trials of the Landing Helicopter Dock in Australia.

From designing submarines with better waste compacting systems to helping customers make vehicles last longer, our engineers work to reduce environmental impacts across the product lifecycle. This includes reducing the environmental impacts of our products during design, 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.

Deloitte LLP assurance

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;

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

Diversity – total employees split by gender and age;

Community – total Community Investment programme donations (£); and

Environment – greenhouse gas emissions.

More online

To see Deloitte LLP's Unqualified Assurance Statement visit www.baesystems.com/deloitteassurancestatement

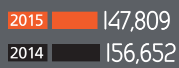
To see our Basis of Reporting 2015 visit www.baesystems.com/2015crdata

Greenhouse gas emissions data for the period 1 November to 31 October (tonnes CO_2e)

Combustion of fuel within BAE Systems facilities and vehicles (Scope 1)[2]

Electricity and steam purchased for BAE Systems use (Scope 2)[2]

Business travel in non-BAE Systems vehicles (Scope 3)[2]



Methodology

The greenhouse gas emissions data is reported in line with the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard 'Operational Control' approach, and emission factors for fuels and electricity are taken from the UK government's Department for Environment Food & Rural Affairs (DEFRA), published at www.ukconversionfactorscarbonsmart.co.uk/

The CO_2e 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 and are, therefore, not reported.

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.

Emissions from joint ventures and pension scheme properties not occupied by the Group are not included.

1. Including share of equity accounted investments.
2. See summary of Deloitte LLP assurance above.

How we manage risk

Effective management of risks and opportunities is essential to the delivery of the Group's strategic objectives and the creation of sustainable shareholder value.

Board

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.

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 oversight of 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. The Committee 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 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 2015 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. 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 54 to 57.

As a result of its assessment of the Group's principal risks, the Board has determined that the principal risks are consistent with the 2014 Annual Report.

P54
Principal risks

Risk management framework

Board
Overall responsibility for risk management

Monitoring

Audit Committee
Operational Assurance Statement Risk Register
Non-financial Risk Register

Corporate Responsibility Committee
Non-financial Risk Register

Monitoring and reporting

Monitoring and reporting

Monitoring and reporting

Executive Committee
Operational Assurance Statement Risk Register
Non-financial Risk Register

Monitoring and reporting

Businesses

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

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

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

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

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

Monitoring and reporting

Business Risk
Risk Management Policy – Mandated Policy*

1. Identification
Financial and non-financial risks recorded in risk registers

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

3. Evaluation
Risk exposure reviewed and risks prioritised

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

*As defined in the Group's Operational Framework.

P62
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 2015, 92% 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.

With the Eurozone area experiencing financial difficulties, affordability continues to be a key focus for customers.

Some countries' economies may be influenced by oil prices, with consequent reduced defence spending.

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:

– In the US, further clarity regarding potential market improvement was gained after Congress reached agreement on a new budget deal that provides for defence and domestic programme spending above the Budget Control Act caps through 2017.

– In the UK, the Strategic Defence and Security Review announced in November provides clarity, continuity and stability for the business. An increased budget for defence equipment overall includes significant investments in military aerospace, maritime, cyber and intelligence, surveillance and reconnaissance capabilities and ongoing support for defence exports.

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

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 8% of the Group's sales in 2015.

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 for their convenience 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 terminating a contract 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 the 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; the introduction of burdensome taxes or tariffs; and the inability to obtain or maintain the necessary export licences.

The Group is exposed to translational volatility arising from movements in currency exchange rates, particularly in respect of the US dollar, Euro, Saudi Riyal and Australian dollar.

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.

The Group's contracts are often long-term in nature and, consequently, it may be able to mitigate these risks over the terms of those contracts.

Political risk insurance is held in respect of export contracts not structured on a government-to-government basis.

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 markets outside the UK and US.

The Group is dependent upon UK and US government support in relation to a number of its business opportunities in export markets.

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.

In the UK, export contracts can be 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.

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

Export restrictions could become more stringent and political factors or changing international circumstances could result in the Group being unable to obtain or maintain 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.

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 2015, 48% of the Group's sales were generated by its 12 largest programmes. At 31 December 2015, 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 other cash allocation priorities.

In December 2015, BAE Systems, Airbus and the scheme trustees agreed to work towards the creation of a separate Airbus section of the BAE Systems Pension Scheme (Main Scheme) in 2016 with the allocation of the deficit to the BAE Systems and Airbus sections based on each member's last employer. This allocation methodology is considered to represent a better estimate of the deficit allocation and has been reflected in the allocation of the IAS 19 pension deficit in the Main Scheme at 31 December 2015. The impact of this change on the amounts allocated at 31 December 2015 is an increase of £187m (£153m post-tax) in the Group's share of the reported IAS 19 deficit.

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 a total of £4.4bn of liabilities, and, in 2014, 38% of eligible Main 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	Impact	Mitigation
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.	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.	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.

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

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.

Strategic report

The Strategic report was approved by the board of directors on 17 February 2016.

David Parkes
Company Secretary

Governance summary

This section of the report details the arrangements the Board has put in place to help ensure that it fulfils the obligations it has for the good governance of the Company. The detail can be found in the following pages, but I would like to highlight briefly two important matters; diversity and our approach to board evaluation.

I'm pleased to report that we have exceeded the target set by the Board back in 2011, when it committed to an aspirational target of at least 25% of its membership being women by 2015 – the figure is currently 30%. The Company and I have always been supportive of the Women on Boards initiative led by Lord Davies, which has been successful in promoting greater diversity across UK listed company boardrooms. Diversity, in all its aspects, is an important element in the composition of any board and we will ensure that it continues to be an important part of our succession planning activity.

In pursuit of achieving the highest standards of governance, during the course of the year, the Board completed a formal and structured internal review of process and practice to determine areas for improvement. The review concluded that sound progress had been made in deepening the Board's understanding of the business and strengthening engagement in assessing both performance and strategic direction. Areas for improvement included the need to develop a better understanding of competitors, a more granular awareness of our offset policy and greater visibility of high-potential members of the management team. The dynamic and effectiveness of the Board were assessed to be good, and the contribution and enthusiasm of Board members was judged to be strong.

This year, the annual board evaluation is being undertaken by an external facilitator.

The following report details how the Board has applied the principles in the UK Corporate Governance Code (2014) and complied with its provisions. However, I and all Board members are very much aware of the need to ensure that our governance structure, and all that we do as a company, is underpinned by the right business culture. As I have emphasised elsewhere in these reports, from the Board downwards, it is not just what we do, but how we do it.

Sir Roger Carr Chairman

How the Company has applied the principles of the UK Corporate Governance Code (2014) (the Code)

The Company was compliant with the provisions of the Code throughout 2015 and the Board has applied its principles in its governance structure and operations.

The Code

"The Listing Rules require companies to apply the Main Principles and report to shareholders on how they have done so. The principles are the core of the Code and the way in which they are applied should be the central question for a board..."

The UK Corporate Governance Code

Leadership

An effective board collectively responsible for the long-term success of the company.	Board of directors Board effectiveness	P60 P62
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	P62
The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.	The Board and its responsibilities	P62
Non-executive directors should constructively challenge and help develop proposals on strategy.	How we manage risk The Board and its responsibilities	P52 P62

Effectiveness

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 report Board of directors	P70 P60
There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.	Nominations Committee report Governance summary	P70 P58
All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.	Board attendance table Board effectiveness	P62 P62
All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.	Board effectiveness	P62
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	P62
The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.	Board effectiveness Governance summary	P62 P58
All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.	The Board and its responsibilities Board effectiveness	P62 P62

Accountability

The board should present a fair, balanced and understandable assessment of the company's position and prospects.	Strategic report Risk management, viability assessment and going concern	P(i) P64
The board is responsible for determining the nature and extent of the principal 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	P52
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	P65

Remuneration

Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.	Remuneration Committee report	P71
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	P71

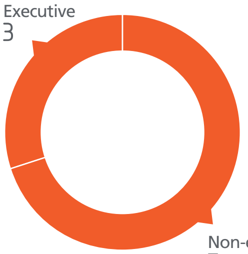
Relations with shareholders

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	P64
The board should use general meetings to communicate with investors and to encourage their participation.	Shareholder engagement	P64

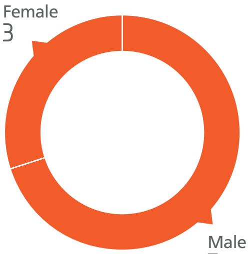
Board of directors

Our business is led by our board of directors (the Board) whose biographical details can be found below.

Board composition



Board diversity



P62
Board members' attendance at scheduled meetings

More online
baesystems.com

Chairman

Sir Roger Carr
Chairman

Appointed to the Board: 2013 **Nationality:** UK

Skills and experience
Having joined the Board on 1 October 2013 as Chairman designate, Sir Roger was appointed 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 Deputy Chairman 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, Business for New Europe and the Prime Minister's Business Advisory Group.

Other appointments
Vice Chairman of the BBC Trust, a senior adviser to Kohlberg Kravis Roberts, a 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.

Other past appointments
Chairman of Thames Water plc and Mitchells & Butlers plc.

Committee membership
Chairman of the Nominations Committee and the Non-Executive Directors' Fees Committee.

Executive directors

Ian King
Chief Executive

Appointed to the Board: 2007 **Nationality:** UK

Skills and experience
Appointed as Chief Executive in 2008 having been originally appointed to the Board as Chief Operating Officer, UK and Rest of the World. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Prior to the BAe/MES merger, he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems.

Other past appointments
Non-executive director and senior independent director of Rotork plc.

Committee membership
Non-Executive Directors' Fees Committee.

Jerry DeMuro
President and Chief Executive Officer of BAE Systems, Inc.

Appointed to the Board: 2014 **Nationality:** US

Skills and experience
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.

Other appointments
Non-executive director of Aero Communications, Inc.

Committee membership
Non-Executive Directors' Fees Committee.

Peter Lynas
Group Finance Director

Appointed to the Board: 2011 **Nationality:** UK

Skills and experience
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.

Other appointments
Non-executive director of SSE plc and chairman of its audit committee.

Non-executive directors

Elizabeth Corley CBE
Non-executive director

Appointed to the Board: 2016 **Nationality:** UK

Skills and experience
Elizabeth Corley was appointed to the Board on 1 February 2016. She has served as Chief Executive Officer of Allianz Global Investors since 2012 and will be stepping back from this role to take on a position with AllianzGI as vice chair on a part-time non-executive basis with effect from March 2016. Prior to joining Allianz in 2005, she spent 11 years working at Merrill Lynch Investment Managers (formerly Mercury Asset Management). She was previously a partner with Coopers & Lybrand.

Other appointments
Non-executive director of Pearson plc, the UK Financial Reporting Council and the supervisory board of Euler Hermes, a member of the European Securities and Markets Authority's stakeholder group, and an advisory council member of TheCityUK.

Committee membership
Nominations Committee and Remuneration Committee.

Harriet Green OBE
Non-executive director

Appointed to the Board: 2010 **Nationality:** UK

Skills and experience
Harriet Green is Vice President and General Manager, Internet of Things, Commerce and Education at IBM. She previously served as Chief Executive Officer and executive director of Thomas Cook Group plc and, prior to that, was Chief Executive Officer and executive director of Premier Farnell plc. She is a member of the British Chambers of Commerce's International Advisory Council and has served as a member of the Prime Minister's Business Advisory Group.

Other past appointments
Non-executive director of Emerson Electric Co. and senior vice president of Arrow Electronics, Inc.

Committee membership
Corporate Responsibility Committee and Nominations Committee.

Chris Grigg
Non-executive director

Appointed to the Board: 2013 **Nationality:** UK

Skills and experience
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.

Committee membership
Corporate Responsibility Committee and Nominations Committee.

Paula Rosput Reynolds
Non-executive director

Appointed to the Board: 2011 **Nationality:** US

Skills and experience
Paula Rosput Reynolds is Chief Executive Officer and President of the business advisory group, PreferWest LLC. She had previously spent over 20 years in the energy sector, 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.

Other appointments
Non-executive director of BP p.l.c. and TransCanada Corporation.

Other past appointments
Non-executive director of Coca-Cola Enterprises, Inc., Anadarko Petroleum Corporation, Delta Air Lines, Inc. and Air Products and Chemicals, Inc.

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

Nick Rose
Non-executive director and Senior Independent Director

Appointed to the Board: 2010 **Nationality:** UK

Skills and experience
Nick Rose held the position of Chief Financial Officer of Diageo plc for over ten years until October 2010 where, in addition to his finance responsibilities, he was also responsible for supply, procurement, strategy and IT on a global basis. His financial experience has encompassed a number of roles at Diageo, including group treasurer and group controller, having spent his earlier career with Ford Finance.

Other appointments
Chairman of Williams Grand Prix Holdings PLC, non-executive director and senior independent director of BT Group plc, and adviser to CCMP Capital Advisors, LLC.

Other past appointments
Chairman of Edwards Group Limited, and non-executive director of Moët Hennessy SNC and Scottish Power plc.

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

Ian Tyler
Non-executive director

Appointed to the Board: 2013 **Nationality:** UK

Skills and experience
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.

Other appointments
Chairman of Cairn Energy PLC and Bovis Homes Group PLC, and non-executive director of Mediclinic International plc.

Other past appointments
Non-executive director of Cable & Wireless Communications Plc and VT Group plc.

Committee membership
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 (2014) (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.

There is a clear division of responsibility at the head of the Company and these are detailed in the Board Charter. 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.

As required by the Code, the Company ensures that all non-executive directors have sufficient time to fulfil their obligations. This is assessed when a director is appointed and also in the event of there being a material change to an individual's circumstances. During the year, such an assessment was undertaken for Ian Tyler. Mr Tyler is currently chairman of Cairn Energy and Bovis Homes Group and a non-executive director of Mediclinic International plc. During 2015, he retired as a non-executive director of Cable & Wireless Communications. With effect from 24 February 2016, he will be appointed Chairman of AWE, a non-listed company. Given the significant changes, the Chairman led an assessment of Mr Tyler's commitments and it was agreed that they would not impact his ability to fulfil his commitments to the Company. It was agreed that the matter would be further reviewed in 12 months' time.

The Board has adopted robust processes for dealing with potential conflicts of interest. All directors declare their interests on appointment and any subsequent changes are required to be notified to the Company and an assessment made as to any potential conflicts. All directors' interests are reviewed on an annual basis and formally noted by the Board.

In general, non-executive directors help constructively challenge and 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 2015 is shown below.

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 2015 is being undertaken by an external facilitator, Independent Board Evaluation. The facilitator has no other connection with the Company.

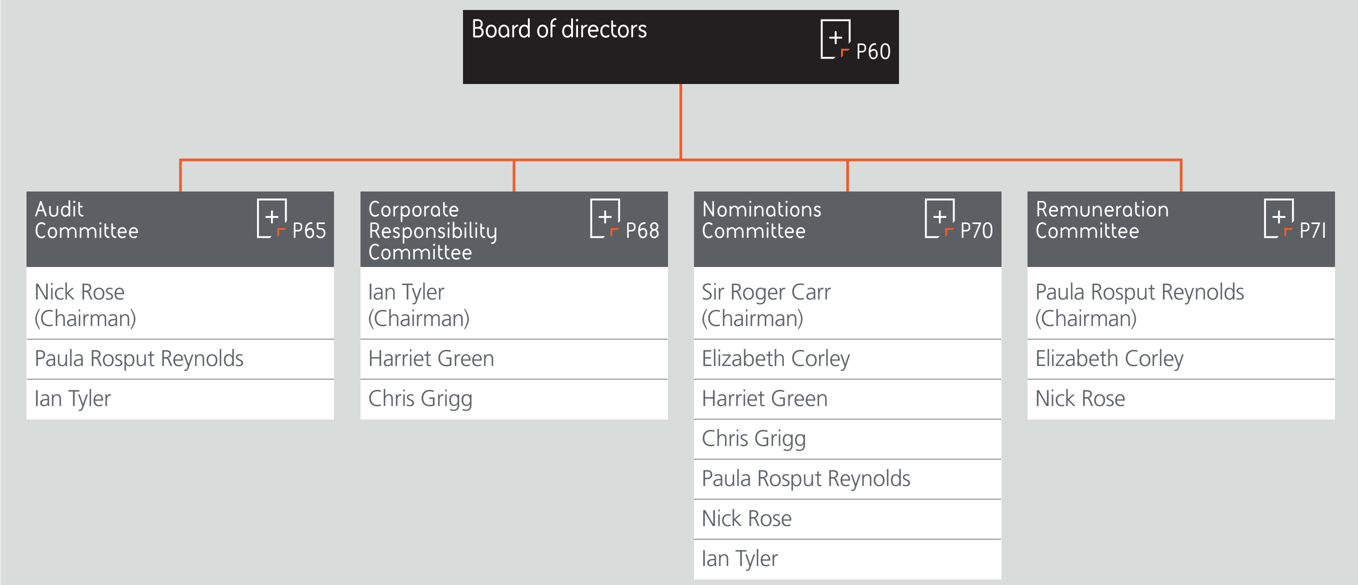
The 2015 evaluation is underway and is a full evaluation of the Board, its committees and individual Board members based on face-to-face interviews with directors and regular contributors to Board meetings. In addition, the facilitator has observed Board and committee meetings. The results of the assessment as they apply to the Board will be discussed collectively and objectives agreed for 2016. 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.

Following the evaluation undertaken last year, the Board agreed a number of objectives aimed at further improving its effectiveness. These included objectives concerning Board succession planning, how Board members develop their understanding of the business and use this to develop future strategy, and the use of modern technology to improve the efficiency and effectiveness of reporting. Good progress was made against these objectives during the year.

Attendance by individual directors at meetings of the Board and its committees in 2015

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Sir Roger Carr	8/8	–	–	5/5	–
Jerry DeMuro	7/8	–	–	–	–
Harriet Green	8/8	–	4/4	5/5	–
Chris Grigg	8/8	–	–	5/5	4/4
Ian King	8/8	–	–	–	–
Peter Lynas	8/8	–	–	–	–
Paula Rosput Reynolds	8/8	5/5	–	5/5	2/2
Nick Rose	8/8	5/5	–	5/5	4/4
Carl Symon	3/3	–	–	1/1	2/2
Ian Tyler	7/8	5/5	4/4	5/5	–

Board committees



Board induction

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.

Risk management, internal control and viability assessment

Principal risks

Details of how the Company manages risks can be found on pages 52 and 53 of the Strategic report. This section of the report includes details of how the Board and its committees maintain oversight of the key risks within the business and how these are being managed. It also describes the Company's approach to risk management and the processes used to identify, analyse, evaluate and mitigate risks. These processes are the basis of the Company's risk management and internal control systems, and the Board regularly reviews both the output from them and their effectiveness.

The Board has completed a robust assessment of the principal risks facing the Company and these are detailed on pages 54 to 57.

Corporate governance report
continued

Viability assessment

As required by the provisions of the Code, the Board has undertaken an assessment of the future prospects of the Company taking account of the Company's current position and principal risks. This assessment was made using the Company's core business processes, including the following:

Integrated Business Plan (IBP) – the IBP represents a common process with standard outputs and requirements that produces an integrated strategic and business plan for the Group and also for each of its businesses. 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.

Risk management – as detailed above, the Company has developed a structured approach to the management of risk and the principal risks identified are considered as part of the Board's annual review of the IBP.

Liquidity analysis – based on the financial output from the IBP, the Board regularly reviews an analysis looking at the forecast working capital requirements, cash flow, and committed borrowing and other funding facilities available to the Company over the five-year period covered by the IBP. This analysis includes 'stress testing' of the Company's liquidity under severe, but plausible, scenarios as developed from the IBP.

In addition to the above, the Board's review of the effectiveness of the Company's risk management and internal control systems (see below) is important to the viability statement. As such, systems are designed to ensure that the information used for business planning processes is accurate and robust. Directors have also reviewed the Company's insurance arrangements and the level of cover these provide.

In undertaking its review of the IBP in 2015, 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 long-term decisions can be made concerning, among other things, strategic priorities, funding requirements, capital expenditure and resource planning. 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 54 to 57).

Risk management and internal control

The Board is responsible for the Company's risk management and internal control systems. Details of these systems and how they operate can be found on pages 52 and 53 of the Strategic report. These include ongoing processes for identifying, analysing, evaluating and managing the principal risks faced by the Company, which have been in place throughout the year and up to the date of this report. The Board has reviewed the effectiveness of the Company's risk management and internal control systems, and believes that they accord with the Financial Reporting Council's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

The Board has delegated to the Audit Committee responsibility for reviewing in detail the effectiveness of the Company's risk management and internal control systems. Having undertaken such reviews, the Audit Committee reports to the Board on its findings so that the Board as a whole can take a view on this matter. In order to assist the Board and the Audit Committee in this review, the Company has developed the Operational Assurance Statement (OAS) process (as detailed on page 52). Part of this requires that a return is completed every six months by each operational and functional business head, reporting their formal review against such matters as compliance with law and regulations, ethical business conduct, financial controls, risk management, compliance with business planning processes, health and safety, conflicts of interest, delegated authorities, appointment of advisers and product safety. Where simple yes/no answers are not appropriate, an assessment of compliance is required to be made against structured qualitative guidance.

The twice-yearly OAS assessment process is owned by the Company's Internal Audit function, which provides assurance as to the accuracy of returns relative to the findings of audit work undertaken during the year. The returns are also shared with the Company's auditors.

A separate OAS return is required to be completed by the most senior BAE Systems employee responsible for joint ventures and BAE Systems employees on the boards of these companies are required to exert such influence as the Company may have to encourage the adoption of a governance structure that is substantially equivalent to that mandated for the Group for wholly-owned or controlled parts of the Group.

Going concern

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 and the Code requires that, if appropriate, this report includes a statement to that effect. Following review, the directors have concluded that it is appropriate to adopt the going concern basis for these financial statements and have not identified any material uncertainties concerning the Company's ability to do so in the 12-month period from the date of approving them. 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 Board uses the Company's Annual General Meeting to communicate with investors. The 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.

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 2015 and held five 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
- Approving the audit fee
- 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,

One of the recurring themes across the Audit Committee's deliberations throughout the year under review has been forward-looking assurance – and how, as part of our consideration of the effectiveness of internal controls, can we best ensure that our focus is not only on current performance of the internal control and risk management systems, but also forward-facing towards potential future areas of risk.

This ongoing dialogue at Committee meetings has supplemented the Board's discussions on risk and has led to management demonstrating to the Committee how a number of risk indicators currently in use across the business could be used holistically as an additional tool for focus on future assurance. This will help inform us in a number of areas, not least of which is the Committee's oversight of the annual Internal Audit assurance programme and its resourcing.

Internal control and risk
The Board has delegated to the Committee responsibility for reviewing in detail the effectiveness of the Company's risk management and internal control system. The Committee's review of internal controls has encompassed a review of the reports relating to the six-monthly Operational Assurance Statements (OAS), 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.

As ever, a key controls focus for the Committee is the controls environment surrounding the Company's Lifecycle Management (LCM) process. 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.

The Committee values meeting with operational management on a face-to-face basis to discuss the internal control environment within that particular business, and to seek feedback from both internal and external audit during such sessions. In 2015, we focused on our Saudi Arabian business in terms of both our main business and also our portfolio of interests in industrial companies in Saudi Arabia (our Kingdom Partner Companies (KPCs)) which are being reorganised as a result of our enhanced relationship with Riyadh Wings. This gave us

Audit Committee report
continued

the opportunity to discuss the wider business environment and its complexities, as well as to review the governance alignment with our Operational Framework by the individual KPCs.

The defence industry is a highly-regulated environment where export control laws and regulations place significant obligations on the Company. We have a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements. In addition to receiving regular reporting on export control compliance under the OAS process and internal audit output, the Group General Counsel reports to the Committee on an annual basis in this regard. We considered this in more detail during 2015 by reviewing with senior management from the Group's Military Air & Information business how one of our larger businesses manages export control compliance. This engagement with management enabled us to better understand process and procedures, along with IT enablement, communication and training across a substantial workforce.

We have reviewed the ongoing effectiveness of the Company's risk management processes as part of our wider review of internal controls. As part of the work that we originally undertook in the fourth quarter of 2014 at the Board's request for the Committee to review the Company's principal risks, we subsequently met in 2015 with the Director of Insurable Risk Services for a review of the Group's insurance arrangements. This helped us to gain a better understanding of the Group's global insurance risk model and principles of insurance purchase, as well as giving us an overview of claims in recent years.

Financial reporting
The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2015 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 Typhoon, UK aircraft carrier programme, Astute and Successor submarine programmes, Radford Army Ammunition Plant contract, losses on US commercial shipbuilding contracts, and Landing Helicopter Dock programme in Australia. The review of Australia shipbuilding also included a A$48m (£24m) impairment charge relating to shipyard assets in Williamstown.

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 8 to the Group accounts on page 124.

– **Impairments:** the Group has incurred a goodwill impairment of £75m relating to the US Intelligence & Security business reflecting lower growth assumptions.

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. In particular, the Committee reviewed and agreed the allocation of the deficit between BAE Systems and Airbus.

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 22. On a twice-yearly basis, we reviewed the Group's tax charge and tax provisions. We also reviewed the basis for the overseas tax provision release of 2.6p per share and the UK tax provision release of 1.7p per share.

The Committee also 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, taken as a whole, 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
As we have previously reported, KPMG LLP and their legacy predecessors have been in place as the Company's auditors since 1981 without re-tender and we have initiated an audit re-tendering process for the 2018 accounts, 2017 being the last year of the current audit engagement partner. There are no contractual obligations that would restrict the selection of a different auditor and we undertook to use our regular reviews of auditor effectiveness to assess whether an earlier date for a re-tender would be desirable. I am pleased to report that our review of auditor effectiveness for 2015 – referred to below – concluded that KPMG remain effective.

Mindful of the fact that we are a large and relatively complex Group, operating in a number of international jurisdictions, we are keen to provide a sufficient time period for participants in the tender to familiarise themselves with our business and assess the key risk areas prior to them delivering their final audit proposal for our consideration. On current timings, the Committee expects to have completed the competitive tender process by mid-2017 enabling us to make a recommendation to the Board on the appointment of a new audit firm which would then be subject to shareholder approval at the 2018 Annual General Meeting (AGM). We believe this time frame to be in the best interests of shareholders as it allows sufficient time for a thorough tender process and subsequent transition.

Given the length of their current incumbency as our Auditors, KPMG will not be invited to tender, but are fully committed to providing a smooth transition to the incoming auditor from mid-2017, when their successor is selected, through to them stepping down as our outgoing Auditors at the 2018 AGM, a period which will cover both our 2017 half-year review and full-year audit.

As I noted above, we undertook an annual review of the effectiveness of the Auditors. This encompassed a Group-wide evaluation at management and functional level, together with input from each of the Committee members. The evaluation 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; the quality of communications; and the ability to provide a seamless service across differing jurisdictions. We have provided feedback to the Auditors on the evaluation. We have also discussed with KPMG the need to ensure the continuity and quality of audit during the tendering period, particularly given the necessary rotation of significant partners off the account in the interim, and have agreed with them a transition plan that includes partner rotation.

On the basis of the review following the 2015 year-end audit, the Committee has proposed to the Board that it recommend that shareholders support the re-appointment of KPMG LLP at the 2016 AGM.

New EU regulations on non-audit services become effective from June 2016 which may be impacted by UK legislation prior to that date. We will be keeping this under review, not only with respect to the non-audit services currently provided by KPMG, but also with regard to any such services currently provided by audit firms who participate in our audit re-tender. Our present Non-Audit Services Policy, and how auditor objectivity and independence are safeguarded, are discussed opposite.

Internal Audit

Internal Audit plays an integral role in the Company's governance structure and provides regular reports to the Committee, including the outputs of the twice-yearly OAS process and the tracking of remedial action in the case of any control failures. Our forward-looking assurance theme has been carried over into this area of reporting too in order to enable us to get a feel for areas where there may be emerging risk that has not yet been identified as such.

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 key areas of ethical and reputational risk, as well as financial risk. The assurance programme covers a broad range of audits covering areas such as mandated governance, OAS outputs, risk register findings, change programmes, and areas relating to responsible behaviour and non-financial risk, as well as accommodating ad hoc internal audit requests. The Committee considered the output from the 2015 annual internal audit programme of assurance twice during the year.

During the year under review, we took the opportunity when we were in the US to meet with the Group's US Vice President, Internal Audit, who briefed us on the approach to internal audit in that jurisdiction.

We monitor the effectiveness of the Internal Audit function on an annual basis and, this year, we revised the format and content of the evaluation tool enabling us to elicit a wider range of responses across areas including the role of internal audit, audit planning, people and skilling, processes, execution and reporting. Feedback was requested from the various heads of the Audit Review Boards across the Group and other senior business leaders as well as from the external auditors. The Committee is mindful of the need for the Internal Audit function to operate with the appropriate level of independence, be suitably skilled and resourced, ensure that its recommendations are actionable and acted on, and be able to escalate matters to the Committee if required. The output of the evaluation was discussed with the Internal Audit Director and the Committee concluded that the Internal Audit function remains effective.

In 2013, I reported that the Internal Audit function had undergone an External Quality Assessment, the output of which had been positive. Since then, the function has been building further on its effectiveness in a number of areas, including the attainment of external accreditation by individual internal audit managers. One key value-add in recent years has been to include the audit of our culture as a part of the internal audit process. The feedback from this latest evaluation will be incorporated into the next phase of the function's continuous improvement plan.

Other key areas

During the year, the Committee has:

- agreed the Auditors' terms of engagement and the audit fee;
- reviewed and agreed the scope of the external audit plan with the Auditors;
- 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 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; and
- reviewed on a twice-yearly basis the procedures for the identification, assessment and reporting of risk, one of the reviews having been undertaken jointly with the Corporate Responsibility Committee.

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, baesystems.com.

Details of fees payable to the Auditors are set out on page 116. In 2015, non-audit fees represented 44% of the audit fee. The principal non-audit services provided by the Auditors related to M&A, tax compliance and advisory services, the interim review and equity advisory services.

Competition & Markets Authority Audit Order

The Committee has complied with the provisions of the Competition & Markets Authority Audit Order in setting out on page 66: (i) the financial year in which the Company will next complete a Competitive Tender Process (Tender); and (ii) the reasons as to why completing a Tender in that year is in the best interests of the Company's members.

Corporate Responsibility Committee report

Ian Tyler
Chairman of the Corporate Responsibility Committee

Members

Ian Tyler (Chairman)

Harriet Green

Chris Grigg

Governance

The Corporate Responsibility Committee was in place throughout 2015 and held four meetings. All its members are independent in accordance with the provisions of the Code.

Summary of responsibilities

- Assisting the Board in overseeing the development of strategy, and policy on social, environmental and ethical matters
- Keeping under review the effectiveness of the Company's internal control policies and procedures for the identification, assessment, management and reporting of reputational and other non-financial risks
- Monitoring and reviewing the role and effectiveness of the Company's Internal Audit function in relation to corporate responsibility
- Providing oversight of the Company's compliance with corporate responsibility-related policies and procedures
- Reviewing audit and assurance reports produced by the corporate responsibility assurer
- Overseeing and supporting key stakeholder engagement on social, environmental and ethical issues
- Making proposals to the Remuneration Committee regarding appropriate corporate responsibility-related performance objectives for executive directors
- Reviewing the Company's arrangements for employees to obtain further advice on ethical issues in confidence
- Ensuring that the Code of Conduct is regularly reviewed and reflects best practice for such codes
- Ensuring the Company's Annual Report 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 my second report as Chairman of the Corporate Responsibility Committee. During 2015, the Committee has continued to provide oversight of corporate responsibility-related matters, with a particular focus on ethics and safety. This will remain our focus in 2016 and I am pleased that Chris Grigg has joined the Committee recently to assist us with this work. He will bring different skills and his own experiences which will no doubt further broaden our debate and bring fresh challenge to our discussions. In this report, I review the key areas of work that the Committee undertook during the year, throughout which I am pleased to report that the Committee continued to enjoy a constructive and open engagement with the Chief Executive and senior management.

Last year, I reported on the survey that had been undertaken by Ethical Leadership Group (NAVEX Global) and the way in which the findings of this report had been implemented. This is not an activity that we review once and then put aside until it is time for a formal review; rather the Committee will continue to review how management is embedding our principles of responsible behaviour across the business.

This year, the Committee undertook a deep dive into culture and behaviour across the business. As well as progress on the actions from the Ethical Leadership Group (NAVEX Global) report, the Committee also considered the results of a Company-wide employee engagement survey. The survey provided a helpful insight into responsible business matters at all organisational levels, and also gave us an indication of where the Company sits against global norms. From such surveys, we gain a good indication of our strengths and also the areas that we need to focus on for further improvement. It is important that we continue to use tools such as this to gain an understanding of such matters and thereby assist in providing us with an indication of the underlying culture of the business concerning corporate responsibility-related matters. More work on this will be undertaken in 2016.

The Committee supports the work that the Company undertakes to continue to embed the Code of Conduct in the culture of the Company. The Code was updated in 2014 and issued to employees during 2015, and is the key reference point for how we do business and how we expect our employees to behave. This is reinforced through the formal training that accompanies any updates to the Code and employees are encouraged to use the Code as a way to discuss issues that may concern them.

For a number of years, the Committee has monitored the development and roll-out of a system of ethics officers. There are now over 160 ethics officers across the Group and these employees continue to provide a first point of contact for any ethical issues or concerns that employees may have. In addition, the Company has had an Ethics Helpline managed by a third party for a number of years, providing a means by which employees can raise matters of concern in confidence and, if the individual wishes, anonymously. The Committee monitors the number and nature of calls to the helpline and also ensures that it remains effective. The majority of issues raised through the Ethics Helpline are usually managed by local management in the first instance, but there is an escalation process that ensures that the most serious issues are brought to the attention of the Committee.

A key focus for the Company is ensuring that we have a diverse and inclusive workforce. Therefore, we monitor where we are currently and, more importantly, the actions that we can take to improve the levels of diversity and inclusion across the Company. A critical part of this is the need to continue to make progress in developing a talent pipeline which will allow us to build the right leadership team in the future and allow talented people to reach senior positions. The work that is done with schools and universities supports our aim to encourage diversity in the engineering sector. This is discussed in more detail in the Responsible business section of the report.

We are saddened to report that, during 2015, there were two air incidents that resulted in seven fatalities, four of our employees and three from other companies. The Company has been supporting investigations with air accident authorities in Saudi Arabia and the US, and are carrying out internal reviews into the incidents.

The safety of our employees and all those working on our sites continues to be another key focus for the Committee, and an important part of the work we undertook during the year was to identify a credible, realistic and readily reproducible safety benchmark that will allow us to compare our performance relative to organisations that are world class in terms of safety. The Committee will monitor the work being undertaken by each of our businesses as they seek to achieve the world-class level of safety performance represented by this benchmark. The drive to improve safety will always be with us as we seek to continually improve performance and we recognise that progress needs to be measured over a number of years, but with annual goals to monitor progress towards the agreed benchmark.

Performance against safety objectives forms part of the Annual Incentive Plan that is operated for the executive directors and is also an equal part of the incentive arrangements for all senior executives in the Company. These objectives measure performance not only against key safety indicators, but also improvements in behavioural safety and action taken to eliminate safety risks. Our safety culture was a particular focus of the Committee during 2015 and will continue to be so throughout 2016. As part of a deep dive review, the Committee reviewed the way in which culture interacts with safety and how lessons learned from other sites can be shared with other parts of the business quickly and effectively.

The Committee also carried out a review of our product safety policy, which is aimed at ensuring that we have a robust approach to product safety across the Group, including compliance with contractual, legal and regulatory requirements. Finally, the Committee took time in 2015 to look at our commercial arrangements and the processes we have in place governing how we contract with customers and the behaviours we expect to see from our employees when dealing with commercial arrangements.

During 2016, we will continue to undertake deep dive reviews into the priority areas and to receive updates on progress against our objectives for safety, ethics behaviour, and diversity and inclusion. Also in 2016, the Committee plans to carry out another site visit to support its understanding of the culture of the business and the challenges it faces.

Ian Tyler
Chairman of the Corporate Responsibility Committee

Responsible business in action
Developing first-hand understanding of corporate responsibility

Visit to Mobile and Norfolk shipyards, US

For a number of years, the Committee has included a whole-day visit to one of the Company's sites as part of its annual schedule of activities. These visits have proved to be a valuable means for Committee members to develop a first-hand understanding of the Company's approach to corporate responsibility and to take a deeper look into certain matters. In August last year, the members of the Committee visited two US shipyards in Mobile, Alabama, and Norfolk, Virginia, to gain a more detailed understanding of the approach to safety at these sites. The Committee chose to visit these two locations recognising the challenging safety environment in which they operate. The directors spoke to a cross-section of employees in the yards and spent time with management, learning about safety performance and the actions being taken to embed the right safety culture.

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Nominations Committee report

Sir Roger Carr
Chairman of the Nominations Committee

Members

- Sir Roger Carr (Chairman)
- Elizabeth Corley
- Harriet Green
- Chris Grigg
- Paula Rosput Reynolds
- Nick Rose
- Ian Tyler

Carl Symon was a member of the Committee up to 12 June 2015.

Governance
The Nominations Committee was in place throughout 2015 and held five 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.

Summary of responsibilities
- 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

Dear Shareholders,

Throughout last year, the Nominations Committee was engaged in developing a deeper engagement with management in understanding the depth of management resources across the Group. In particular, work was undertaken to provide a more focused approach to identifying and developing those individuals with the potential to take on the most senior roles at Executive Committee and Board level. As part of this work, it is important that all directors have the opportunity to meet senior executives on a regular basis, and changes have been made to the Board's annual programme to provide more interaction with senior executives, both formally and informally.

As a result of the work we have undertaken in the last 18 months, I believe our management development and succession plans are more robust and insightful. However, we will continue to work with the executive team to refine our approach to talent management and make sure that the high-potential people we employ at all levels throughout the Company have the opportunity to develop and succeed.

As part of our succession planning programme, I am pleased that we have been able to announce recently that Charles Woodburn will be joining the Board and Executive Committee in the newly-created role of Chief Operating Officer. Charles has outstanding engineering credentials with proven international industrial experience and will strengthen and broaden the strategic and operational capabilities of the business. The Committee engaged the recruitment consultants Spencer Stuart and MWM Consulting to assist with its search activities.

The Committee is also tasked with ensuring that we have independent non-executive directors with the right mix of skills, knowledge and experience. In 2015, the members of the Committee identified Elizabeth Corley as an excellent candidate for appointment to the Board based on her high standing within the financial services industry and, more recently, her non-executive role with the Financial Reporting Council. I'm very pleased that she has joined the Board – increasing the number of independent non-executive directors to six and the women on the Board to 30%. During 2016, the Nominations Committee will be looking to make at least one more non-executive appointment.

Sir Roger Carr
Chairman of the Nominations Committee

Remuneration Committee report

Paula Rosput Reynolds
Chairman of the Remuneration Committee

Members

Paula Rosput Reynolds (Chairman)

Elizabeth Corley

Nick Rose

Carl Symon served as Chairman until 12 June 2015. Chris Grigg served as a member of the Committee throughout 2015 until 16 February 2016. Elizabeth Corley joined the Committee on 1 February 2016.

Governance
The Remuneration Committee was in place throughout 2015 and held four 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 pleased to present the Remuneration Committee's report for 2015. I assumed the chairmanship in June 2015 and, with the support of my fellow committee members, have undertaken an immersion in the history, policies and practices relating to remuneration. Like my Board colleagues, I am keenly aware of the sensitivity of investors and the public regarding remuneration. We are equally sensitive to these concerns and, at all times, seek to balance views about excessive or inappropriate remuneration with the legitimate need for incentives to drive value creation within the agreed-upon risk parameters.

We were pleased by the level of shareholder support received for our 2014 Remuneration Committee report, our second year of reporting under the new reporting regulations. The Committee has previously stated that it does not intend to make any revisions to the Directors' remuneration policy (the Policy) ahead of the 2017 AGM. I am confirming that, for 2016, no revisions are proposed to our executive remuneration framework which would constitute a change to the Policy.

The Committee did undertake a thorough review of the effectiveness of our current remuneration framework in 2015 and concluded that some modest changes in compensation design and levels were warranted. Therefore, while remaining within the bounds of the agreed policy, described below are the changes to the executive remuneration framework proposed for 2016. In line with our commitment to continued transparency and engagement with our shareholders, we have consulted with our major shareholders on these proposed changes for 2016.

Context to the Committee's decisions
Our remuneration strategy is designed to motivate our key talent to achieve 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 to balance 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 build more direct alignment with shareholder value creation and to reduce the complexity of our long-term incentive arrangements.

We believe the approval of the single Long-Term Incentive (LTI) plan at the 2014 AGM achieved simplification of our arrangements. The focus for 2015 has been on ensuring that our long-term incentives are appropriately rewarding our executive team only when their performance

Remuneration Committee report continued

delivers tangible business results in line with the Group's strategy. As noted below, the focus of 2016 is essentially unchanged, but certain modest adjustments are being implemented to improve the effectiveness of the rewards structure.

Earnings per Share (EPS) performance condition applicable to LTI grants

Following consultation with our major shareholders at the beginning of 2015, a performance range of 3% to 7% average annual growth was set for the EPS performance condition with 25% vesting at threshold. The changes were reflective of the inherently challenging market conditions in the defence sector, the impact of pivotal orders on the overall results, and to ensure alignment with shareholder interests and market practice.

The Committee stated at the time it made these changes that it would consider the performance condition again for 2016. The Committee carefully reviewed how the business plan approved by the Board would be translated into targets that are appropriately challenging, aligned with shareholder expectations and would provide a meaningful incentive for executives to drive performance. Taking account of the continued market conditions and outlook, including the continued dependency on winning a number of pivotal orders, the Committee believes that this performance range and vesting profile should continue to apply for awards of Performance Shares to be granted in 2016. These conditions will be reviewed at the end of 2016 to ensure the reward remains aligned with the challenge for 2017.

The EPS performance condition will continue to be subject to the same 'quality of earnings' performance hurdle as applies to the Total Shareholder Return (TSR) condition, namely 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). This condition ensures that the effort to achieve one year's EPS and other financial measures does not come at the expense of the long-term capacity of the Company to produce future value.

TSR condition applicable to LTI grants

The Committee has also considered whether the current TSR metric applicable to Performance Shares and Share Options remains appropriate. No changes are proposed to the current TSR vesting scale, with no vesting below median, 25% vesting for median performance, 100% vesting if the Company's TSR is in the top quintile and vesting on a straight-line basis for intermediate performance.

The current methodology considers BAE Systems' TSR performance against a peer group of 13 other defence and security companies, of which more than two-thirds are drawn from the US. The Committee reviewed this methodology in some detail because it was concerned that: (i) the comparator group was not fully reflective of the interests of investment decisions of the majority of our shareholder base; and (ii) the comparator group was not well matched to the particular dynamics of BAE Systems' defence business. The Committee believes it should continue to evaluate performance against our industry peers worldwide and sought advice from its independent consultants on how BAE Systems' performance might also be measured relative to peers listed in the UK. As it reviewed the results of the analysis, the Committee decided that applying a 'split' TSR measure would provide a more balanced assessment. Consequently, for 2016, the Committee is proposing to base 50% of the TSR measure on the current peer comparator group and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. Each element will be considered independently of the other, with the overall vesting outcome reflecting the average result of the two assessments.

Business performance in 2015

In 2015, BAE Systems continued to perform robustly under challenging conditions. Page 16 sets out the performance against 2015 financial key performance indicators, with order intake, underlying earnings per share and net debt determining 80% of the UK executive directors' annual bonus, and safety and key strategic objectives determining the remaining 20%. In summary, for the purpose of the annual bonus:

- Order intake at £14.9bn was similar to 2014, although below threshold performance.
- Underlying earnings per share included a 4.3p benefit from tax provision releases and increased to 40.2p, which was between target and stretch performance.
- Net debt of £1,422m, a net increase of £390m from 2014, resulted in performance between target and stretch.
- Whilst the Group achieved a 15% reduction in the Recordable Accident Rate, this was not achieved across all businesses and so resulted in performance between target and stretch. The number of major injuries increased by 21%.

No LTI awards made to the current executive directors have vested based on performance over the three-year period 2013 to 2015 due to:

- TSR performance being below the median performance of companies in our comparator group; and
- EPS growth being below the 5% per annum requirement with 2015 performance being impacted by the Typhoon production slowdown and Australian shipyard impairment and rationalisation charges.

Decisions for 2015

- 2015 annual bonus pay-outs for the executive directors ranged from 72.4% to 85.7% of maximum.
- Performance Share Plan (PSP) awards granted in March 2013 to UK executive directors will lapse in 2016 as the TSR and EPS performance measures were not met.
- Share options granted in March 2013 to the executive directors will lapse as the TSR condition was not met.
- Share Matching Plan (SMP) matching award granted in March 2013 will lapse in 2016 as the EPS condition was not met.
- First awards granted in Spring 2015 of Performance Shares, Share Options and (to US executive director only) Restricted Shares under the single umbrella LTI plan.
- Application of a performance range of 3% to 7% average annual EPS growth with 25% vesting at threshold to LTI awards.
- Strengthened malus and clawback provisions applicable to the executive directors and members of the Executive Committee reflecting the changes in the 2014 UK Corporate Governance Code.

Key changes for 2016

- For the first time since 2012, the salary of the Chief Executive Officer is increased by 2% with effect from 1 January 2016.
- To recognise the skills, experience and performance of the Group Finance Director and President and Chief Executive Officer of BAE Systems, Inc., increases of 2.5% will apply to their base salaries with effect from 1 January 2016.
- Proposal to base 50% of the TSR measure on the current peer comparator group and 50% on a TSR percentile ranking against the companies in the FTSE 100 index.
- Performance range of 3% to 7% average annual EPS growth with 25% vesting at threshold will continue to apply to 2016 LTI awards.
- A Chief Operating Officer has been newly appointed, effective in the second quarter of 2016, and the details of his remuneration package are set out on page 75.

On behalf of the Board

Paula Rosput Reynolds
Chairman of the Remuneration Committee

Annual remuneration report

for the year ended 31 December 2015

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2015 and will be proposed for an advisory vote by shareholders at the 2016 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 2016

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 2016 will be implemented as follows:

- The salary of the Chief Executive Officer is being increased by 2% with effect from 1 January 2016.
- The salaries of the Group Finance Director and President and Chief Executive Officer of BAE Systems, Inc. are being increased by 2.5% with effect from 1 January 2016.
- The performance measures and weightings for 2016 for the Annual Incentive and Long-Term Incentives are set out on page 87.
- 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.
- A new Chief Operating Officer has been appointed as an executive director. His remuneration package is structured in line with the Directors' remuneration policy and is set out on page 75.
- The fee structure for non-executive directors has been reviewed by the Non-Executive Directors' Fees Committee and remains unchanged for 2016.

Annual remuneration report
continued

Single total figure of remuneration

Single total figure of remuneration for the Chairman and non-executive directors

	Fees		Benefits		Other		Total	
	2015 £'000	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000
Chairman								
Sir Roger Carr[1]	**650**	602	**–**	–	**–**	–	**650**	602
Sir Richard Olver[2]	**n/a**	60	**n/a**	1	**n/a**	–	**n/a**	61
Non-executive directors								
P M Anderson[3]	**n/a**	84	**n/a**	1	**n/a**	23	**n/a**	108
H Green	**75**	75	**8**	–	**4**	9	**87**	84
C M Grigg	**75**	75	**2**	–	**9**	9	**86**	84
P Rosput Reynolds	**85**	75	**7**	1	**23**	23	**115**	99
N C Rose	**120**	120	**2**	1	**4**	9	**126**	130
C G Symon[4]	**43**	95	**4**	1	**14**	23	**61**	119
I P Tyler	**95**	85	**2**	1	**9**	9	**106**	95

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. Retired from the Board on 12 June 2015.

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. Sir Richard Olver's 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 2015 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.

Single total figure of remuneration for the executive directors

	Base salary		Taxable benefits[1]		Bonus[2]		LTIP[3,7]		Pension[4]		Other[5]		Total	
	2015 £'000	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000	**2015 £'000**	2014 £'000
I G King	**963**	963	**47**	45	**1,569**	1,610	**–**	690	**349**	210	**1**	1	**2,929**	3,519
P J Lynas	**557**	546	**39**	46	**659**	651	**–**	391	**396**	369	**–**	–	**1,651**	2,003
J DeMuro†[6]	**637**	529	**23**	22	**1,223**	671	**–**	–	**10**	9	**657**	575	**2,550**	1,806
L P Hudson††[7]	**n/a**	56	**n/a**	20	**n/a**	60	**n/a**	261	**n/a**	–	**n/a**	–	**n/a**	397

† Jerry DeMuro was appointed to the Board on 1 February 2014.
†† Linda Hudson retired from the Board on 1 February 2014.

1. The benefits received by Ian King include the provision of a car allowance and the private use of a chauffeur-driven car (2015 £47k; 2014 £45k). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2015 £17k; 2014 £18k). In addition, Peter Lynas received a second residence allowance of £22k (2014 £28k) on the basis disclosed in previous years. Jerry DeMuro's benefits include private use of a chauffeur-driven car and parking (2015 £4k, 2014 £2k); medical and dental benefits (2015 £11k; 2014 £9k); insured life and disability benefits (2015 £7k; 2014 £6k); and the private use of a company aircraft (2015 £1k; 2014 £5k). Linda Hudson's benefits for her period of service as an executive director in 2014 included the provision of a cash allowance for a car and parking and the private use of a chauffeur-driven car (£5k); medical and dental benefits (£288); insured life and disability benefits (£1k); and the private use of a company aircraft (£14k).
2. Further detail on bonus payments is provided on page 76. One-third of the net 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 conditions.
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 2013 PSP^{EPS} and 2013 SMP awards (for which the performance periods ended on 31 December 2015) did not meet their EPS performance condition and will lapse. The 2013 PSP^{TSR} and ExSOP^{2012} awards (for which the performance periods also ended on 31 December 2015) did not meet their TSR performance condition and will lapse. The prior year figures relate to the 2012 PSP^{TSR} and ExSOP^{2012} (for which the performance period ended on 31 December 2014), which exceeded the threshold TSR level and vested at 26.7%.

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: Pensionable salary is averaged over three years. The figures for Peter Lynas reflect the salary increase he received in 2015.
   – 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.
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 £469); and (ii) for Jerry DeMuro, the value of the 2015 grant of Restricted Shares. This award formed part of Jerry DeMuro's 2015 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached; his prior year figure relates to a similar award in 2014 under the Restricted Share Plan (RSP).
6. As previously reported, 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, 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 79.
7. Linda Hudson retired from the Board on 1 February 2014 and her leaving arrangements were reported in the Company's 2014 Annual Report.
   – As previously reported, outstanding awards made under the Company's LTIPs 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 attributed to Linda Hudson in 2015 was £123,562.
   – 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. As reported last year, after her departure from the company she received full payment of her qualified and non-qualified pension benefits. A further payment of $72,518 was made to Linda Hudson in 2015 in connection with an under-payment on the encashment of the non-qualified pension benefit to which she was entitled.
   – Linda Hudson served as a non-executive director of BAE Systems, Inc. from the end of May 2014 until 24 April 2015. For the period from 1 January 2015 to 24 April 2015, the fee paid to her in this regard was $31,667.

The above table has been subject to audit.

Appointment of Chief Operating Officer

As announced on 15 February 2016, Charles Woodburn has been appointed as Chief Operating Officer, effective in the second quarter of 2016, and will join the Board as an executive director on the same date. His salary on appointment is £750,000. His ongoing remuneration package and benefits will be structured in line with the Directors' remuneration policy approved by shareholders. He will be eligible to participate in the Annual Incentive Plan with an on-target opportunity of 100% of base salary (maximum 200%), with one-third of the net amount of any bonus payable deferred into BAE Systems shares for a period of three years. He will also receive annual LTIP awards at the following levels: Performance Share award of 230% of salary and Share Option award of 300% of salary, as described on pages 81 and 82. Additionally, he will be eligible to join the BAE Systems Defined Contribution (DC) retirement plan as described below.

In accordance with the Directors' remuneration policy, the Company will buy out certain bonus and long-term incentives previously awarded by Charles Woodburn's current employer and forfeited as a consequence of joining BAE Systems. The Committee's approach to compensating him for these was based on not over-paying on recruitment and taking account of the performance conditions and vesting dates associated with the incentives being forfeited on leaving the previous employer. He will be entitled to the following awards which take into account the fair value of the awards being forfeited and significantly extend the vesting/holding period of the incentives being given up:

(i) a cash payment of £1,620,000 in respect of incentives earned and payable within six months, of which 50% of this net amount must be used to purchase BAE Systems shares within 120 days following payment. These shares must continue to be held in accordance with BAE Systems Minimum Shareholding Requirement (which has been set at 200% in respect of his appointment); and

(ii) a one-off grant of Performance Shares equal to 266% of salary, subject to the same performance conditions applicable to awards made under the LTIP as set out on page 81 with vesting in equal tranches of one-third in 2019, 2020 and 2021.

Charles Woodburn's service contract with BAE Systems requires a minimum of 12-months' notice of termination by either party and contains mitigation provisions enabling a reduction in any phased payments in the event that he finds alternative employment during the notice period.

He will be eligible to participate in the BAE Systems DC retirement plan, which is a defined contribution arrangement for senior executives. The plan has a core employee contribution level of 4% of salary and a Company contribution of 14%. If he chooses to contribute a further 1% or 2% of his basic salary, the Company's contribution will be increased to 16% and 19%, respectively. In the event that the contributions will mean that the Annual Allowance (AA) is breached, he will be provided with the pension benefit up to the AA limit and the balance of the contributions will be paid as a salary supplement. Salary supplements will be paid in line with the contributions that would be payable to the DC retirement plan, assuming that the employee would have paid sufficient contributions to have secured the maximum employer matching.

Annual remuneration report continued

Annual bonus

Bonuses for the 2015 year are paid in March 2016. The breakdown of bonus measures, achievement and pay-out for each executive director is shown below. One-third of the net 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 (Below / Threshold / Target / Stretch)	Threshold for 2015	Target for 2015	Stretch for 2015	Actual performance[4]	Percentage of maximum opportunity
Financial	Group EPS	40.0		38.5p	39.5p	41.5p	40.8p	82.5%
	Group cash	25.0		£(2,150)m	£(1,946)m	£(1,535)m	£(1,630)m	88.5%
	Group order intake	15.0		n/a	£17.5bn	£18.2bn	£14.1bn	0.0%
Personal	Safety	5.0		See note 1 below				85.0%
	Key strategic objectives	15.0		See note 2 below				77.5%
				Total bonus (as a percentage of maximum)				**72.4%**

Group Finance Director

Measures		Weight (as a percentage of target)	Actual performance against targets set (Below / Threshold / Target / Stretch)	Threshold for 2015	Target for 2015	Stretch for 2015	Actual performance[4]	Percentage of maximum opportunity
Financial	Group EPS	40.0		38.5p	39.5p	41.5p	40.8p	82.5%
	Group cash	25.0		£(2,150)m	£(1,946)m	£(1,535)m	£(1,630)m	88.5%
	Group order intake	15.0		n/a	£17.5bn	£18.2bn	£14.1bn	0.0%
Personal	Safety	5.0		See note 1 below				85.0%
	Key strategic objectives	15.0		See note 2 below				87.5%
				Total bonus (as a percentage of maximum)				**73.9%**

President and Chief Executive Officer of BAE Systems, Inc.

Measures		Weight (as a percentage of target)	Actual performance against targets set (Below / Threshold / Target / Stretch)	Threshold for 2015	Target for 2015	Stretch for 2015	Actual performance[4]	Percentage of maximum opportunity
Financial	Group EPS	13.3		38.5p	39.5p	41.5p	40.8p	82.5%
	Group cash	8.3		£(2,150)m	£(1,946)m	£(1,535)m	£(1,630)m	88.5%
	Group order intake	5.0		n/a	£17.5bn	£18.2bn	£14.1bn	0.0%
	BAE Systems, Inc. profit	26.7		$1,005.5m	$1,022.9m	$1,075.2m	$1,102.6m	100.0%
	BAE Systems, Inc. cash	16.7		$1,238m	$1,310m	$1,448m	$1,661m	100.0%
	BAE Systems, Inc. order intake	10.0		n/a	$9.9bn	$10.4bn	$10.3bn	85.5%
Personal	Safety	5.0		See note 3 below				37.5%
	Key strategic objectives	15.0		See note 2 below				87.5%
				Total bonus (as a percentage of maximum)				**85.7%**

1. Whilst the Group achieved a 15% reduction in the Recordable Accident Rate, this was not achieved across all businesses and so resulted in performance between target and stretch. The other elements of the objective relating to reduction in significant risk rating and driving improvements in behavioural safety were achieved.
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 10% 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 achieved.
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 2015	Threshold	Maximum	Actual	Percentage of maximum achieved
2015 EPS requirement	44.6p	51.6p	40.1p	
Annual average EPS growth	5%	11%	<5%	0%

Relative TSR against comparator group

Outperformance of performance conditions ending on 31 December 2015	Threshold	Maximum	Actual	Percentage of maximum achieved
TSR against comparator group	122.5%	166.1%	68.5%	0%

The following awards had performance periods that ended on 31 December 2015:

2013 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 2015 which resulted in nil vesting and, accordingly, the TSR portion will lapse. The EPS growth was not achieved and, accordingly, this portion will lapse.

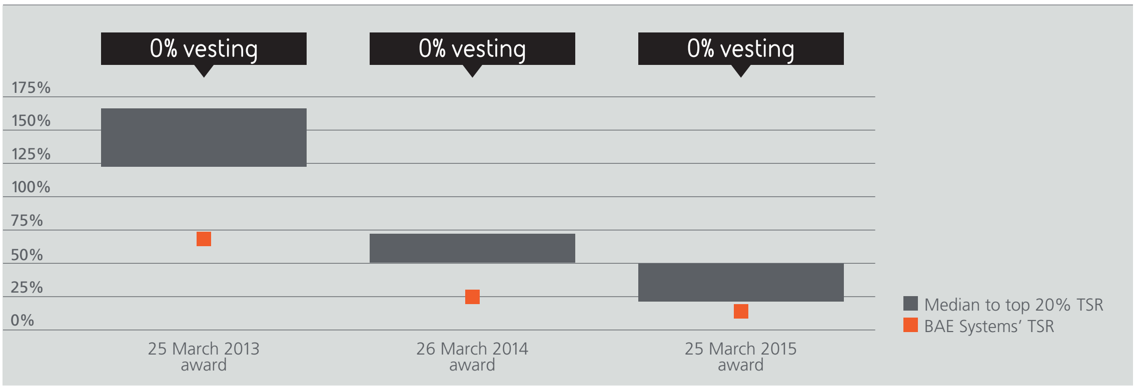
2013 Executive Share Option Plan (ExSOP[2012])
- Performance condition: relative TSR against comparator group. The TSR performance condition ended on 31 December 2015 and the option will lapse as the performance condition was not met.

2013 Share Matching Plan (SMP)
- 2:1 match on shares deferred from 2012 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 award will lapse.

A summary of TSR performance to 31 December 2015 on outstanding TSR-related LTIP awards is illustrated in the chart below.

The dark grey boxes show the range of TSR required for 25% vesting to full vesting and the orange boxes show BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.

TSR performance under the TSR-related awards as at 31 December 2015 (%)

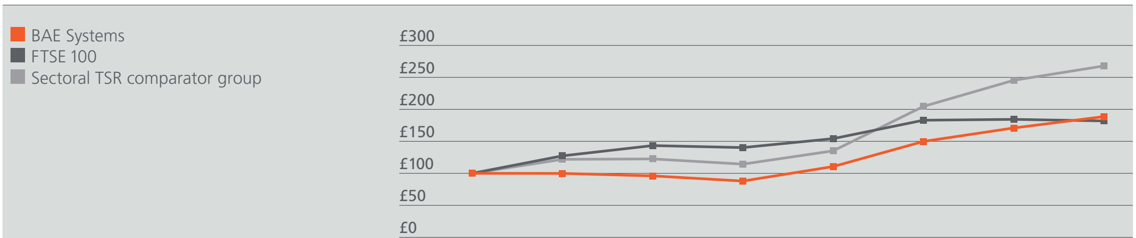


Annual remuneration report
continued

TSR performance and Chief Executive pay

The graph below shows the value by 31 December 2015, on a TSR basis, of £100 invested in BAE Systems on 31 December 2008 compared with the value of £100 invested in the FTSE 100 index, including the effect of dividends. 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 and reflects the interests of investment decisions of the majority of our shareholder base. The equivalent data is shown for the sectoral TSR comparator group of other international defence companies.

Value at 31 December 2015 of £100 investment at 31 December 2008 (£)



Change in Chief Executive's remuneration over seven years

	2008	2009	2010	2011	2012	2013	2014	2015
Chief Executive's single figure (£'000)		4,030	4,810	4,613	2,574	2,499	3,519	**2,929**
Bonus paid as a percentage of maximum		83.0%	71.0%	68.6%	55.6%	53.4%	74.3%	**72.4%**
LTI as a percentage of maximum vesting		65.5%	57.6%	44.3%	nil	nil	16.8%	**nil**

Note: Total remuneration includes the value of share plans vesting that were granted prior to appointment as Chief Executive.

The percentage change from 2014 to 2015 in remuneration of the Chief Executive and average UK employee was as follows:

	Change in Chief Executive's remuneration %	Change in average UK employee[1] remuneration %
Salary	0	+2.6
Benefits	+2.6	+2.6
Bonus	–2.5	–26.9

1. The BAE Systems UK employee 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[1], amounts paid in returns to shareholders, total employee costs and average headcount for the years ended 31 December 2014 and 2015.

Underlying EBITA[1] (£m)

Returns to shareholders[2] (£m)

Total employee costs (£m)

Average headcount[3] ('000)

1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 17).
2. Includes share buyback of £7m (2014 £283m).
3. Excluding share of equity accounted investments.

Pension entitlements

Total pension entitlements

Director	Age	Normal retirement age	Accrued benefit at 1 January 2015[1,2] £ per annum	Accrued benefit at 31 December 2015[1,2,3] £ per annum	Figures in the remuneration table on page 74: Added pension value received in the year from defined benefit scheme[2] £	Added pension value received in the year from defined contribution scheme £	Total £
Ian King	59	62	794,973	826,209	349,169	–	349,169
Peter Lynas	57	62	409,350	436,487	395,573	–	395,573
Jerry DeMuro	60	65	8,601	51,291	–	10,233	10,233

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 will be the total value of his 401(k) account, including both employee and company contributions as well as investment returns.

The above table has been subject to audit.

The 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 UK 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 US regulatory limits (for 2016 $265,000). In 2015, the company paid contributions of $15,080 into this arrangement.

Annual remuneration report
continued

External directorships

Fees retained in 2015 by executive directors during the period in which they served in that capacity in respect of non-executive directorships were: Peter Lynas £75,063 in respect of his directorship of SSE plc; and Jerry DeMuro $50,000 in respect of his directorship of Aero Communications, Inc. These amounts are not included in the remuneration table on page 74.

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[1] £	Exercise price £	Date to which performance is measured	Performance condition	Percentage of interests receivable if minimum performance achieved
Ian King									
LTIP PS[TSR]	Performance Shares/nil cost option	25.03.15	221,900	125% of salary	1,203,808	nil	Three years to 31.12.17	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	25.03.15	221,901	125% of salary	1,203,813	nil	Three years to 31.12.17	EPS/secondary financial measure	25%
LTIP SO	Share option	25.03.15	532,562	300% of salary	2,889,149	5.43	Three years to 31.12.17	TSR/secondary financial measure	25%
Peter Lynas									
LTIP PS[TSR]	Performance Shares/nil cost option	25.03.15	110,373	107.5% of salary	598,773	nil	Three years to 31.12.17	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares/nil cost option	25.03.15	110,373	107.5% of salary	598,773	nil	Three years to 31.12.17	EPS/secondary financial measure	25%
LTIP SO	Share option	25.03.15	308,018	300% of salary	1,670,998	5.43	Three years to 31.12.17	TSR/secondary financial measure	25%
Jerry DeMuro									
LTIP PSP[TSR]	Performance Shares	25.03.15	146,620	121% of salary	795,414	n/a	Three years to 31.12.17	TSR/secondary financial measure	25%
LTIP PS[EPS]	Performance Shares	25.03.15	146,621	121% of salary	795,419	n/a	Three years to 31.12.17	EPS/secondary financial measure	25%
LTIP SO	Share option	25.03.15	472,579	390% of salary	2,563,741	5.43	Three years to 31.12.17	TSR/secondary financial measure	25%
LTIP RS	Retention	25.03.15	121,174	100% of salary	657,369	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.

Key: LTIP – Long-Term Incentive Plan. PS – Performance Shares. SO – Share Options. RS – Restricted Shares.

Note: Performance Shares and Restricted Shares – Shares under award attract dividends prior to vesting. Performance Shares are intended to be free share awards and are structured as a nil cost option to give the participant more flexibility as to the timing of the benefit. For the US executive director, awards of Performance Shares 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/LTIP Performance Shares

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 equal 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. From 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 87 and 89 and will be termed 'Performance Shares'.

Awards made to the UK executive directors since 2008, and to date to the current US executive director, have been weighted 50% on the PSP^{EPS} performance condition and 50% on the PSP^{TSR} performance condition. The TSR comparator groups are shown below.

Plan	Performance condition
LTIP PS^{EPS}	For awards made from 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 Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; order book; risk; and project performance.
PSP^{EPS}	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.
PSP^{TSR}/ LTIP PS^{TSR}	The proportion of the award capable of exercise is determined by: (i) For awards made up to and including 2015, the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 13 other international defence companies over a three-year performance period (12 comparators for awards made from 2012 to 2014). For awards made in 2016, 50% of the TSR measure on the current peer comparator group of 13 other international defence companies and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. Under both the sectoral and FTSE 100 comparator groups, no shares vest if the Company's TSR is below the top 50% of TSRs achieved by the 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 (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[1]; order book; turnover; risk; and project performance.

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

The TSR peer comparator group for awards from 2015 comprises:

Cobham	Leidos	SAIC
Finmeccanica	Lockheed Martin	Thales
General Dynamics	Meggitt	United Technologies
Harris Corporation	Northrop Grumman	
L-3 Communications	Raytheon	

The TSR comparator group for awards from 2012 to 2014 comprises:

Cobham	L-3 Communications	Raytheon
Finmeccanica	Lockheed Martin	SAIC
General Dynamics	Meggitt	Thales
ITT Exelis[2]	Northrop Grumman	United Technologies

The comparator group for PSP^{TSR} awards from 2008 to 2011 comprises:

Boeing	General Dynamics	Raytheon
Cobham	GKN	Rockwell Collins
Dassault Aviation	Goodrich[3]	Rolls-Royce
EADS	Honeywell International	Smiths Group
Embraer PN	Lockheed Martin	Thales
Finmeccanica	Northrop Grumman	United Technologies

2. ITT Exelis is now part of Harris Corporation.
3. Goodrich is now part of United Technologies.

Annual remuneration report
continued

ExSOP2012/LTIP Share Options

Options are normally exercisable between the third and tenth anniversary of their grant, subject to the performance condition set out below being achieved. From 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 87 and 89 and will be termed 'Share Options'. Awards made from 2015 are subject to a further two-year clawback period after the three-year vesting period.

Plan	Performance condition
ExSOP2012/ LTIP SO	For awards made up to and including 2015, 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 13 other international defence companies over a three-year performance period (12 comparators for awards made from 2012 to 2014). For awards made in 2016, 50% of the TSR measure on the current peer comparator group of 13 other international defence companies and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. Under both the sectoral and FTSE 100 comparator groups, no shares vest if the Company's TSR is below the top 50% of TSRs achieved by the 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/LTIP Restricted Shares

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. From 2015, shares will be awarded under the single umbrella plan that was approved at the 2014 AGM as detailed on pages 87 and 89 and will be termed 'Restricted Shares'. Awards made from 2015 are 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 net 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 attracted 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:

	Initial Value	Subsequent Value
Ian King	150%	300%
Peter Lynas	100%	200%
Jerry DeMuro	175%	350%

Ian King and Peter Lynas were both in excess of their 'Subsequent Value' MSR at 31 December 2015. Jerry DeMuro joined the Board in 2014 and has started to establish a personal holding of shares in the Company which, at 31 December 2015, stood at just under 20%. The higher MSR values applicable to Jerry DeMuro recognise the higher LTI opportunity and broader US market practice.

There are no shareholding requirements for the Chairman or the non-executive directors.

Share interests as at 31 December 2015 (or on ceasing to be a director of the Company)

The interests of the directors, who served during the year ended 31 December 2015, 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				
		Share awards with performance	Share awards without performance	Share options with performance	Share options with performance, vested but unexercised	Total scheme interests
Sir Roger Carr	92,224	–	–	–	–	–
J DeMuro	25,077	631,757	261,056	1,018,122	–	1,910,935
H Green	–	–	–	–	–	–
C M Grigg	24,555	–	–	–	–	–
I G King	1,795,985	206,412	–	3,351,589	256,279	3,814,280
P J Lynas	364,577	82,468	–	1,828,953	–	1,911,421
P Rosput Reynolds	21,200	–	–	–	–	–
N C Rose	55,000	–	–	–	–	–
C G Symon[1]	20,000	–	–	–	–	–
I P Tyler	–	–	–	–	–	–

1. Retired from the Board on 12 June 2015.

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 2015 are given on pages 84 and 85, together with details of share options exercised in 2015.

Awards under the PSP and Performance Shares granted under the LTIP 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 2015, Ian King has acquired an additional 79 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 1,796,064.

Elizabeth Corley, who was appointed to the Board on 1 February 2016, had a nil shareholding in BAE Systems plc at the date of her appointment and at the date of this report.

There have been no changes in the interests of the remaining directors in the shares of BAE Systems plc between 31 December 2015 and the date of this report.

Annual remuneration report
continued

Breakdown of scheme interests: Options and awards held as at 31 December 2015

Ian King

	31 December 2015	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP$^{\text{TSR}}$	**35,594**[1]	29.03.12	nil	29.03.16
PSP$^{\text{TSR}}$	**154,771**[2]	25.03.13	nil	25.03.16
PSP$^{\text{EPS}}$	**154,771**[2]	25.03.13	nil	25.03.16
PSP$^{\text{TSR}}$	**292,542**[3]	26.03.14	nil	26.03.17
PSP$^{\text{EPS}}$	**292,543**[3]	26.03.14	nil	26.03.17
LTIP PS$^{\text{TSR}}$	**221,900**[3]	25.03.15	nil	25.03.18
LTIP PS$^{\text{EPS}}$	**221,901**[3]	25.03.15	nil	25.03.18
	1,374,022			
ExSOP^{2012}	**256,279**[4]	29.03.12	3.01	29.03.15
ExSOP^{2012}	**742,903**[2]	25.03.13	3.89	25.03.16
ExSOP^{2012}	**702,102**[3]	26.03.14	4.12	26.03.17
LTIP SO	**532,562**[3]	25.03.15	5.43	25.03.18
	2,233,846			
SMP	**206,412**[2]	25.03.13	n/a	25.03.16

Peter Lynas

	31 December 2015	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP$^{\text{TSR}}$	**20,180**[1]	29.03.12	nil	29.03.16
PSP$^{\text{TSR}}$	**87,747**[2]	25.03.13	nil	25.03.16
PSP$^{\text{EPS}}$	**87,747**[2]	25.03.13	nil	25.03.16
PSP$^{\text{TSR}}$	**142,636**[3]	26.03.14	nil	26.03.17
PSP$^{\text{EPS}}$	**142,637**[3]	26.03.14	nil	26.03.17
LTIP PS$^{\text{TSR}}$	**110,373**[3]	25.03.15	nil	25.03.18
LTIP PS$^{\text{EPS}}$	**110,373**[3]	25.03.15	nil	25.03.18
	701,693			
ExSOP^{2012}	**421,187**[2]	25.03.13	3.89	25.03.16
ExSOP^{2012}	**398,055**[3]	26.03.14	4.12	26.03.17
LTIP SO	**308,018**[3]	25.03.15	5.43	25.03.18
	1,127,260			
SMP	**82,468**[2]	25.03.13	n/a	25.03.16

Jerry DeMuro

	31 December 2015	Date of grant	Exercise price £	Date from which exercisable or part exercisable
PSP$^{\text{TSR}}$	**169,258**[3]	26.03.14	n/a	26.03.17
PSP$^{\text{EPS}}$	**169,258**[3]	26.03.14	n/a	26.03.17
LTIP PS$^{\text{TSR}}$	**146,620**[3]	25.03.15	n/a	25.03.18
LTIP PS$^{\text{EPS}}$	**146,621**[3]	25.03.15	n/a	25.03.18
	631,757			
ExSOP^{2012}	**545,543**[3]	26.03.14	4.12	26.03.17
LTIP SO	**472,579**[3]	25.03.15	5.43	25.03.18
	1,018,122			
RSP	**139,882**	26.03.14	n/a	26.03.17
LTIP RS	**121,174**	25.03.15	n/a	25.03.18
	261,056			

1. Exercisable in two tranches on the fourth and fifth anniversary of grant.
2. The outstanding option or award will lapse after the end of the financial year having not met the performance condition.
3. Subject to a performance condition that is yet to be tested.
4. Vested but unexercised.

Options exercised during 2015

Ian King

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP[TSR]	17,797	nil	29.03.12	15.04.15	5.30
ExSOP	145,443	4.28	12.04.06	15.04.15	5.30
ExSOP	173,960	4.57	30.03.07	15.04.15	5.30

The PSP option exercised by Ian King attracted reinvested dividends which equated to an additional 2,825 shares.

Peter Lynas

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSP[EPS]	9,025	nil	24.03.09	15.04.15	5.30
PSP[TSR]	10,090	nil	29.03.12	15.04.15	5.30
ExSOP	13,386	3.56	22.12.05	15.04.15	5.30
ExSOP	75,887	4.28	12.04.06	15.04.15	5.30
ExSOP	73,522	4.57	30.03.07	15.04.15	5.30
ExSOP[2012]	145,297	3.01	29.03.12	15.04.15	5.30

The PSP options exercised by Peter Lynas attracted reinvested dividends which equated to an additional 3,004 shares.

The tables on pages 84 and 85 have been subject to audit.

Performance conditions

Performance conditions for the LTIP, PSP, ExSOP[2012] and SMP are detailed on pages 81 and 82. The ExSOP (Executive Share Option Plan) was established in 2001 and its ten-year life expired in 2011. Options granted under this plan were usually exercisable between the third and tenth anniversary of grant. The options granted between 2005 and 2007 met their performance condition (EPS growth of 5% or more per annum over the three-year performance period).

Statement of voting on the 2014 Annual remuneration report

Shareholder voting on the resolution to approve the Annual remuneration report put to the 2015 AGM was as follows:

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,178,267,228	93.16	160,048,861	6.84	2,338,316,089	7,605,002

Annual remuneration report
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Remuneration Committee composition and advisers

The Committee members comprise Paula Rosput Reynolds (Chairman from 24 June 2015), Elizabeth Corley (appointed to the Committee on 1 February 2016) and Nick Rose. Carl Symon served as Chairman until he stepped down as a director on 12 June 2015 and Chris Grigg served as a member of the Committee throughout 2015, stepping down from the Committee on 16 February 2016. Advisers to the Remuneration Committee are shown below.

Adviser	Services provided	Appointment	Governance	Fees
Kepler (part of Mercer)	Advises Committee members on remuneration matters, including independent advice on the information and proposals presented to the Committee by Company executives.	Committee appointment.	Kepler engages directly with the members of the Committee. Kepler does not undertake any other work for the Company. Kepler is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£32,685 Fee basis: Hourly
Linklaters	Provided legal services, principally regarding share plan rule amendments in respect of corporate governance requirements.	By the Company with the approval of the Committee.	Only provides legal compliance, legal drafting and review services, and does not advise the Committee. The Committee is aware that Linklaters is one of a number of legal firms that provides legal advice and services to the Company on a range of matters. Linklaters is regulated by the Law Society.	£33,037 (in respect of services provided to the Committee) Fee basis: Hourly
PricewaterhouseCoopers	Provides information on market practice in relation to different aspects of remuneration, market trends and benchmarking of the remuneration packages for the executive population.	By the Company at the request of the Committee.	The Committee is aware that PricewaterhouseCoopers provides a variety of other services to the Company, including tax and pensions advice. PricewaterhouseCoopers also provides 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 is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£73,000 (in respect of services provided to the Committee) Fee basis: Hourly
New Bridge Street (part of Aon Hewitt)	Advises on the TSR outcomes as required for assessing the performance condition under the Performance Share Plan.	By the Company.	The Committee is aware that New Bridge Street provides 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. New Bridge Street is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£9,500 (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 comprises Sir Roger Carr, Philip Bramwell, Jerry DeMuro and Ian King.

Preface to the Directors' remuneration policy

The Directors' remuneration policy (the Policy) set out on pages 88 to 96 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, where appropriate, refer to the 2015 Annual Report in order to aid readability.

Directors' remuneration for 2016

For 2016, 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 2016.

Following approval of the single Long-Term Incentive Plan (LTIP) at the 2014 AGM, the first awards were made under this plan in Spring 2015. As set out in our Remuneration Committee Chairman's letter on page 71, the Committee intends to make the following changes to our executive remuneration arrangements for 2016 which do not constitute a change to the Policy approved by shareholders in 2014:

Total Shareholder Return (TSR) condition applicable to Long-Term Incentive (LTI) grants

The Committee has decided that applying a 'split' TSR measure would provide a more balanced assessment to better reflect the interests of investment decisions of our shareholders and match the particular dynamics of BAE Systems' defence business. Therefore, for 2016, the Committee is proposing to base 50% of the measure on the current peer comparator group and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. No changes are proposed to the current TSR vesting scale, with no vesting below median, 25% vesting for median performance, 100% vesting if the Company's TSR is in the top quintile and vesting on a straight-line basis for intermediate performance. Each element would be considered independently of the other, with the overall vesting outcome reflecting the average result of the two assessments.

Earnings per Share (EPS) performance condition applicable to LTI grants

A performance range of 3% to 7% average annual EPS growth was applied for the 2015 awards of Performance Shares under the LTIP. It is intended to apply the same performance range for the 2016 awards. 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 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).

As set out in the 2014 Annual Report, the following additional changes were made in 2015 which did not constitute a change to the Policy approved by shareholders in 2014:

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 2016

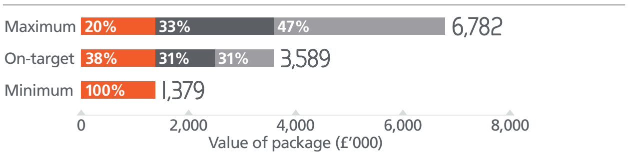
- The performance metrics and weightings applicable to the 2016 annual incentive are unchanged from those set out last year (see page 89).
- Performance Shares will continue to have 50% of the award based on TSR performance as set out above. For 2016, the remaining 50% of the award is subject to the EPS performance condition set out above. For US participants, other than members of the Executive Committee, 50% of the awards made in 2016 are subject to the long-term operating cash performance of the US business in place of TSR growth.
- There is no change in 2016 to the criteria and weightings applying to Restricted Shares.
- Share Options will continue to be based on TSR performance as set out above.

Illustration of application of policy for 2016

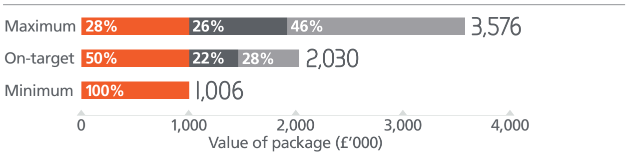
The following charts show the value of the package each of the executive directors would receive based on 2016 base salaries, remuneration and 2016 LTI awards assuming the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 74); 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 (see page 92). The charts below are reporting the actual levels for 2016.

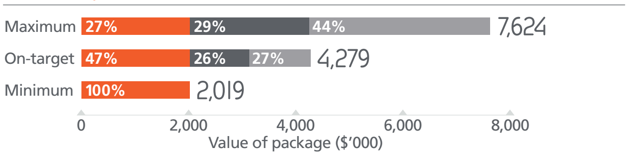
Chief Executive (£'000)



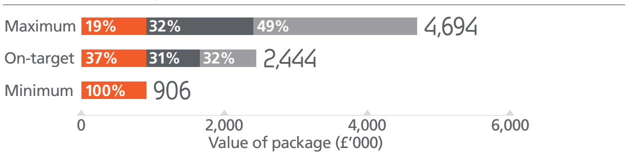
Group Finance Director (£'000)



President and Chief Executive Officer of BAE Systems, Inc. ($'000)



Chief Operating Officer (£'000)



Fixed elements of remuneration
Annual bonus
Performance Shares and Share Options

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[1].

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

Base salary

Purpose and link to strategy
Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.

Operation
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.

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.

Maximum opportunity
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.

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.

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.

Performance metrics used, weighting and time period applicable
None.

Annual incentive

Purpose and link to strategy
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.

Compulsory deferral into shares increases alignment with shareholder interests.

Operation
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.

One-third of the total annual incentive amount is subject to compulsory deferral for three years in BAE Systems shares without any matching.

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.

Cash dividends are payable to the participants on the shares during this three-year deferral period.

Maximum opportunity
Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary

Group Finance Director: 160% of salary

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.

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 92 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 92 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[1].

Maximum opportunity
Subject to shareholder approval of the proposed umbrella plan at the 2014 AGM[1], 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 92.

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 81.
- 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 92.

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 92.

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 92.

Executive directors' policy table continued

Benefits

Purpose and link to strategy
Provide employment benefits which ensure that the overall package is market competitive when these elements are taken into account.

Operation
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.

Opportunity for UK executive directors to participate in the Share Incentive Plan, a tax approved all-employee plan.

Additional benefits such as relocation assistance may also be provided in certain circumstances if considered reasonable and appropriate by the Committee.

Maximum opportunity
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.

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.

Benefits are as reported and itemised within the single total figure shown as part of the Annual remuneration report on page 74. 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.

Participation limits for the Share Incentive Plan are those set by the UK tax authorities from time-to-time.

Performance metrics used, weighting and time period applicable
None.

Pension

Purpose and link to strategy
Provide competitive post-retirement benefits or cash allowance equivalent.

Operation
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.

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 79 as part of the Annual remuneration report.

Any new externally appointed US executive directors would be offered membership of the US defined contribution plan.

Maximum opportunity
Company contribution of 19% (in addition to employee contribution of 6%) of base salary only.

Under the existing defined benefit scheme, a maximum of two-thirds of FPE accrued at 1/30th for each year of service.

The US defined contribution plan provides 100% company matching contributions up to a maximum of 6% of base salary, subject to US statutory limits.

Operation
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.

Maximum opportunity
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

1. 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.
2. 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.
3. 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

4. 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.
5. 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)

6. 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:

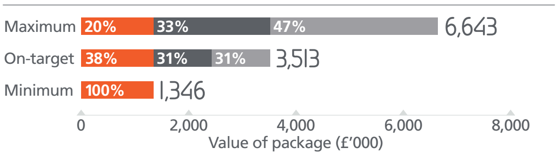
	Initial Value	Subsequent Value
Chief Executive	150%	300%
Group Finance Director	100%	200%
President and Chief Executive Officer of BAE Systems, Inc.	175%	350%

Illustration of application of remuneration policy

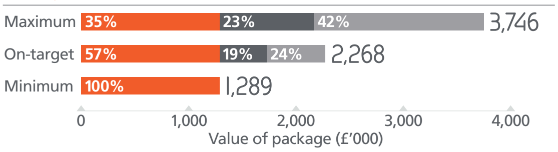
The charts opposite show the value of the package each of the executive directors would receive based on 2014 base salaries, remuneration and 2014 LTI awards assuming the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 74); 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.

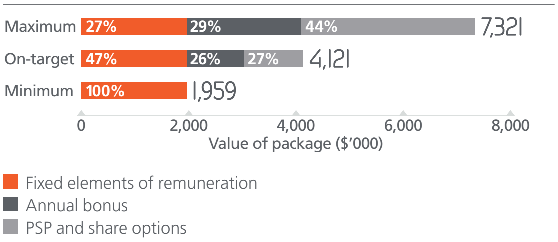
Chief Executive (£'000)



Group Finance Director (£'000)



President and Chief Executive Officer of BAE Systems, Inc. ($'000)



Non-executive directors' (NEDs) policy table

Fees

Purpose and link to strategy
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.

Operation
NEDs' fees are set by the Non-Executive Directors' Fees Committee.

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.

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.

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.

The Chairman's fees are set by the Remuneration Committee on a three-year basis and not normally subject to review during that period.

Maximum opportunity
Actual fee levels are disclosed in the Annual remuneration report for the relevant financial year.

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).

The aggregate cost of fees and benefits paid to NEDs (including the Chairman) will not exceed an annual limit of £2.5m.

Performance metrics used, weighting and time period applicable
None.

Benefits

Purpose and link to strategy
Reimbursement for reasonable and documented expenses incurred in the performance of duties.

Operation
NEDs are not eligible to participate in any pension benefits provided by the Company, nor do they participate in any performance-related incentives.

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.

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.

Maximum opportunity
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 page 102 of the 2013 Annual Report under the PSP, SMP, RSP, ExSOP and ExSOP[2012], Linda Hudson's leaving arrangements as detailed on page 98 of the 2013 Annual Report and Peter Lynas' second residence allowance as detailed on page 93 of the 2013 Annual Report.

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 93.

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 91.

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[1]

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.

Note: See page 75 for details of the service contract for Charles Woodburn, the incoming Chief Operating Officer, whose appointment was announced on 15 February 2016.

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.

Note: As stated on page 5, the Chairman's term of appointment has been extended until February 2020.

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
Elizabeth Corley[1]	01.02.2016	31.01.2019
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	07.02.2019
Carl Symon[2]	11.06.2008	–
Ian Tyler	08.05.2013	07.05.2016

1. Appointed to the Board on 1 February 2016.
2. Retired from the Board on 12 June 2015.

Note: The above table has been amended to reflect the position as of 17 February 2016.

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.

Statutory and other information

Company registration
BAE Systems plc is a public company limited by shares registered in England and Wales with the registered number 1470151.

Directors
The current directors who served during the 2015 financial year are listed on pages 60 and 61. Carl Symon also served as a director until his retirement from the Board on 12 June 2015. Elizabeth Corley was appointed to the Board on 1 February 2016.

The Company has announced that Charles Woodburn will be joining the Board in the newly-created role of Chief Operating Officer with effect from a date in the second quarter of 2016.

Dividend
An interim dividend of 8.4p per share was paid on 30 November 2015. The directors propose a final dividend of 12.5p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2016 to shareholders on the share register on 22 April 2016. Information on dividend waivers is given on page 150.

Annual General Meeting (AGM)
The Company's AGM will be held on 4 May 2016. 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 (i) to (iv) and 1 to 57:

– disclosures in relation to the use of financial instruments;

– particulars of important events affecting the Group which have occurred since 31 December 2015;

– 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 trading update announcement on 12 November 2015, the Group made the following statement, which is regarded as a profit forecast for the purposes of the Financial Conduct Authority's Listing Rule 9.2.18 (and which replaced the profit forecast made in the Group's full-year results announcement on 19 February 2015, the Annual Report 2014 and its half-year results announcement on 30 July 2015):

"Including a benefit of some 2 pence from adjustment of certain overseas tax provisions in the light of rulings received, the Group's underlying earnings per share for 2015 are expected to be around 38 pence."

Underlying earnings per share was 38.0p in 2014. In 2015, underlying earnings per share was 40.2p.

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 2015.

Issued share capital
As at 31 December 2015, BAE Systems' issued share capital of £86,686,002 comprised 3,467,440,044 ordinary shares of 2.5p each and one Special Share of £1.

Share buyback
During the year, 1,450,000 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 £6,708,336.

The percentage of called up share capital (excluding treasury shares) as at 31 December 2015, which the shares repurchased in 2015 represents, is 0.05%.

Treasury shares
As at 1 January 2015, 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 1 January 2015). During 2015, the Company used 14,018,511 treasury shares (having a total nominal value of £350,463 and representing 0.4% of the Company's called up share capital at 31 December 2015) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (6,162,973 shares in aggregate), awards under the Matching element of the International Share Incentive Plan (16,352 shares in aggregate), awards vested under the Restricted Share Plan (2,154,228 shares), and options exercised under the Executive Share Option Plan (5,684,958 shares). The treasury shares utilised in respect of the Share Incentive Plan, the International Share Incentive Plan and the Restricted Share Plan were disposed of by the Company for nil consideration. The 5,684,958 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 £11,634,317. As at 31 December 2015, the number of shares held in treasury totalled 301,808,103 (having a total nominal value of £7,545,203 and representing 8.7% of the Company's called up share capital at 31 December 2015).

The rights to treasury shares are restricted in accordance with the Companies Act and, in particular, the voting and dividend rights attaching to these shares are automatically suspended.

Statutory and other information 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 Conduct 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, Performance Share Plan, Share Matching Plan, Restricted Share Plan, Share Incentive Plan, International Share Incentive Plan, Group All-Employee Free Shares Plan and International Profit Sharing Scheme 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 31 December 2015 (and unchanged as at 17 February 2016), 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.	6.05%
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 directors also have the power to make appointments to the Board at any time. Any individual so appointed will hold office until the next AGM and shall then be eligible for re-election.

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 not less than 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 2016 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 2015 AGM, the directors were given the power to buy back a maximum number of 315,464,024 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 2016 AGM or 30 June 2016. A special resolution will be proposed at the 2016 AGM to renew the Company's authority to acquire its own shares.

At the 2015 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,286,039. This power will expire on the earlier of the conclusion of the 2016 AGM or 30 June 2016. Accordingly, a resolution will be proposed at the 2016 AGM to renew the Company's authority to issue further new shares. At the 2015 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £26,286,039 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2016 AGM or 30 June 2016, and a resolution will be proposed at the 2016 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 2015 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.

Statutory and other information 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 2015.
- 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 23 October 2015 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. In November 2015, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 5 of the Astute Class programme. 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 agreements 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), including Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework.

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
17 February 2016

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 position and 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
Elizabeth Corley	Non-executive director
Harriet Green	Non-executive director
Chris Grigg	Non-executive director
Paula Rosput Reynolds	Non-executive director
Nick Rose	Non-executive director
Ian Tyler	Non-executive director

On behalf of the Board

Sir Roger Carr
Chairman
17 February 2016

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 2015 set out on pages 106 to 175.

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 2015 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, including FRS 101, Reduced Disclosure Framework; 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 66 (Audit Committee report) and pages 112 to 115 (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. The estimates and assumptions are subject to a high degree of uncertainty, in particular those being made to:

- assess the proportion of revenues to recognise in line with contract completion;
- forecast the outturn profit margin on each contract incorporating appropriate allowances for technical and commercial risks related to performance milestones yet to be achieved; and
- appropriately identify, value and provide for loss-making contracts.

The directors have detailed procedures and processes, called Lifecycle Management (LCM), in place to manage the commercial, technical and financial aspects of long-term contracts. The LCM process includes the regular preparation of a Contract Status Report (CSR), which includes key accounting and forecast information for the relevant contract.

The risk of material misstatement is that the accounting for the Group's significant contracts does not accurately reflect the progress made and status of the relevant contract at the reporting date.

The contracts requiring the highest degree of judgement that occupied a significant proportion of the audit effort included:

- Astute Class submarines;
- European Typhoon;
- Queen Elizabeth Class aircraft carriers;
- Saudi British Defence Co-operation Programme;
- Saudi Typhoon; and
- US commercial shipbuilding contracts.

Procedures to address these audit risks included those listed below

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 the 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 contracts in the scope of the LCM framework.

For significant contracts (including those listed in our audit risk description), 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 through attendance at project teams' contract review meetings;
- challenged the Group's 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;
- verified the consistency of information presented in the year-end CSRs to underlying ledgers, as well as 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 milestones achieved and allowances made for risks.

Carrying value of US goodwill (£7.4bn)

Refer to page 66 (Audit Committee report) and pages 123 to 125 (accounting policy and financial disclosures)

Audit risk

The uncertainty over future US defence spending as a whole has reduced since 2014, although the allocation of the budget between BAE Systems and competitors remains uncertain. This places continued importance on the US business to secure export contracts. Both of these factors contribute to the risk that the goodwill allocated to the Group's US Cash-Generating Units (CGU) will not be recoverable.

The Group's annual goodwill impairment testing is based on the five-year Integrated Business Plan forecasts. 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. Furthermore, changes in the Group's operating and management structure that have taken place over the past two years have affected the assessment of CGUs and the related allocation of goodwill.

The Group's 2015 testing identified an impairment charge of £75m, recognised against the US CGUs (2014 £87m impairment charge).

Given the uncertainty associated with the valuation of the recoverable amounts, transparent disclosures and clarity of sensitivities to key assumptions are critical to help inform readers how the directors have made their assessment.

Procedures to address these audit risks included those listed below

In respect of the assessment of CGUs: We challenged the directors' assessment of CGUs with reference to accounting standards and considered the operating and management structure changes with reference to our understanding of the business. We also critically assessed whether the allocation of goodwill to those CGUs was done on a consistent and reasonable basis.

In respect of the cash flows: We considered the Group's procedures used to develop the forecasts and the principles and integrity of the Group's discounted cash flow model. To challenge 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, such as 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 appropriate. We conducted our own assessments to challenge 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 CGU recoverable amounts: In one instance, we compared the valuation of a CGU to externally available information.

As an additional sense check to challenge the recoverable value of goodwill as a whole, we compared the sum of discounted cash flows to the Group's market capitalisation.

In respect of the sensitivity of the goodwill valuation to the key assumptions: We have used our own analytical tool to run scenario-specific models including changes to the discount rate and forecast cash flows as well as break-even analyses to stress-test the valuations of the CGUs' recoverable amounts.

In respect of the disclosures: We assessed whether the Group's disclosures about the sensitivities to changes in key assumptions reflected the risks inherent in the valuation of goodwill as well as our knowledge of the business.

Retirement benefit obligations (£4.7bn)

Refer to page 66 (Audit Committee report) and pages 139 to 148 (accounting policy and financial disclosures)

Audit risk

The Group's share of the pension schemes' net deficit was £4.7bn after allocating £1.1bn to equity accounted investments and other participating employers.

Previously, all allocations to participating employers were based on the relative payroll contributions of active members.

In 2015, BAE Systems and Airbus, the largest of the other participating employers, worked towards a sectionalisation of the BAE Systems Pension Scheme. On this basis, they have changed the method in respect of the allocation of the scheme assets and liabilities to Airbus.

There is a risk that the method does not accurately reflect the obligations of the two employers or that the resulting estimate may have been calculated incorrectly.

All other multi-employer allocations continue to be based on the previous method.

Given the size of the schemes, small changes in assumptions and estimates used to value the Group's retirement benefit obligations have a significant impact on the Group's share of the retirement benefit obligations.

Procedures to address these audit risks included those listed below

In respect of the change in allocation method: We considered whether the updated method provides a more appropriate allocation of the deficit by challenging the key assumptions in the context of what we know about the business and member profile.

We assessed whether the allocation had been performed in line with this method, including:

- checking the allocation of a sample of members through to underlying data;
- using our actuarial specialists to roll forward the asset valuations from 31 March 2014, the point at which the split of the assets has been based, to the period end; and
- agreeing to correspondence between the two parties.

In respect of the multi-employer allocations: For all other allocations, we considered whether the methodology used, to allocate a proportion of the Group's retirement benefit obligations 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.

In respect of the disclosures: We considered the adequacy of the Group's disclosures in respect of the key assumptions, including the sensitivity of the deficit to changes and in respect of the change in methodology of the allocation between participating employers.

Tax accruals (£353m)

Refer to page 66 (Audit Committee report) and pages 107 and 119 to 121 (accounting policy and financial disclosures)

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 local and 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 affecting the effective tax rate and whether or not any 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, the Company's external tax advisers and third parties. 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 the directors. 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 £55m (2014 £80m), determined with reference to a benchmark of Group profit before tax from continuing operations (normalised to remove the effects of goodwill impairments), of which it represents 4.7%, reflecting industry consensus levels (2014 7.6%).

We reported to the Audit Committee any corrected or uncorrected identified misstatements exceeding £2.75m for income statement items, in addition to other identified misstatements that warranted reporting on qualitative grounds.

Of the Group's 41 reporting components, we subjected 11 to audits for group reporting purposes and 11 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.

Independent Auditor's report continued

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[1]	11	68	75	82
Specified risk-focused audit procedures[2]	11	24	14	11
Total	**22**	**92**	**89**	**93**

1. In the UK, US, Saudi Arabia and Australia.
2. In the UK, US and Saudi Arabia.

For the remaining components, we performed analysis at an aggregated level to re-examine our preliminary assessment that there were unlikely to be any significant risks of material misstatement within them.

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 materiality levels, which ranged from £3m to £33m, having regard to the mix of size and risk profile of the Group across the components. The work on 20 of the 22 components was performed by component auditors and the rest by the Group audit team.

The Group audit team held a global audit conference in 2014, where all significant components came together in London to consider the audit risk and strategy. Similar planning days took place in 2015 with the most significant component teams from the UK, US and Saudi Arabia. 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 audit procedures. Video and telephone conference meetings were also held with these component auditors and any 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.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the Strategic report and the Directors' report:

– we have not identified material misstatements in those reports; and

– in our opinion, those reports have been prepared in accordance with the Companies Act 2006.

5. We have nothing to report on the disclosures of principal risks

Based on the knowledge we acquired during our audit, we have nothing material to add or draw attention to in relation to:

– the directors' risk management, internal control and viability assessment on pages 63 to 64 concerning the principal risks, their management and, based on that, the directors' assessment and expectations of the Group continuing in operation over the five years to 2020; or

– the disclosures in the Preparation section of the financial statements concerning the use of the going concern basis of accounting.

6. 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 position and 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 64, in relation to going concern and longer-term viability; and

– the part of the Directors' report section relating to the Company's compliance with the 11 provisions of the 2014 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 101, 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. 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, 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
17 February 2016

Financial statements

Group accounts

Company accounts

Group accounting policies
Accounting policies are included within the relevant note to the Group accounts.

Group accounts

Preparation

Basis of 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 64, 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.

Significant accounting policies

The significant 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. 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.

Certain of the Group's significant 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
Revenue and profit recognition		1
– The recognition of revenue and profit on long-term contracts.	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. 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. Revenue and cost estimates are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances. Profit is recognised progressively as risks have been mitigated or retired.	
Carrying value of intangible assets		8
– The valuation of acquired intangible assets; and	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.	
– the determination of assumptions underpinning goodwill impairment testing.	Goodwill is not amortised, but is tested annually for impairment and carried at cost less accumulated impairment losses. For the purposes of impairment testing, goodwill is allocated to Cash-Generating Units on a consistent basis. 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.	
Valuation of retirement benefit obligations		20
– The determination of assumptions underpinning the valuation of retirement benefit obligations for defined benefit pension schemes; and	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.	
– the determination of the share of the pension deficit allocated to the Group's equity accounted investments and other participating employers.	With the exception of the allocation of the BAE Systems Pension Scheme (Main Scheme) deficit to Airbus, the deficit allocation method for other employers of the Main Scheme and for all other schemes is based on the relative payroll contributions of active members, which is consistent with prior years and is intended to reflect a reasonable approximation of the share of the deficit. In December 2015, BAE Systems, Airbus and the scheme trustees agreed to work towards the creation of a separate Airbus section of the Main Scheme in 2016 with the allocation of the deficit to the BAE Systems and Airbus sections based on each member's last employer. This allocation methodology is considered to represent a better estimate of the deficit allocation and has been reflected in the allocation of the IAS 19 pension deficit in the Main Scheme at 31 December 2015.	

Preparation continued

Tax provisions
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. Included within the Consolidated balance sheet as at 31 December 2015 are current tax liabilities of £315m, which comprise a provision of £353m and other tax creditors of £35m, offset by a debtor of £73m in respect of research and development expenditure credits. The provision of £353m is in respect of known tax issues, of which £287m relates to non-UK jurisdictions. 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. The directors believe that adequate provision is made for each known tax risk.

Changes in accounting policies
IFRS 9, Financial Instruments, issued in July 2014 with an effective date of 1 January 2018, is not yet EU endorsed. It is not expected to have a material impact on the Group.

IFRS 15, Revenue from Contracts with Customers, issued in May 2014 with an effective date of 1 January 2018, is not yet EU endorsed. Management is in the process of reviewing the impact that this will have on the Group.

IFRS 16, Leases, issued in January 2016 with an effective date of 1 January 2019, is not yet EU endorsed.

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.

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	2015 £m	2015 Total £m	2014 £m	2014 Total £m
Continuing operations					
Combined sales of Group and share of equity accounted investments	1		**17,904**		16,637
Less: share of sales of equity accounted investments	1		**(1,117)**		(1,207)
Revenue	1		**16,787**		15,430
Operating costs	2		**(15,622)**		(14,387)
Other income	4		**227**		174
Group operating profit			**1,392**		1,217
Share of results of equity accounted investments	1		**110**		83
Underlying EBITA[1]	1	**1,683**		1,702	
Non-recurring items	1	**26**		–	
EBITA		**1,709**		1,702	
Amortisation of intangible assets	1	**(108)**		(184)	
Impairment of intangible assets	1	**(78)**		(170)	
Financial income/(expense) of equity accounted investments	5	**3**		(30)	
Taxation expense of equity accounted investments		**(24)**		(18)	
Operating profit	1		**1,502**		1,300
Financial income		**241**		241	
Financial expense		**(653)**		(659)	
Finance costs	5		**(412)**		(418)
Profit before taxation			**1,090**		882
Taxation expense	6		**(147)**		(130)
Profit for the year			**943**		752
Attributable to:					
Equity shareholders			**918**		740
Non-controlling interests			**25**		12
			943		752
Earnings per share	7				
Basic earnings per share			**29.0p**		23.4p
Diluted earnings per share			**28.9p**		23.3p

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	2015 Other reserves[1] £m	2015 Retained earnings £m	2015 Total £m	2014 Other reserves[1] £m	2014 Retained earnings £m	2014 Total £m
Profit for the year		**–**	**943**	**943**	–	752	752
Other comprehensive income							
Items that will not be reclassified to the income statement:							
Remeasurements on retirement benefit schemes:							
Subsidiaries		**–**	**864**	**864**	–	(2,023)	(2,023)
Equity accounted investments		**–**	**21**	**21**	–	(73)	(73)
Tax on items that will not be reclassified to the income statement	6	**–**	**(261)**	**(261)**	–	503	503
Items that may be reclassified to the income statement:							
Currency translation on foreign currency net investments:							
Subsidiaries		**260**	**–**	**260**	277[2]	–	277[2]
Equity accounted investments		**(45)**	**–**	**(45)**	(13)[2]	–	(13)[2]
Reclassification of cumulative currency translation reserve on disposal	25	**20**	**–**	**20**	–	–	–
Fair value (loss)/gain on available-for-sale financial assets		**–**	**(1)**	**(1)**	–	4	4
Amounts credited/(charged) to hedging reserve:	13						
Subsidiaries		**11**	**–**	**11**	(92)	–	(92)
Equity accounted investments		**(36)**	**–**	**(36)**	–	–	–
Tax on items that may be reclassified to the income statement	6	**5**	**–**	**5**	19	–	19
Total other comprehensive income for the year (net of tax)		**215**	**623**	**838**	191	(1,589)	(1,398)
Total comprehensive income for the year		**215**	**1,566**	**1,781**	191	(837)	(646)
Attributable to:							
Equity shareholders		**216**	**1,541**	**1,757**	191	(849)	(658)
Non-controlling interests		**(1)**	**25**	**24**	–	12	12
		215	**1,566**	**1,781**	191	(837)	(646)

1. An analysis of other reserves is provided in note 22.
2. Restated.

Consolidated statement of changes in equity
for the year ended 31 December

	Issued share capital £m	Share premium £m	Other reserves[1] £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
	Attributable to equity holders of the parent						
At 1 January 2015	87	1,249	5,061	(4,555)	1,842	35	1,877
Profit for the year	–	–	–	918	918	25	943
Total other comprehensive income for the year	–	–	216	623	839	(1)	838
Share-based payments	–	–	–	44	44	–	44
Net sale of own shares	–	–	–	1	1	–	1
Ordinary share dividends	–	–	–	(655)	(655)	(40)	(695)
Disposal of non-controlling interest	–	–	–	–	–	(6)	(6)
At 31 December 2015	**87**	**1,249**	**5,277**	**(3,624)**	**2,989**	**13**	**3,002**
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)
At 31 December 2014	87	1,249	5,061	(4,555)	1,842	35	1,877

1. An analysis of other reserves is provided in note 22.

Consolidated balance sheet
as at 31 December

	Notes	2015 £m	2014 £m
Non-current assets			
Intangible assets	8	**10,117**	9,983
Property, plant and equipment	9	**1,698**	1,589
Investment property	10	**120**	129
Equity accounted investments	11	**250**	229
Other investments		**6**	7
Other receivables	12	**275**	347
Retirement benefit surpluses	20	**193**	162
Other financial assets	13	**107**	38
Deferred tax assets	14	**985**	1,327
		13,751	13,811
Current assets			
Inventories	15	**726**	690
Trade and other receivables including amounts due from customers for contract work	12	**2,940**	2,850
Current tax		**4**	7
Other financial assets	13	**105**	46
Cash and cash equivalents	16	**2,537**	2,308
Assets held for sale		**20**	76
		6,332	5,977
Total assets	17	**20,083**	19,788
Non-current liabilities			
Loans	18	**(3,775)**	(2,868)
Other payables	19	**(1,020)**	(932)
Retirement benefit obligations	20	**(4,694)**	(5,530)
Other financial liabilities	13	**(72)**	(79)
Deferred tax liabilities	14	**(13)**	(21)
Provisions	21	**(354)**	(436)
		(9,928)	(9,866)
Current liabilities			
Loans and overdrafts	18	**(237)**	(482)
Trade and other payables	19	**(6,162)**	(6,670)
Other financial liabilities	13	**(130)**	(107)
Current tax		**(315)**	(448)
Provisions	21	**(301)**	(315)
Liabilities held for sale		**(8)**	(23)
		(7,153)	(8,045)
Total liabilities		**(17,081)**	(17,911)
Net assets		**3,002**	1,877
Capital and reserves			
Issued share capital	22	**87**	87
Share premium		**1,249**	1,249
Other reserves	22	**5,277**	5,061
Retained earnings – deficit		**(3,624)**	(4,555)
Total equity attributable to equity holders of the parent		**2,989**	1,842
Non-controlling interests		**13**	35
Total equity		**3,002**	1,877

Approved by the Board on 17 February 2016 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	2015 £m	2014 £m
Profit for the year		**943**	752
Taxation expense	6	**147**	130
Research and development expenditure credits		**(65)**	–
Share of results of equity accounted investments	1	**(110)**	(83)
Finance costs	5	**412**	418
Depreciation, amortisation and impairment	2	**460**	657
Profit on disposal of property, plant and equipment	2,4	**(28)**	(20)
Profit on disposal of investment property	2,4	**(41)**	(12)
Profit on disposal of non-current other investments		**(1)**	–
Loss on disposal of businesses	2	**24**	–
Fair value gain	4	**–**	(47)
Cost of equity-settled employee share schemes		**44**	42
Movements in provisions		**(139)**	(153)
Decrease in liabilities for retirement benefit obligations		**(234)**	(345)
(Increase)/decrease in working capital:			
Inventories		**(6)**	(1)
Trade and other receivables		**60**	197
Trade and other payables		**(542)**	(622)
Cash inflow from operating activities		**924**	913
Interest paid		**(180)**	(152)
Taxation paid		**(116)**	(92)
Net cash inflow from operating activities		**628**	669
Dividends received from equity accounted investments	11	**41**	63
Interest received		**7**	7
Purchase of property, plant and equipment, and investment property		**(359)**	(263)
Purchase of intangible assets		**(54)**	(59)
Proceeds from sale of property, plant and equipment, and investment property		**136**	539
Proceeds from sale of non-current other investments		**1**	–
Purchase of subsidiary undertakings	23	**(5)**	(233)
Cash and cash equivalents acquired from purchase of subsidiary undertakings	23	**–**	3
Equity accounted investment funding	11	**(8)**	(2)
Proceeds from sale of subsidiary undertakings	23	**34**	–
Cash and cash equivalents disposed of with subsidiary undertakings	23	**(13)**	–
Net cash (outflow)/inflow from investing activities		**(220)**	55
Net sale/(purchase) of own shares		**1**	(281)
Equity dividends paid	22	**(655)**	(642)
Dividends paid to non-controlling interests		**(40)**	(14)
Cash inflow from matured derivative financial instruments		**12**	8
Cash inflow from movement in cash collateral		**3**	10
Cash inflow from loans		**1,625**	679
Cash outflow from repayment of loans		**(1,135)**	(398)
Net cash outflow from financing activities		**(189)**	(638)
Net increase in cash and cash equivalents		**219**	86
Cash and cash equivalents at 1 January		**2,313**	2,222
Effect of foreign exchange rate changes on cash and cash equivalents		**5**	5
Cash and cash equivalents at 31 December		**2,537**	2,313
Comprising:			
Cash and cash equivalents	16	**2,537**	2,308
Cash and cash equivalents (included within assets held for sale)		**–**	6
Overdrafts	18	**–**	(1)
Cash and cash equivalents at 31 December		**2,537**	2,313

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 (defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature). 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 115 on a segmental basis and reconciled to the reporting segment result and operating profit in the consolidated financial statements.

Non-recurring items
In 2015, the Group completed the sale of its 75% holding in BAE Systems Land Systems South Africa (Pty) Limited, resulting in a loss on disposal of businesses of £24m.

In 2013, UK legislation changed so that UK government credits for research and development spend are now accounted for as part of operating profit rather than as part of taxation expense. This treatment was optional for the first three years. During 2015, the Group exercised that option, effective from 2013, and has reflected this change in the 2015 accounts. The credits relating to 2013 and 2014, totalling £50m, are included in non-recurring items in 2015.

In 2014, there were two equal and opposite non-recurring items, a fair value gain (see note 4) and an impairment loss (see note 9).

1. Segmental analysis continued

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, 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 security, secure government, and commercial and financial security activities;
- **Platforms & Services (US)** comprises operations in the US, UK and Sweden, and produces combat vehicles, weapons and munitions, and delivers US-based services and sustainment activities, including ship repair and the management of government-owned munitions facilities;
- **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 head office activities, together with a 49% interest in Air Astana.

Management monitors the results of these reporting segments to assess performance and make decisions about the allocation of resources. Segmental performance is evaluated based on combined sales of the Group and its share of sales 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, the Integrated Electronics & Warfare Systems activities previously included in Platforms & Services (US) are, from 1 January 2015, reported within Cyber & Intelligence. Comparatives for 2014 have been re-presented accordingly.

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	
	2015 £m	2014[1] £m	**2015 £m**	2014 £m	**2015 £m**	2014 £m	**2015 £m**	2014[1] £m
Electronic Systems	**2,638**	2,415	**(72)**	(74)	**72**	74	**2,638**	2,415
Cyber & Intelligence	**1,848**	1,658	**–**	–	**–**	–	**1,848**	1,658
Platforms & Services (US)	**2,779**	2,689	**(101)**	(83)	**–**	–	**2,678**	2,606
Platforms & Services (UK)	**7,405**	6,623	**(1,524)**	(1,207)	**1,438**	1,104	**7,319**	6,520
Platforms & Services (International)	**3,742**	3,572	**(785)**	(793)	**–**	–	**2,957**	2,779
HQ	**237**	279	**(237)**	(279)	**–**	–	**–**	–
	18,649	17,236	**(2,719)**	(2,436)	**1,510**	1,178	**17,440**	15,978
Intra-group sales/revenue	**(745)**	(599)	**–**	–	**92**	51	**(653)**	(548)
	17,904	16,637	**(2,719)**	(2,436)	**1,602**	1,229	**16,787**	15,430

	Intra-group revenue		Revenue from external customers	
	2015 £m	2014[1] £m	**2015 £m**	2014[1] £m
Electronic Systems	**91**	104	**2,547**	2,311
Cyber & Intelligence	**55**	44	**1,793**	1,614
Platforms & Services (US)	**22**	13	**2,656**	2,593
Platforms & Services (UK)	**480**	381	**6,839**	6,139
Platforms & Services (International)	**5**	6	**2,952**	2,773
	653	548	**16,787**	15,430

1. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.

Notes to the Group accounts continued

1. Segmental analysis continued

Sales and revenue by customer location

	Sales		Revenue	
	2015 £m	2014 £m	**2015 £m**	2014 £m
UK	**4,006**	3,703	**3,812**	3,518
Rest of Europe[1]	**2,506**	2,215	**1,971**	1,514
US	**6,380**	5,979	**6,377**	5,978
Canada	**74**	51	**74**	51
Saudi Arabia	**3,839**	3,320	**3,653**	3,153
Rest of Middle East	**102**	154	**63**	124
Australia	**559**	682	**558**	680
Rest of Asia and Pacific	**347**	420	**234**	326
Africa, and Central and South America	**91**	113	**45**	86
	17,904	16,637	**16,787**	15,430

Revenue by category

	2015 £m	2014 £m
Long-term contracts	**9,420**	8,687
Sale of goods	**3,647**	3,211
Provision of services	**3,715**	3,518
Royalty income	**5**	14
	16,787	15,430

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2015 £m	2014 £m
UK Ministry of Defence[1]	**4,838**	4,230
US Department of Defense	**3,838**	3,655
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**3,582**	3,124

1. Includes £1.4bn (2014 £1.1bn) generated under the Typhoon work share agreement with Eurofighter Jagdflugzeug GmbH.

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. Segmental analysis continued

Reporting segment result

	Underlying EBITA[1]		Non-recurring items[2]		Amortisation of intangible assets[3]		Impairment of intangible assets[4]		Reporting segment result	
	2015 £m	2014[5] £m	**2015 £m**	2014 £m	**2015 £m**	2014[5] £m	**2015 £m**	2014[5] £m	**2015 £m**	2014[5] £m
Electronic Systems	**396**	373	**–**	–	**(18)**	(14)	**–**	(1)	**378**	358
Cyber & Intelligence	**145**	153	**–**	–	**(57)**	(61)	**(78)**	(4)	**10**	88
Platforms & Services (US)	**177**	117	**(24)**	–	**(13)**	(15)	**–**	(165)	**140**	(63)
Platforms & Services (UK)	**721**	772	**50**	–	**(11)**	(84)	**–**	–	**760**	688
Platforms & Services (International)	**335**	366	**–**	–	**(9)**	(10)	**–**	–	**326**	356
HQ[6]	**(91)**	(79)	**–**	–	**–**	–	**–**	–	**(91)**	(79)
	1,683	1,702	**26**	–	**(108)**	(184)	**(78)**	(170)	**1,523**	1,348
Financial income/(expense) of equity accounted investments									**3**	(30)
Taxation expense of equity accounted investments									**(24)**	(18)
Operating profit									**1,502**	1,300
Finance costs									**(412)**	(418)
Profit before taxation									**1,090**	882
Taxation expense									**(147)**	(130)
Profit for the year									**943**	752

Share of results of equity accounted investments within reporting segments

	2015 £m	2014 £m
Underlying EBITA[1]:		
Electronic Systems	**7**	2
Platforms & Services (US)	**12**	12
Platforms & Services (UK)	**15**	21
Platforms & Services (International)	**96**	70
HQ	**5**	31
	135	136
Amortisation of intangible assets	**(4)**	(5)
Financial income/(expense)	**3**	(30)
Taxation expense	**(24)**	(18)
	110	83

1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
2. In 2015, Platforms & Services (US) comprises a loss on the sale of the Group's 75% holding in BAE Systems Land Systems South Africa (Pty) Limited and Platforms & Services (UK) includes research and development expenditure credits relating to 2013 and 2014 (see page 112).
3. The reduction in amortisation of intangible assets primarily reflects acquired intangible assets fully amortising in 2014 in the Group's Maritime business within Platforms & Services (UK).
4. See note 8.
5. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.
6. In 2014, HQ included a £30m benefit from re-assessment of a long-term liability.

Notes to the Group accounts
continued

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.

	2015 £m	2014 £m
Raw materials, subcontracts and other bought-in items	**6,030**	6,114
Change in inventories of finished goods and work-in-progress	**1,027**	8
Cost of inventories expensed	**7,057**	6,122
Staff costs (note 3)	**5,052**	4,827
Depreciation, amortisation and impairment	**460**	657
Loss on disposal of property, plant and equipment, and investment property	**4**	1
Loss on disposal of businesses	**24**	–
Other operating charges	**3,025**	2,780
Operating costs	**15,622**	14,387
Included within the analysis of operating costs are the following expenses:		
Lease and sublease expense	**257**	242
Research and development expense including amounts funded under contract	**1,263**	1,343

Fees payable to the Company's auditor and its associates included in operating costs

	2015			2014		
	UK £'000	**Overseas £'000**	**Total £'000**	UK[1] £'000	Overseas[1] £'000	Total[1] £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	**1,759**	**–**	**1,759**	1,669	–	1,669
Fees payable to the Company's auditor and its associates for other services pursuant to legislation:						
The audit of the Company's subsidiaries*	**2,612**	**3,659**	**6,271**	2,687	3,425	6,112
Interim review*	**490**	**–**	**490**	485	–	485
Other	**164**	**19**	**183**	200	2	202
Audit-related assurance services:						
Advice on accounting matters	**–**	**6**	**6**	9	2	11
Tax compliance services	**22**	**457**	**479**	7	637	644
Tax advisory services	**30**	**125**	**155**	59	141	200
Corporate finance services:						
M&A	**–**	**1,806**	**1,806**	–	–	–
Other assurance services:						
Due diligence	**–**	**–**	**–**	–	134	134
IT advisory	**–**	**–**	**–**	123	–	123
Other non-audit services:						
Investor relations	**220**	**–**	**220**	200	3	203
Other	**184**	**47**	**231**	315	16	331
Total fees payable to the Company's auditor and its associates	**5,481**	**6,119**	**11,600**	5,754	4,360	10,114
*Total fees payable to the Company's auditor and its associates for audit services and interim review			**8,520**			8,266
Fees in respect of BAE Systems pension schemes:						
Audit	**140**	**241**	**381**	139	214	353
Tax compliance	**–**	**4**	**4**	44	–	44
Tax advisory	**19**	**–**	**19**	–	–	–
	159	**245**	**404**	183	214	397

1. Restated.

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	
	2015 Number '000	2014[1] Number '000	**2015 Number '000**	2014[1] Number '000
Electronic Systems	**12**	12	**12**	12
Cyber & Intelligence	**13**	13	**13**	13
Platforms & Services (US)	**11**	12	**11**	11
Platforms & Services (UK)	**29**	29	**29**	29
Platforms & Services (International)	**10**	10	**9**	10
HQ	**1**	1	**1**	1
	76	77	**75**	76

1. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were as follows:

	2015 £m	2014 £m
Wages and salaries	**4,367**	4,184
Social security costs	**333**	334
Share-based payments (note 28)	**16**	14
Pension costs – defined contribution plans (note 20)	**140**	125
Pension costs – defined benefit plans (note 20)	**194**	169
US healthcare costs (note 20)	**2**	1
	5,052	4,827

4. Other income

Rental income
Rental income is recognised in other income on a straight-line basis over the term of the relevant lease.

	2015 £m	2014 £m
Research and development expenditure credits[1]	**65**	–
Rental income from operating leases – investment property	**23**	21
Rental income from operating leases – other	**19**	20
Profit on disposal of property, plant and equipment	**28**	21
Profit on disposal of investment property	**45**	12
Profit on disposal of non-current other investments	**1**	–
Fair value gain[2]	**–**	47
Management recharges to equity accounted investments (note 29)	**17**	17
Other[3]	**29**	36
Other income	**227**	174

1. In 2013, UK legislation changed so that UK government credits for research and development spend are now accounted for as part of operating profit rather than as part of taxation expense. This treatment was optional for the first three years. During 2015, the Group exercised that option, effective from 2013, and has reflected this change in the 2015 accounts. The credits relating to 2013 and 2014, totalling £50m, are included in non-recurring items in 2015.
2. 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 in 2014.
3. There are no individual amounts in excess of £10m.

Notes to the Group accounts continued

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.

	2015 £m	2014 £m
Interest income	**17**	28
Gain on remeasurement of financial instruments at fair value through profit or loss	**167**	99
Foreign exchange gains	**57**	114
Financial income	**241**	241
Interest expense on bonds and other financial instruments	**(175)**	(177)
Facility fees	**(4)**	(4)
Net present value adjustments	**(29)**	(48)
Net interest expense on retirement benefit obligations (note 20)	**(192)**	(147)
Loss on remeasurement of financial instruments at fair value through profit or loss	**(72)**	(75)
Foreign exchange losses	**(181)**	(208)
Financial expense	**(653)**	(659)
Finance costs	**(412)**	(418)

Additional analysis

	2015 £m	2014 £m
Finance costs:		
Group	**(412)**	(418)
Share of equity accounted investments	**3**	(30)
	(409)	(448)
Analysed as:		
Underlying interest expense:		
Group	**(191)**	(201)
Share of equity accounted investments	**(3)**	(3)
	(194)	(204)
Other:		
Group:		
Net interest expense on retirement benefit obligations	**(192)**	(147)
Fair value and foreign exchange adjustments on financial instruments and investments	**(29)**	(70)
Share of equity accounted investments:		
Net interest expense on retirement benefit obligations	**(8)**	(8)
Fair value and foreign exchange adjustments on financial instruments and investments	**14**	(19)
	(409)	(448)

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

	2015 £m	2014 £m
Current taxation		
UK:		
Current tax	**(109)**	(90)
Double tax relief	**–**	1
Adjustments in respect of prior years[1]	**17**	24
	(92)	(65)
Overseas:		
Current year	**(105)**	(56)
Adjustments in respect of prior years[2]	**99**	20
	(6)	(36)
	(98)	(101)
Deferred taxation		
UK:		
Origination and reversal of temporary differences	**8**	21
Adjustments in respect of prior years	**8**	8
Tax rate adjustment[3]	**(5)**	–
	11	29
Overseas:		
Origination and reversal of temporary differences	**(51)**	(67)
Adjustments in respect of prior years	**(9)**	9
	(60)	(58)
	(49)	(29)
Taxation expense	**(147)**	(130)
UK	**(81)**	(36)
Overseas	**(66)**	(94)
Taxation expense	**(147)**	(130)

1. 2015 includes a £52m credit in respect of the adjustment of certain UK tax provisions in the light of clarification received.
2. 2015 includes an £82m credit in respect of the adjustment of certain overseas tax provisions in the light of rulings received. 2014 included a £51m credit in respect of the re-assessment of existing tax provisions where information received in the year enabled the estimate to be updated.
3. The UK current tax rate was reduced from 21% to 20% with effect from 1 April 2015, and will be reduced to 19% with effect from 1 April 2017 and to 18% with effect from 1 April 2020. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 20% to 18%, creating a rate adjustment in 2015, 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

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.

	2015 £m	2014 £m
Profit before taxation	**1,090**	882
UK corporation tax rate	**20.25%**	21.5%
Expected income tax expense	**(221)**	(190)
Effect of tax rates in foreign jurisdictions, including US state taxes	**(69)**	(46)[1]
Effect of intra-group financing	**13**	13[1]
Expenses not tax effected	**(13)**	(12)
Income not subject to tax	**41**	32[1]
Research and development tax credits and patent box benefits	**7**	29
Non-deductible goodwill impairment	**(15)**	(35)
Chargeable gains and non-taxable gains/non-deductible losses on disposal of businesses	**(7)**	–
Utilisation of previously unrecognised tax losses	**4**	3
Adjustments in respect of prior years[2]	**115**	61
Adjustments in respect of equity accounted investments	**22**	18
Tax rate adjustment	**(5)**	–
Other	**(19)**	(3)
Taxation expense	**(147)**	(130)

Calculation of the underlying effective tax rate

	2015 £m	2014 £m
Profit before taxation	**1,090**	882
Add back:		
Taxation expense of equity accounted investments (note 1)	**24**	18
Loss on disposal of businesses (note 1)	**24**	–
Goodwill impairment (note 8)	**75**	161
Adjusted profit before taxation	**1,213**	1,061
Taxation expense	**(147)**	(130)
Taxation expense of equity accounted investments (note 1)	**(24)**	(18)
Exclude: Re-assessment of existing tax provisions[2]	**–**	(51)
Adjusted taxation expense (including equity accounted investments)	**(171)**	(199)
Underlying effective tax rate	**14%**	19%
Adjusted profit before taxation (above)	**1,213**	1,061
Exclude: Research and development expenditure credits[3]	**(77)**	–
	1,136	1,061
Adjusted taxation expense (including equity accounted investments) (above)	**(171)**	(199)
Exclude: Adjustments relating to research and development expenditure credits[3]	**68**	–
Exclude: Adjustment of tax provisions[2]	**(134)**	–
	(237)	(199)
Underlying effective tax rate, excluding research and development expenditure credits[3] and adjustment of tax provisions[2]	**21%**	19%

1. Re-presented.
2. 2015 includes credits totalling £134m in respect of the adjustment of certain UK and overseas tax provisions in the light of clarification and rulings received. 2014 included a £51m credit in respect of the re-assessment of existing tax provisions where information received in the year enabled the estimate to be updated, which was excluded from the calculation of the underlying effective tax rate.
3. In 2013, UK legislation changed so that UK government credits for research and development spend are now accounted for as part of operating profit rather than as part of taxation expense. This treatment was optional for the first three years. During 2015, the Group exercised that option, effective from 2013, and has reflected this change in the 2015 accounts. The adjustment reverses this treatment to show an underlying effective tax rate that is comparable with the prior year. The £77m excluded from profit before taxation comprises £50m included in non-recurring items relating to 2013 and 2014 (see note 1) and £27m included in underlying EBITA relating to 2015, of which £12m relates to the Group's share of equity accounted investments. The £68m includes £45m relating to the £50m included in non-recurring items.

6. Taxation expense continued

Tax recognised in other comprehensive income

	2015 Before tax £m	2015 Tax (expense)/ benefit £m	2015 Net of tax £m	2014 Before tax £m	2014 Tax (expense)/ benefit £m	2014 Net of tax £m
Items that will not be reclassified to the income statement:						
Remeasurements on retirement benefit schemes:						
Subsidiaries	**864**	**(173)**	**691**	(2,023)	482	(1,541)
Equity accounted investments	**21**	**(3)**	**18**	(73)	16	(57)
Share-based payments	**–**	**(3)**	**(3)**	–	4	4
Other	**–**	**(8)**	**(8)**	–	1	1
Tax rate adjustment[1]	**–**	**(74)**	**(74)**	–	–	–
Items that may be reclassified to the income statement:						
Currency translation on foreign currency net investments:						
Subsidiaries	**260**	**–**	**260**	277[2]	–	277[2]
Equity accounted investments	**(45)**	**–**	**(45)**	(13)[2]	–	(13)[2]
Reclassification of cumulative currency translation reserve on disposal	**20**	**–**	**20**	–	–	–
Fair value (loss)/gain on available-for-sale financial assets	**(1)**	**–**	**(1)**	4	–	4
Amounts credited/(charged) to hedging reserve:						
Subsidiaries	**11**	**(2)**	**9**	(92)	19	(73)
Equity accounted investments	**(36)**	**7**	**(29)**	–	–	–
	1,094	**(256)**	**838**	(1,920)	522	(1,398)

	2015 Other reserves £m	2015 Retained earnings £m	2015 Total £m	2014 Other reserves £m	2014 Retained earnings £m	2014 Total £m
Current tax						
Pensions	**–**	**42**	**42**	–	59	59
Other	**–**	**(8)**	**(8)**	–	1	1
	–	**34**	**34**	–	60	60
Deferred tax						
Subsidiaries	**(2)**	**(218)**	**(220)**	19	427	446
Tax rate adjustment[1]	**–**	**(74)**	**(74)**	–	–	–
Equity accounted investments	**7**	**(3)**	**4**	–	16	16
	5	**(295)**	**(290)**	19	443	462
Tax on other comprehensive income	**5**	**(261)**	**(256)**	19	503	522

1. The UK current tax rate was reduced from 21% to 20% with effect from 1 April 2015, and will be reduced to 19% with effect from 1 April 2017 and to 18% with effect from 1 April 2020. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 20% to 18%, creating a rate adjustment in 2015, which is partly reflected in the Consolidated income statement and partly in the Consolidated statement of comprehensive income.
2. Restated.

Notes to the Group accounts
continued

7. 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.

	2015			2014		
	£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	**918**	**29.0**	**28.9**	740	23.4	23.3
(Deduct)/add back:						
Re-assessment of existing tax provisions	**–**			(51)		
Non-recurring items, post tax	**19**			–		
Net interest expense on retirement benefit obligations, post tax[1]	**158**			126		
Fair value and foreign exchange adjustments on financial instruments and investments, post tax[1]	**12**			72		
Amortisation and impairment of intangible assets, post tax[1]	**88**			156		
Impairment of goodwill	**75**			161		
Underlying earnings, post tax	**1,270**	**40.2**	**40.1**	1,204	38.0	37.9
		Millions	**Millions**		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		**3,161**	**3,161**		3,165	3,165
Incremental shares in respect of employee share schemes			**10**			10
Weighted average number of shares used in calculating diluted earnings per share			**3,171**			3,175

1. The tax impact is calculated using the underlying effective tax rate, excluding research and development expenditure credits and adjustment of tax provisions, of 21% (2014 19%).

8. 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 25.

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:

Programme and customer-related	up to 15 years
Other intangible assets:	
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.

Notes to the Group accounts continued

8. Intangible assets continued

	Goodwill £m	Programme and customer-related £m	Other £m	Total £m
Cost or valuation				
At 1 January 2014	13,180	1,729	504	15,413
Additions:				
Acquired separately	–	–	33	33
Internally developed	–	–	23	23
Business acquisitions	208	51	30	289
Disposals[1]	–	(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
At 31 December 2014	13,708	739	533	14,980
Additions:				
Acquired separately	–	–	42	42
Internally developed	–	–	12	12
Disposals[1]	–	(147)	(33)	(180)
Transfer from property, plant and equipment	–	–	5	5
Foreign exchange adjustments	333	12	8	353
At 31 December 2015	**14,041**	**604**	**567**	**15,212**
Amortisation and impairment				
At 1 January 2014	3,799	1,502	377	5,678
Amortisation charge	–	142	37	179
Impairment charge	161	8	1	170
Disposals[1]	–	(1,061)	(77)	(1,138)
Transfer to held for sale	–	–	(3)	(3)
Foreign exchange adjustments	84	18	9	111
At 31 December 2014	4,044	609	344	4,997
Amortisation charge	–	61	43	104
Impairment charge	75	3	–	78
Disposals[1]	–	(147)	(33)	(180)
Foreign exchange adjustments	82	8	6	96
At 31 December 2015	**4,201**	**534**	**360**	**5,095**
Net book value				
At 31 December 2015	**9,840**	**70**	**207**	**10,117**
At 31 December 2014	9,664	130	189	9,983
At 1 January 2014	9,381	227	127	9,735

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 7.47% (2014 7.12%) (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.

The final year growth rate assumption in the value-in-use calculations is in the range 0% to 2%.

8. Intangible assets continued

Significant CGUs

Goodwill allocated to CGUs, which are largely dependent on US government spending on defence, aerospace and security, represents £7.4bn (2014 £7.3bn) 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 2015 £bn	Allocated goodwill 2014[1] £bn	Pre-tax discount rate 2015 %	Pre-tax discount rate 2014[1] %
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**	3.2	**10**	9
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	**1.1**	1.1	**10**	9
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, and in the US for complex infrastructure, maritime and aviation services	**3.1**	3.0	**10**	9

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2015 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 2015 £bn	Headroom as at 31 December 2014[1] £bn	Headroom assuming a 1% reduction in the terminal value growth rate assumption 2015 £bn	Headroom assuming a 1% reduction in the terminal value growth rate assumption 2014[1] £bn	Headroom assuming a 1% increase in the discount rate 2015 £bn	Headroom assuming a 1% increase in the discount rate 2014[1] £bn
Electronic Systems	**1.7**	1.6	**1.0**	0.8	**0.8**	0.6
Intelligence & Security	**–**	0.2	**(0.1)**	(0.1)	**(0.1)**	(0.1)
Platforms & Services (US)	**0.4**	0.5	**(0.1)**	(0.1)	**(0.3)**	(0.2)

1. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.

Other CGUs

The remaining goodwill balance of £2.4bn (2014 £2.4bn) is allocated across multiple CGUs, including £0.6bn (2014 £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 2015, the impairment charge of £75m in the Intelligence & Security CGU reflects lower growth assumptions.

In 2014, the impairment charge of £161m comprised the Platforms & Services (US) CGU, reflecting performance issues at the US commercial shipbuilding business (£87m) and 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 (£74m).

Impairment – intangible assets

In 2015, the impairment charge of £3m relates to the Cyber & Intelligence reporting segment.

In 2014, the impairment charge of £9m related to the Electronic Systems (£1m), Cyber & Intelligence (£4m) and Platforms & Services (US) (£4m) reporting segments.

Notes to the Group accounts
continued

9. 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:

Buildings	up to 50 years, or the lease term if shorter
Plant and machinery:	
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 8.

9. Property, plant and equipment continued

	Land and buildings £m	Plant and machinery £m	Total £m
Cost			
At 1 January 2014	2,103	2,735	4,838
Additions	55	208	263
Business acquisitions	–	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
At 31 December 2014	1,722	2,753	4,475
Additions[1]	108	284	392
Transfer to other intangible assets	–	(5)	(5)
Reclassification between categories	17	(17)	–
Disposals	(113)	(266)	(379)
Foreign exchange adjustments	36	57	93
At 31 December 2015	**1,770**	**2,806**	**4,576**
Depreciation and impairment			
At 1 January 2014	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
At 31 December 2014	963	1,923	2,886
Depreciation charge for the year	80	163	243
Impairment charge for the year	21	8	29
Reclassification between categories	2	(2)	–
Disposals	(80)	(261)	(341)
Foreign exchange adjustments	19	42	61
At 31 December 2015	**1,005**	**1,873**	**2,878**
Net book value			
At 31 December 2015	**765**	**933**	**1,698**
At 31 December 2014	759	830	1,589
At 1 January 2014	1,157	779	1,936

Net book value

	Land and buildings £m	Plant and machinery £m	Total £m
Freehold property	612	–	612
Long leasehold property	17	–	17
Short leasehold property	136	–	136
Plant and machinery	–	811	811
Fixtures, fittings and equipment	–	122	122
At 31 December 2015	**765**	**933**	**1,698**

1. Includes £44m of land and buildings, and £5m of plant and machinery at Barrow-in-Furness, UK, relating to the Successor submarine programme funded by the UK government.

Notes to the Group accounts
continued

9. Property, plant and equipment continued

Impairment

	2015 £m	2014 £m
Cyber & Intelligence	1	–
Platforms & Services (US)	2	1
Platforms & Services (UK)	1	4
Platforms & Services (International)	25	51
	29	56

2015
The viability of the Williamstown shipyard in Australia remains uncertain with no near-term prospect of work beyond the Landing Helicopter Dock and Air Warfare Destroyer programmes. The impairment in Platforms & Services (International) includes a £24m charge against the carrying value of the Williamstown facility.

2014
The impairment in Platforms & Services (International) included the £47m charge against the carrying value of Aircraft Accessories and Components Company upon classification of the business as held for sale.

Assets in the course of construction

	Land and buildings[1] £m	Plant and machinery £m	Total £m
At 31 December 2015	**98**	**194**	**292**
At 31 December 2014	36	154	190

1. Includes £42m (2014 £nil) at Barrow-in-Furness, UK, relating to the Successor submarine programme funded by the UK government.

Operating leases

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property – see note 10) are as follows:

	2015 £m	2014 £m
Receipts due:		
Not later than one year	25	23
Later than one year and not later than five years	93	84
Later than five years	94	99
	212	206

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.

10. 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 8.

	£m
Cost	
At 1 January 2014	199
Additions	8
Disposals	(21)
At 31 December 2014	186
Additions	13
Disposals	(23)
At 31 December 2015	**176**
Depreciation and impairment	
At 1 January 2014	64
Depreciation charge for the year	4
Disposals	(11)
At 31 December 2014	57
Depreciation charge for the year	4
Impairment charge for the year	2
Disposals	(7)
At 31 December 2015	**56**
Net book value	
At 31 December 2015	**120**
At 31 December 2014	129
At 1 January 2014	135

Fair value	
At 31 December 2015	**178**
At 31 December 2014	226

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.

Notes to the Group accounts
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11. 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 8.

Principal equity accounted investments

Joint venture	Principal activities	Shareholding	Principally operates in
Eurofighter Jagdflugzeug	Management and control of the European Typhoon programme	33%	Germany
MBDA	Development and manufacture of guided weapons	37.5%	Europe
Air Astana	Carriage by air of passengers and cargo	49%	Kazakhstan

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.

	2015			2014		
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Air Astana £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m
Revenue (100%)	**4,239**	**2,087**	**484**	3,281	1,929	570
EBITA[1] excluding depreciation	**24**	**282**	**41**	46	215	91
Depreciation and amortisation	**–**	**(60)**	**(30)**	–	(54)	(28)
Financial income	**2**	**59**	**37**	2	68	–
Financial expense	**(1)**	**(70)**	**(12)**	(1)	(79)	(44)
Taxation expense	**(7)**	**(53)**	**(7)**	(13)	(19)	(6)
Profit for the year (100%)	**18**	**158**	**29**	34	131	13
Remeasurements on retirement benefit schemes, net of tax	**–**	**47**	**–**	–	(151)	–
Amounts charged to hedging reserve, net of tax	**–**	**–**	**(58)**	–	–	–
Foreign exchange adjustments	**–**	**1**	**(89)**	–	(6)	(29)
Total comprehensive income for the year (100%)	**18**	**206**	**(118)**	34	(26)	(16)
Group's share of total comprehensive income for the year before elimination of unrealised profit	**6**	**77**	**(58)**	11	(10)	(8)
Elimination of unrealised profit	**–**	**–**	**–**	–	(4)	–
Group's share of total comprehensive income for the year	**6**	**77**	**(58)**	11	(14)	(8)
Non-current assets	**9**	**1,498**	**219**	9	1,507	358
Cash and cash equivalents	**4**	**1,047**	**143**	6	1,182	16
Current assets excluding cash and cash equivalents	**1,048**	**2,921**	**56**	1,102	2,940	194
Current assets	**1,052**	**3,968**	**199**	1,108	4,122	210
Non-current financial liabilities excluding trade and other payables, and provisions	**–**	**(7)**	**(255)**	–	(10)	(267)
Other non-current liabilities	**(19)**	**(742)**	**–**	(18)	(903)	–
Non-current liabilities	**(19)**	**(749)**	**(255)**	(18)	(913)	(267)
Current financial liabilities excluding trade and other payables, and provisions	**–**	**–**	**(28)**	(4)	(20)	(26)
Other current liabilities	**(1,011)**	**(4,421)**	**(82)**	(1,062)	(4,580)	(103)
Current liabilities	**(1,011)**	**(4,421)**	**(110)**	(1,066)	(4,600)	(129)
Net assets (100%)	**31**	**296**	**53**	33	116	172

1. Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

11. Equity accounted investments continued

	2015				2014			
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Air Astana £m**	**Total £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m	Total £m
Group's share of net assets	**10**	**111**	**26**	**147**	11	43	84	138
Elimination of unrealised profit	**–**	**(4)**	**–**	**(4)**	–	(4)	–	(4)
Goodwill	**–**	**4**	**–**	**4**	–	15	–	15
Carrying value	**10**	**111**	**26**	**147**	11	54	84	149

	2015				2014			
	Eurofighter Jagdflugzeug £m	**MBDA £m**	**Air Astana £m**	**Total £m**	Eurofighter Jagdflugzeug £m	MBDA £m	Air Astana £m	Total £m
Dividends received	**6**	**17**	**3**	**26**	6	44	3	53

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.

	Principal equity accounted investments £m	Other £m	Total £m
At 1 January 2014	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	–	(2)	(2)
Foreign exchange adjustments	(1)	4	3
At 31 December 2014	149	80	229
Group's share of profit for the year	79	31	110
Group's share of remeasurements on retirement benefit schemes	21	–	21
Tax on items that will not be reclassified to the income statement	(3)	–	(3)
Foreign exchange adjustments	(42)	(1)	(43)
Amounts charged to hedging reserve	(36)	–	(36)
Tax on items that may be reclassified to the income statement	7	–	7
Group's share of total comprehensive income for the year	26	30	56
Equity accounted investment funding	–	8	8
Dividends received from equity accounted investments	(26)	(15)	(41)
Foreign exchange adjustments	(2)	–	(2)
At 31 December 2015	**147**	**103**	**250**

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

Notes to the Group accounts
continued

12. 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.

	2015 £m	2014 £m
Non-current		
Prepayments and accrued income	**23**	85
US deferred compensation plan assets	**234**	238
Other receivables	**18**	24
	275	347
Current		
Long-term contract balances	**4,407**	5,413[1]
Less: Attributable progress payments	**(3,762)**	(4,571)[1]
Amounts due from contract customers	**413**	476
Amounts due from customers for contract work	**1,058**	1,318
Trade receivables	**1,284**	935
Amounts owed by equity accounted investments (note 29)	**75**	92
Prepayments and accrued income	**254**	251
Other receivables	**269**	254
	2,940	2,850

1. Restated.

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2015 is estimated to be £26.4bn (2014 £30.2bn).

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 27.

13. 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.

	2015		2014	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**52**	**(72)**	28	(79)
Other foreign exchange/interest rate contracts	**2**	**–**	–	–
Debt-related derivative financial instruments – assets[1]	**53**	**–**	10	–
	107	**(72)**	38	(79)
Current				
Cash flow hedges – foreign exchange contracts	**47**	**(123)**	41	(97)
Other foreign exchange/interest rate contracts	**58**	**(7)**	5	(10)
	105	**(130)**	46	(107)

1. Includes fair value hedges of £7m (2014 £4m).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (see note 18).

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 £25m (2014 £92m), including a £54m (2014 £1m) credit on reclassification to profit and loss on maturity and a £79m (2014 £93m) charge on contracts held at 31 December 2015.

Fair value hedges

The gain arising in the income statement on fair value hedging instruments was £3m (2014 loss £2m). The loss arising in the income statement on the fair value of the underlying hedged items was £2m (2014 £1m). The ineffective portion recognised in the income statement arising from fair value hedges was £1m (2014 £3m).

Notes to the Group accounts
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14. 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.

The most significant recognised deferred tax assets relate to the deficits on the Group's pension/retirement schemes (see below). This is because retirement benefit costs are deducted in determining accounting profit as service is provided by employees, but deducted in determining taxable profit either when contributions are paid to the pension/retirement schemes or when retirement benefits are paid. In reviewing the probability that taxable profits will be available in the future against which such contributions/payments can be deducted, account has been taken of the deficit recovery plans agreed with the trustees of the relevant schemes which run until 2026. In other words, these temporary differences are largely expected to reverse over the next ten years.

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	
	2015 £m	2014 £m	**2015 £m**	2014 £m	**2015 £m**	2014 £m
Property, plant and equipment	**16**	15	**(101)**	(93)	**(85)**	(78)
Intangible assets	**13**	4	**(30)**	(39)	**(17)**	(35)
Provisions and accruals	**299**	287	**–**	–	**299**	287
Goodwill	**–**	–	**(326)**	(273)	**(326)**	(273)
Pension/retirement schemes:						
Deficits	**908**	1,154	**–**	–	**908**	1,154
Additional contributions and other[1]	**112**	121	**–**	–	**112**	121
Share-based payments	**15**	21	**–**	–	**15**	21
Financial instruments	**16**	26	**(6)**	(5)	**10**	21
Other items	**35**	66	**–**	–	**35**	66
Rolled over capital gains	**–**	–	**(12)**	(13)	**(12)**	(13)
Capital losses carried forward	**12**	13	**–**	–	**12**	13
Trading losses carried forward	**21**	22	**–**	–	**21**	22
Deferred tax assets/(liabilities)	**1,447**	1,729	**(475)**	(423)	**972**	1,306
Set off of tax	**(462)**	(402)	**462**	402	**–**	–
Net deferred tax assets/(liabilities)	**985**	1,327	**(13)**	(21)	**972**	1,306

1. Includes deferred tax assets on US deferred compensation plans.

14. Deferred tax continued

Movement in temporary differences during the year

	At 1 January 2015 £m	Foreign exchange adjustments £m	Acquisitions and disposals £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2015 £m**
Property, plant and equipment	(78)	(6)	–	(1)	–	**(85)**
Intangible assets	(35)	(1)	–	19	–	**(17)**
Provisions and accruals	287	13	–	(1)	–	**299**
Goodwill	(273)	(17)	–	(36)	–	**(326)**
Pension/retirement schemes:						
Deficits	1,154	14	–	15	(275)	**908**
Additional contributions and other[1]	121	6	–	(3)	(12)	**112**
Share-based payments	21	–	–	(2)	(4)	**15**
Financial instruments	21	–	–	(8)	(3)	**10**
Other items	66	(1)	–	(30)	–	**35**
Rolled over capital gains	(13)	–	–	1	–	**(12)**
Capital losses carried forward	13	–	–	(1)	–	**12**
Trading losses carried forward	22	1	–	(2)	–	**21**
	1,306	9	–	(49)	(294)	**972**

	At 1 January 2014 £m	Foreign exchange adjustments £m	Acquisitions and disposals[2] £m	Recognised in income £m	Recognised in equity £m	At 31 December 2014 £m
Property, plant and equipment	(62)	(6)	–	(10)	–	(78)
Intangible assets	(45)	1	(29)	38	–	(35)
Provisions and accruals	308	13	(2)	(32)	–	287
Goodwill	(221)	(15)	–	(37)	–	(273)
Pension/retirement schemes:						
Deficits	692	15	–	12	435	1,154
Additional contributions and other[1]	124	7	–	2	(12)	121
Share-based payments	19	–	–	(2)	4	21
Financial instruments	1	–	–	1	19	21
Other items	59	(3)	–	10	–	66
Rolled over capital gains	(13)	–	–	–	–	(13)
Capital losses carried forward	13	–	–	–	–	13
Trading losses carried forward	19	1	13	(11)	–	22
	894	13	(18)	(29)	446	1,306

1. Includes deferred tax assets on US deferred compensation plans.
2. In 2014, included net deferred tax liabilities on acquisition of subsidiaries (£17m) and the transfer of net deferred tax assets to held for sale (£1m).

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2015 £m	2014 £m
Deductible temporary differences, including tax credits	**1**	2
Capital losses carried forward	**31**	38
Trading and other losses carried forward	**38**	62
	70	102

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 21% to 20% with effect from 1 April 2015. Under the Finance (No. 2) Act 2015, the UK current tax rate will reduce to 19% with effect from 1 April 2017 and to 18% with effect from 1 April 2020. This will reduce future UK current tax charges accordingly.

The reduction to 18% was substantively enacted before 31 December 2015. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from 20% to 18%, creating a rate adjustment in 2015, which is partly reflected in the Consolidated income statement and partly in the Consolidated statement of comprehensive income. Accordingly, both recognised and unrecognised UK deferred tax balances as at 31 December 2015 have been calculated at 18%.

Notes to the Group accounts
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15. Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

	2015 £m	2014 £m
Short-term work-in-progress	**455**	439
Raw materials and consumables	**197**	189
Finished goods and goods for resale	**74**	62
	726	690

The Group recognised £16m (2014 £4m) as a write down of inventories to net realisable value.

16. 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.

	2015 £m	2014 £m
Cash	**536**	537
Short-term deposits	**2,001**	1,777
	2,537	2,314
Less: Cash and cash equivalents (included within assets held for sale)	**–**	(6)
	2,537	2,308

17. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Notes	2015 £m	2014 £m
UK		**2,537**	2,505
Rest of Europe		**538**	546
US		**8,635**	8,444
Saudi Arabia		**349**	316
Australia		**406**	469
Rest of Asia and Pacific		**1**	2
Africa, and Central and South America		**–**	2
Non-current segment assets		**12,466**	12,284
Retirement benefit surpluses	20	**193**	162
Other financial assets	13	**159**	74
Tax		**989**	1,334
Inventories	15	**726**	690
Current trade and other receivables	12	**2,940**	2,850
Cash (as defined by the Group)[1]	24	**2,590**	2,318
Assets held for sale		**20**	76
Consolidated total assets		**20,083**	19,788

1. Includes cash and cash equivalents (note 16) and debt-related derivative financial instrument assets (note 13).

18. 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.

	2015 £m	2014 £m
Non-current		
US$350m 3.5% bond, repayable 2016	–	224
Albertville Hangar bond, repayable 2018	**6**	6
US$1bn 6.375% bond, repayable 2019	**680**	642
US$500m 2.85% bond, repayable 2020	**337**	–
US$500m 4.75% bond, repayable 2021	**339**	320
£400m 4.125% bond, repayable 2022	**398**	398
US$800m 3.8% bond, repayable 2024	**546**	514
US$750m 3.85% bond, repayable 2025	**501**	–
US$500m 7.5% bond, repayable 2027	**337**	319
US$400m 5.8% bond, repayable 2041	**268**	254
US$550m 4.75% bond, repayable 2044 (2014 US$300m)	**363**	190
Debt-related derivative financial instruments – liabilities	–	1
	3,775	2,868
Current		
US$750m 5.2% bond, repayable 2015	–	481
US$350m 3.5% bond, repayable 2016	**237**	–
Overdrafts	–	1
	237	482

US$500m of the US$1bn 6.375% bond, repayable 2019, has been converted to a floating rate bond by utilising interest rate swaps that mature in June 2019 and give an effective rate during 2015 of 5.8%.

US$500m of the US$800m 3.8% bond, repayable 2024, has been converted to a floating rate bond by utilising interest rate swaps that mature in October 2019 and give an effective rate during 2015 of 2.9%. US$500m of the US$800m bond is measured at fair value.

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%.

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 13).

Notes to the Group accounts
continued

19. Trade and other payables

Trade and other payables are stated at their cost.

	2015 £m	2014 £m
Non-current		
Amounts due to long-term contract customers	**456**	404
Amounts owed to equity accounted investments (note 29)	**32**	40
Accruals and deferred income[1]	**121**	45
US deferred compensation plan liabilities	**264**	262
Other payables	**147**	181
	1,020	932
Current		
Amounts due to long-term contract customers	**3,119**	3,713
Amounts due to other customers	**204**	285
Trade payables	**690**	599
Amounts owed to equity accounted investments (note 29)	**414**	454
Other taxes and social security costs	**155**	76
Accruals and deferred income	**1,371**	1,181
Other payables	**209**	362
	6,162	6,670
Included above:		
Amounts due to long-term contract customers, including contract losses	**3,575**	4,117
Advances from long-term contract customers	**3,416**	3,935

1. Includes £46m (2014 £nil) of funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Successor submarine programme.

20. Retirement benefit obligations

Pension schemes

Defined contribution

Obligations for contributions are recognised as an expense in the income statement as incurred.

Defined benefit

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 142 reduced by the fair value of scheme assets. The bid values of scheme assets are not intended to be realised in the short term and may be subject to significant change before they are realised. The present values of scheme liabilities are derived from cash flow projections over long periods and are therefore inherently uncertain.

Certain of the Group's equity accounted investments participate in the Group's defined benefit schemes as well as Airbus SAS (Airbus), 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 pension deficit to its equity accounted investments and other participating employers.

In December 2015, BAE Systems, Airbus and the scheme trustees agreed to work towards the creation of a separate Airbus section of the BAE Systems Pension Scheme (Main Scheme) in 2016 with the allocation of the deficit to the BAE Systems and Airbus sections based on each member's last employer. This allocation methodology is considered to represent a better estimate of the deficit allocation than the relative payroll contributions of active members and has been reflected in the allocation of the IAS 19 pension deficit in the Main Scheme at 31 December 2015. The impact of this change on the amounts allocated at 31 December 2015 is an increase of £187m (£153m post-tax) in the Group's share of the reported IAS 19 deficit. Currently, 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. However, following the creation of an Airbus section of the Main Scheme, the Group's obligation in respect of Airbus is expected to be removed.

With the exception of the allocation of the Main Scheme deficit to Airbus, the deficit allocation method for other employers of the Main Scheme and for all other schemes is based on the relative payroll contributions of active members, which is consistent with prior years and is intended to reflect a reasonable approximation of the share of the deficit.

The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments.

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% (2014 71%) of the total IAS 19 defined benefit obligation at 31 December 2015. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2015, the weighted average durations of the UK and US defined benefit pension obligations were 18 years (2014 19 years) and 12 years (2014 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[1]	32	19	49
2000 Plan[2]	14	29	57
US schemes[3]	34	18	48

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 2015.

Notes to the Group accounts continued

20. Retirement benefit obligations continued

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: 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.

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 142. 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 2015 were £438m (2014 £548m) excluding those amounts allocated to equity accounted investments and participating employers of £98m (2014 £92m). This includes additional contributions of £33m into the UK schemes relating to the share buyback programme (2014 £108m).

In 2016, the Group expects to make contributions at a similar level to the recurring contributions and deficit funding as made in 2015.

The Group incurred a charge of £140m (2014 £125m) in relation to defined contribution schemes for employees.

20. Retirement benefit obligations continued

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
Market (investment) risk	
Asset returns may not move in line with the liabilities and may be subject to volatility.	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. Some 48% (2014 46%) 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. 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.
Interest rate risk	
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.
Inflation risk	
Liabilities are sensitive to movements in inflation, with higher inflation leading to an increase in the valuation of liabilities.	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. 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.
Longevity risk	
Liabilities are sensitive to life expectancy, with increases in life expectancies leading to an increase in the valuation of liabilities.	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. In February 2013, with the agreement of the Company, the trustees of the 2000 Plan entered into an arrangement with Legal & General to insure against longevity risk for the current pensioner population, covering £2.7bn of pension scheme liabilities. In December 2013, similar arrangements were entered into, with Legal & 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 reduce the funding volatility relating to increasing life expectancy.

Notes to the Group accounts
continued

20. 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		
	2015	2014	2013	**2015**	2014	2013
Financial assumptions						
Discount rate (%)	**3.9**	3.6	4.5	**4.5**	4.1	4.9
Inflation (%)	**3.2**	3.2	3.4	**n/a**	n/a	n/a
Rate of increase in salaries (%)	**3.2**	3.2	3.4	**n/a**	n/a	n/a
Rate of increase in deferred pensions (%)	**2.3/3.2**	2.3/3.2	2.5/3.4	**n/a**	n/a	n/a
Rate of increase in pensions in payment (%)	**1.8 – 3.6**	1.8 – 3.6	1.9 – 3.7	**n/a**	n/a	n/a
Demographic assumptions						
Life expectancy of a male currently aged 65 (years)	**87 – 89**	87 – 89	87 – 89	**87**	87	84
Life expectancy of a female currently aged 65 (years)	**89 – 90**	89 – 90	89 – 90	**89**	89	86
Life expectancy of a male currently aged 45 (years)	**89 – 91**	89 – 91	88 – 90	**87**	87	84
Life expectancy of a female currently aged 45 (years)	**91 – 92**	91 – 92	91 – 92	**89**	89	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% (2014 RPI inflation of 3.2%), plus a promotional scale. From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on Consumer Prices Index (CPI) inflation of 2.3% (2014 CPI inflation of 2.3%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.2% (2014 RPI inflation of 3.2%). For all UK schemes, the rate of increase in deferred pensions is subject to inflation caps.

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 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.

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% (2014 1.25%), for both pensioner and non-pensioner members.

In October 2015, 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 2015 are a blend of the fully generational RP-2014 Aggregate table and the RP-2014 White Collar table, both projected using Scale MP-2015. The mortality table changes resulted in a small reduction 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.

20. Retirement benefit obligations continued

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 2015. These valuations were rolled forward to reflect the information at 31 December 2015. 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 4.8% (2014 5.3%) based on the assumptions that the increases are 7.3% in 2016 reducing to 4.5% by 2024 and 4.5% each year thereafter for pre-retirement, and 8% in 2016 reducing to 4.5% by 2024 and 4.5% each year thereafter for post-retirement.

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.

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total IAS 19 deficit at 1 January 2015	(6,066)	(746)	(6,812)
Actual return on assets excluding amounts included in interest expense	(335)	(198)	(533)
Decrease in liabilities due to changes in financial assumptions	1,348	202	1,550
Decrease in liabilities due to changes in demographic assumptions	–	29	29
Experience gains/(losses)	224	(4)	220
Additional contributions in excess of service cost	177	–	177
Recurring contributions in excess of service cost	44	53	97
Past service cost – plan amendments	(10)	–	(10)
Settlements	–	4	4
Net interest expense	(206)	(32)	(238)
Foreign exchange adjustments	–	(40)	(40)
Movement in US healthcare schemes	–	2	2
Total IAS 19 deficit at 31 December 2015	**(4,824)**	**(730)**	**(5,554)**
Allocated to equity accounted investments and other participating employers	1,053	–	1,053
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 2015	**(3,771)**	**(730)**	**(4,501)**

Notes to the Group accounts
continued

20. Retirement benefit obligations continued

Amounts recognised on the balance sheet

The table below shows a reconciliation between the gross assets and liabilities of the Group's UK, US and other post-retirement benefit schemes and the amounts recognised on the Group's balance sheet after allocation to equity accounted investments and other participating employers.

	2015				2014			
	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	**(59)**	**(131)**	**–**	**(190)**	(41)	(138)	–	(179)
Present value of funded obligations	**(24,974)**	**(4,072)**	**(145)**	**(29,191)**	(26,195)	(4,132)	(146)	(30,473)
Fair value of scheme assets	**20,209**	**3,452**	**166**	**23,827**	20,170	3,505	165	23,840
Total IAS 19 (deficit)/surplus, net	**(4,824)**	**(751)**	**21**	**(5,554)**	(6,066)	(765)	19	(6,812)
Allocated to equity accounted investments and other participating employers	**1,053**	**–**	**–**	**1,053**	1,444	–	–	1,444
Group's share of IAS 19 (deficit)/surplus, net	**(3,771)**	**(751)**	**21**	**(4,501)**	(4,622)	(765)	19	(5,368)
Represented by:								
Retirement benefit surpluses	**120**	**41**	**32**	**193**	89	41	32	162
Retirement benefit obligations	**(3,891)**	**(792)**	**(11)**	**(4,694)**	(4,711)	(806)	(13)	(5,530)
	(3,771)	**(751)**	**21**	**(4,501)**	(4,622)	(765)	19	(5,368)
Group's share of IAS 19 deficit of equity accounted investments	**(139)**	**–**	**–**	**(139)**	(165)	–	–	(165)

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £5.2bn (2014 £6.0bn).

20. 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 2014	18,331	3,043	148	21,522
Interest income	820	146	7	973
Actual return on assets excluding amounts included in interest income	1,240	208	5	1,453
Actual return on assets	2,060	354	12	2,426
Contributions by employer	554	86	1	641
Contributions by employer in respect of employee salary sacrifice arrangements	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)
Value of scheme assets at 31 December 2014	20,170	3,505	165	23,840
Interest income	720	142	7	869
Actual return on assets excluding amounts included in interest income	(335)	(198)	(9)	(542)
Actual return on assets	385	(56)	(2)	327
Contributions by employer	460	76	2	538
Contributions by employer in respect of employee salary sacrifice arrangements	103	–	–	103
Total contributions by employer	563	76	2	641
Members' contributions	11	–	–	11
Administrative expenses	–	(12)	(1)	(13)
Settlements	–	(64)	–	(64)
Foreign exchange translation	–	190	9	199
Benefits paid	(920)	(187)	(7)	(1,114)
Value of scheme assets at 31 December 2015	**20,209**	**3,452**	**166**	**23,827**

Notes to the Group accounts continued

20. Retirement benefit obligations continued

Assets of defined benefit pension schemes

	2015								
	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[1]	**4,133**	**–**	**4,133**	**–**	**–**	**–**	**4,133**	**–**	**4,133**
Overseas	**2,883**	**–**	**2,883**	**602**	**–**	**602**	**3,485**	**–**	**3,485**
Pooled investment vehicles[2]	**3,254**	**–**	**3,254**	**480**	**–**	**480**	**3,734**	**–**	**3,734**
Fixed interest securities:									
UK gilts	**2,103**	**–**	**2,103**	**–**	**–**	**–**	**2,103**	**–**	**2,103**
UK corporates	**2,771**	**–**	**2,771**	**–**	**–**	**–**	**2,771**	**–**	**2,771**
Overseas government	**–**	**–**	**–**	**111**	**–**	**111**	**111**	**–**	**111**
Overseas corporates	**389**	**–**	**389**	**2,084**	**–**	**2,084**	**2,473**	**–**	**2,473**
Index-linked securities:									
UK gilts	**1,754**	**–**	**1,754**	**–**	**–**	**–**	**1,754**	**–**	**1,754**
UK corporates	**1,678**	**–**	**1,678**	**–**	**–**	**–**	**1,678**	**–**	**1,678**
Property[3]	**1,280**	**153**	**1,433**	**–**	**146**	**146**	**1,280**	**299**	**1,579**
Derivatives	**–**	**(678)**	**(678)**	**–**	**–**	**–**	**–**	**(678)**	**(678)**
Cash:									
Sterling	**253**	**–**	**253**	**–**	**–**	**–**	**253**	**–**	**253**
Foreign currency	**57**	**–**	**57**	**23**	**–**	**23**	**80**	**–**	**80**
Other	**–**	**179**	**179**	**–**	**6**	**6**	**–**	**185**	**185**
Total	**20,555**	**(346)**	**20,209**	**3,300**	**152**	**3,452**	**23,855**	**(194)**	**23,661**

	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[1]	4,183	–	4,183	–	–	–	4,183	–	4,183
Overseas	2,920	–	2,920	640	–	640	3,560	–	3,560
Pooled investment vehicles[2]	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[3]	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
Total	20,105	65	20,170	3,332	173	3,505	23,437	238	23,675

1. Includes £31m (2014 £14m) of the Company's own ordinary shares.
2. Primarily comprises equities.
3. Includes £257m (2014 £282m) of property occupied by Group companies.

20. 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 2014	(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
Defined benefit obligations at 31 December 2014	(26,236)	(4,270)	(146)	(30,652)
Current service cost	(239)	(11)	(2)	(252)
Contributions by employer in respect of employee salary sacrifice arrangements	(103)	–	–	(103)
Total current service cost	(342)	(11)	(2)	(355)
Members' contributions	(11)	–	–	(11)
Past service cost – plan amendments	(10)	–	–	(10)
Settlements	–	68	–	68
Actuarial gain due to changes in financial assumptions	1,348	202	7	1,557
Actuarial gain due to changes in demographic assumptions	–	29	2	31
Experience gains/(losses)	224	(4)	1	221
Interest expense	(926)	(174)	(6)	(1,106)
Foreign exchange translation	–	(230)	(8)	(238)
Benefits paid	920	187	7	1,114
Defined benefit obligations at 31 December 2015	**(25,033)**	**(4,203)**	**(145)**	**(29,381)**

Amounts recognised in the income statement after allocation to equity accounted investments and other participating employers

	2015				2014			
	UK defined benefit pension schemes £m	**US and other pension schemes £m**	**US healthcare schemes £m**	**Total £m**	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Included in operating costs:								
Current service cost	**(177)**	**(11)**	**(2)**	**(190)**	(156)	(9)	(1)	(166)
Past service cost – plan amendments	**(10)**	**–**	**–**	**(10)**	(3)	(1)	–	(4)
Settlements	**–**	**4**	**–**	**4**	–	–	–	–
	(187)	**(7)**	**(2)**	**(196)**	(159)	(10)	(1)	(170)
Administrative expenses	**–**	**(12)**	**(1)**	**(13)**	(25)	(9)	(1)	(35)
	(187)	**(19)**	**(3)**	**(209)**	(184)	(19)	(2)	(205)
Included in finance costs:								
Net interest (expense)/income on retirement benefit obligations	**(161)**	**(32)**	**1**	**(192)**	(135)	(14)	2	(147)
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	**(10)**	**–**	**–**	**(10)**	(8)	–	–	(8)
Group's share of equity accounted investments' finance costs	**(6)**	**–**	**–**	**(6)**	(5)	–	–	(5)

Notes to the Group accounts
continued

20. Retirement benefit obligations continued

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2015 and keeping all other assumptions as set out on page 142.

Financial assumptions

Changes in the following financial assumptions would have the following effect on the defined benefit pension obligation before allocation to equity accounted investments and other participating employers:

	(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 analysis does not allow for the impact of the Group's risk management activities in respect of interest rate and inflation risk (see page 141) on the valuation of the assets. Across all of its pension schemes, the Group is hedged against approximately 35% and 40% of interest rate and inflation risk, respectively, measured relative to the funding liabilities. The Group's US schemes are not indexed with inflation.

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 (rate of increase in salaries, rate of increase in deferred pensions and rate of increase in pensions in payment) 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	(1.6)
0.5 percentage point decrease	1.6
1.0 percentage point increase	(3.2)
1.0 percentage point decrease	3.0

Demographic assumptions

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements (see longevity risk on page 141), 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

21. 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	50	46	281	59	436
Current	30	91	135	59	315
At 1 January 2015	80	137	416	118	751
Created	43	52	69	24	188
Utilised	(30)	(95)	(52)	(24)	(201)
Released	(10)	(29)	(41)	(34)	(114)
Reclassification between categories	–	–	14	(14)	–
Net present value adjustments	–	–	14	3	17
Foreign exchange adjustments	2	–	9	3	14
At 31 December 2015	**85**	**65**	**429**	**76**	**655**
Represented by:					
Non-current	48	–	278	28	354
Current	37	65	151	48	301
	85	**65**	**429**	**76**	**655**

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
There are no individually significant provisions included within other provisions.

Notes to the Group accounts continued

22. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2014	3,536	89	1	1	89
Repurchased and cancelled	(67)	(2)	–	–	(2)
At 31 December 2014	3,469	87	1	1	87
Repurchased and cancelled	(2)	–	–	–	–
At 31 December 2015	**3,467**	**87**	**1**	**1**	**87**

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 2015, 1,450,000 (2014 67,417,000) ordinary shares of 2.5p were repurchased under the three-year buyback programme announced in February 2013 and such repurchased shares have been cancelled.

Treasury shares
As at 31 December 2015, 301,808,103 (2014 315,826,614) ordinary shares of 2.5p each with an aggregate nominal value of £7,545,203 (2014 £7,895,665) were held in treasury. During 2015, 14,018,511 (2014 11,818,338) treasury shares were used to satisfy awards and options under the Share Incentive Plan, International Share Incentive 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. Dividend waivers were in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and November 2015.

At 31 December 2015, the ESOP held 897,873 (2014 1,509,844) ordinary shares of 2.5p each, with a market value of £4m (2014 £7m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was also in operation for the dividends paid in June and November 2015 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.

	2015 £m	2014 £m
Prior year final 12.3p dividend per ordinary share paid in the year (2014 12.1p)	**389**	383
Interim 8.4p dividend per ordinary share paid in the year (2014 8.2p)	**266**	259
	655	642

After the balance sheet date, the directors proposed a final dividend of 12.5p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 1 June 2016 to shareholders registered on 22 April 2016. The ex-dividend date is 21 April 2016.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 10 May 2016.

22. Share capital and other reserves continued

Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Capital redemption reserve £m	Hedging reserve £m	Translation reserve £m	Total £m
At 1 January 2014	4,589	202	10	1	31	35	4,868
Currency translation on foreign currency net investments:							
Subsidiaries	–	–	–	–	–	277[1]	277[1]
Equity accounted investments	–	–	–	–	–	(13)[1]	(13)[1]
Amounts charged to hedging reserve	–	–	–	–	(92)	–	(92)
Tax on other comprehensive income	–	–	–	–	19	–	19
Net purchase of own shares	–	–	–	2	–	–	2
At 31 December 2014	4,589	202	10	3	(42)	299	5,061
Currency translation on foreign currency net investments:							
Subsidiaries	–	–	–	–	–	261	261
Equity accounted investments	–	–	–	–	–	(45)	(45)
Reclassification of cumulative currency translation reserve on disposal	–	–	–	–	–	20	20
Amounts charged to hedging reserve	–	–	–	–	(25)	–	(25)
Tax on other comprehensive income	–	–	–	–	5	–	5
At 31 December 2015	**4,589**	**202**	**10**	**3**	**(62)**	**535**	**5,277**

1. Restated.

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.

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 2015, 1,450,000 (2014 67,417,000) ordinary shares with a nominal value of £nil (2014 £2m) were repurchased and have been subsequently cancelled.

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.

Translation reserve
The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

Capital
The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2015, the Group's capital was £3,064m (2014 £1,919m), which comprises total equity of £3,002m (2014 £1,877m), excluding amounts accumulated in equity relating to cash flow hedges of £62m (2014 £42m). Net debt (as defined by the Group) was £1,422m (2014 £1,032m).

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 7);
- making accelerated returns of capital to shareholders when the balance sheet allows and only when the return from doing so is in excess of the Group's Weighted Average Cost of Capital; and
- investing in value-enhancing acquisitions, where market conditions are right and where they deliver on the Group's strategy.

Notes to the Group accounts continued

23. Cash flow analysis

Operating business cash flow

	2015 £m	2014 £m
Cash inflow from operating activities	**924**	913
Purchase of property, plant and equipment, and investment property	**(359)**	(263)
Purchase of intangible assets	**(54)**	(59)
Proceeds from sale of property, plant and equipment, and investment property	**136**	539
Proceeds from sale of non-current other investments	**1**	–
Equity accounted investment funding	**(8)**	(2)
Dividends received from equity accounted investments	**41**	63
Operating business cash flow	**681**	1,191

	2015 £m	2014[1] £m
Electronic Systems	**323**	246
Cyber & Intelligence	**93**	125
Platforms & Services (US)	**100**	147
Platforms & Services (UK)	**220**	173
Platforms & Services (International)	**164**	881
HQ	**(219)**	(381)
Operating business cash flow	**681**	1,191

1. Re-presented for the reallocation of the Integrated Electronics & Warfare Systems activities from Platforms & Services (US) to Cyber & Intelligence.

Cash flows from acquisitions and disposals

	2015 £m	2014 £m
Proceeds from sale of subsidiary undertakings	**34**	–
Cash and cash equivalents disposed of with subsidiary undertakings	**(13)**	–
Proceeds from sale of subsidiary undertakings (net of cash disposed)	**21**	–
Purchase of subsidiary undertakings	**(5)**	(233)
Cash and cash equivalents acquired from purchase of subsidiary undertakings	**–**	3
Acquisitions and disposals	**16**	(230)

24. 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[1].

Movement in net (debt)/cash (as defined by the Group)

	Notes	2015 £m	2014 £m
Operating business cash flow	23	**681**	1,191
Interest		**(173)**	(145)
Taxation		**(116)**	(92)
Free cash inflow		**392**	954
Acquisitions and disposals	23	**16**	(230)
Net sale/(purchase) of own shares		**1**	(281)
Equity dividends paid		**(655)**	(642)
Dividends paid to non-controlling interests		**(40)**	(14)
Cash inflow from matured derivative financial instruments		**12**	8
Cash inflow from movement in cash collateral		**3**	10
Cash inflow from loans		**1,625**	679
Cash outflow from repayment of loans		**(1,135)**	(398)
Net increase in cash and cash equivalents		**219**	86
Foreign exchange adjustments		**(165)**	(146)
Other non-cash movements		**46**	13
Less: Cash classified as held for sale		**–**	(6)
Less: Movement in cash received on customers' account[1]		**–**	1
Less: Cash inflow from loans		**(1,625)**	(679)
Less: Cash outflow from repayment of loans		**1,135**	398
Movement in net debt (as defined by the Group)		**(390)**	(333)
Opening net debt (as defined by the Group)		**(1,032)**	(699)
Closing net debt (as defined by the Group)		**(1,422)**	(1,032)

Components of net (debt)/cash (as defined by the Group)

	Notes	2015 £m	2014 £m
Debt-related derivative financial instrument assets – non-current	13	**53**	10
Cash and cash equivalents	16	**2,537**	2,314
Less: Cash classified as held for sale		**–**	(6)
Cash (as defined by the Group)	17	**2,590**	2,318
Loans – non-current	18	**(3,775)**	(2,868)
Loans and overdrafts – current	18	**(237)**	(482)
Debt (as defined by the Group)		**(4,012)**	(3,350)
Net debt (as defined by the Group)		**(1,422)**	(1,032)

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

25. Acquisition and disposal of subsidiaries

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, Business Combinations.

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.

Subsidiaries acquired during 2015
In June, the Group completed the acquisition of Eclipse Electronic Systems, Inc., a provider of advanced Intelligence, Surveillance and Reconnaissance products and services, for cash consideration of $8m (£5m).

Subsidiaries disposed of during 2015
In April, the Group completed the sale of its 75% holding in BAE Systems Land Systems South Africa (Pty) Limited for cash consideration of 655 million Rand (£36m).

	£m	£m
Cash consideration		36
Transaction costs paid		(2)
Cash proceeds		**34**
Net assets disposed:		
Intangible assets	(19)	
Property, plant and equipment	(9)	
Inventories	(7)	
Trade and other receivables	(9)	
Deferred tax assets	(3)	
Cash and cash equivalents	(13)	
Trade and other payables	8	
Deferred tax liabilities	2	
Provisions	6	
		(44)
Non-controlling interest disposed		6
Cumulative currency translation loss		(20)
Loss on disposal of businesses		**(24)**

Subsidiaries acquired during 2014
In 2014, the Group acquired Perimeter Internetworking Corp., trading as SilverSky; an additional 59% shareholding in Saudi Development and Training Company; and Signal Innovations Group, Inc. For all acquisitions made during 2014, there were no adjustments made in 2015 to the provisional fair values.

26. 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

		2015		2014	
	Notes	**Carrying amount £m**	**Fair value £m**	Carrying amount £m	Fair value £m
Financial instruments measured at fair value:					
Non-current					
Available-for-sale financial assets		**6**	**6**	7	7
Other receivables[1]	12	**234**	**234**	238	238
Other financial assets	13	**107**	**107**	38	38
Other financial liabilities	13	**(72)**	**(72)**	(79)	(79)
Loans	18	**(346)**	**(346)**	(325)	(325)
Trade and other payables[1]	19	**(264)**	**(264)**	(262)	(262)
Current					
Other financial assets	13	**105**	**105**	46	46
Other financial liabilities	13	**(130)**	**(130)**	(107)	(107)
Financial instruments not measured at fair value:					
Non-current					
Loans	18	**(3,429)**	**(3,704)**	(2,543)	(2,900)
Current					
Cash and cash equivalents	16	**2,537**	**2,537**	2,308	2,308
Loans and overdrafts	18	**(237)**	**(241)**	(482)	(494)

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 2015 is £4,291m (2014 £3,719m).

Notes to the Group accounts
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27. 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% (2014 50%) and a maximum of 90% (2014 90%) of gross debt is maintained at fixed interest rates. At 31 December 2015, the Group had 83% (2014 81%) of fixed rate debt and 17% (2014 19%) of floating rate debt based on a gross debt of £4.0bn, including debt-related derivative financial assets (2014 £3.3bn).

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	2,537	–	–
Loans and overdrafts	(681)	(681)	(681)

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 2015, the Group had a total of $1.0bn (2014 $1.0bn) of this type of swap outstanding with a weighted average duration of 3.6 years (2014 4.6 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 11.5 years (2014 10.1 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 3.5% (2014 4.1%) on US dollars. The cost of the fixed rate debt was 4.9% (2014 5.4%).

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 £7m (2014 £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 £7m (2014 £9m).

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 2015					31 December 2014				
		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
Loans and overdrafts	**(4,012)**	**(431)**	**(1,698)**	**(3,939)**	**(6,068)**	(3,350)	(655)	(1,420)	(2,926)	(5,001)
(Sale)/purchase contracts:										
US dollar		**(299)**	**(217)**	**50**	**(466)**		(39)	(41)	71	(9)
Euro		**814**	**238**	**27**	**1,079**		707	761	47	1,515
Sterling		**(555)**	**(89)**	**(77)**	**(721)**		(696)	(696)	(118)	(1,510)
Other		**35**	**55**	**–**	**90**		24	(27)	–	(3)
Cash flow hedges – foreign exchange contracts	**(96)**	**(5)**	**(13)**	**–**	**(18)**	(107)	(4)	(3)	–	(7)
Purchase/(sale) contracts:										
US dollar		**2,133**	**(4)**	**–**	**2,129**		1,399	(9)	–	1,390
Euro		**441**	**–**	**–**	**441**		507	–	–	507
Sterling		**(2,672)**	**4**	**–**	**(2,668)**		(2,044)	9	–	(2,035)
Other		**98**	**–**	**–**	**98**		138	–	–	138
Interest rate contracts		**3**	**(1)**	**–**	**2**		4	(4)	–	–
Other foreign exchange/interest rate contracts	**53**	**3**	**(1)**	**–**	**2**	(5)	4	(4)	–	–
Debt-related derivative financial instruments	**53**	**6**	**11**	**55**	**72**	10	6	2	23	31
Other financial assets and liabilities	**10**	**4**	**(3)**	**55**	**56**	(102)	6	(5)	23	24

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.

27. Financial risk management continued

Borrowing facilities

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2015, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2014 £2bn). The RCF is contracted until 2018 at £2bn and from 2018 to 2020 at £1.9bn. The RCF was undrawn throughout the year. The RCF also acts as a back stop to Commercial Paper issued by the Group. At 31 December 2015, the Group had no Commercial Paper in issue (2014 £nil).

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 2015 of £2,537m (2014 £2,308m) was invested with 35 (2014 30) financial institutions. A credit limit is allocated to each institution taking account of its market capitalisation, credit rating and credit default swap price.

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, Saudi Riyal and Australian dollar.

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 12% of the balance (2014 7%).

The ageing of trade receivables is detailed below:

	2015			2014		
	Gross £m	**Provision £m**	**Net £m**	Gross £m	Provision £m	Net £m
Not past due and not impaired	**807**	**–**	**807**	611	–	611
Up to 180 days overdue and not impaired	**376**	**–**	**376**	266	–	266
Past 180 days overdue and not impaired	**101**	**–**	**101**	58	–	58
Past 180 days overdue and impaired	**25**	**(25)**	**–**	28	(28)	–
	1,309	**(25)**	**1,284**	963	(28)	935

Movements on the provision for bad debts are as follows:

	2015 £m	2014 £m
At 1 January	**28**	27
Created	**8**	15
Utilised	**(3)**	(4)
Released	**(9)**	(11)
Foreign exchange adjustments	**1**	1
At 31 December	**25**	28

Notes to the Group accounts
continued

28. 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 73 to 86.

Expense in year

	2015 Equity-settled £m	2014 Equity-settled £m
Executive Share Option Plan	**6**	4
Performance Share Plan	**6**	5
Restricted Share Plan	**4**	5
	16	14

The Group also incurred a charge of £28m (2014 £28m) in respect of the equity-settled all-employee free shares and matching Partnership Shares elements of the Share Incentive Plan.

Executive Share Option Plan

	2015		2014	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Equity-settled options				
Outstanding at the beginning of the year	**35,594**	**3.70**	30,959	3.52
Granted during the year	**9,349**	**5.25**	10,578	4.12
Exercised during the year	**(9,838)**	**3.38**	(1,644)	3.07
Expired during the year	**(2,940)**	**3.52**	(4,299)	3.71
Outstanding at the end of the year	**32,165**	**4.26**	35,594	3.70
Exercisable at the end of the year	**4,307**	**3.30**	3,633	4.30
Cash-settled share appreciation rights				
Outstanding at the beginning of the year	**694**	**2.69**	1,802	2.38
Exercised during the year	**(678)**	**2.69**	(1,078)	2.19
Expired during the year	**(16)**	**2.71**	(30)	2.07
Outstanding at the end of the year	**–**	**–**	694	2.69
Exercisable at the end of the year	**–**	**–**	694	2.69

	2015		2014	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	**3.01 – 5.43**	**–**	2.64 – 4.79	2.64 – 3.56
Weighted average remaining contracted life (years)	**8**	**–**	8	–
Weighted average fair value of options granted (£)	**0.76**	**–**	0.64	–

28. Share-based payments continued

Performance Share Plan, Share Matching Plan and Restricted Share Plan

	Performance Share Plan		Share Matching Plan		Restricted Share Plan	
	2015 Number of shares '000	2014 Number of shares '000	**2015 Number of shares '000**	2014 Number of shares '000	**2015 Number of shares '000**	2014 Number of shares '000
Outstanding at the beginning of the year	**18,868**	21,693	**5,618**	11,201	**3,760**	6,070
Granted during the year	**7,167**	8,678	**–**	–	**1,218**	1,205
Exercised during the year	**(335)**	(637)	**–**	–	**(1,876)**	(2,872)
Expired during the year	**(6,038)**	(10,866)	**(3,366)**	(5,583)	**(255)**	(643)
Outstanding at the end of the year	**19,662**	18,868	**2,252**	5,618	**2,847**	3,760
Exercisable at the end of the year	**204**	266	**–**	–	**–**	–

	2015	2014	**2015**	2014	**2015**	2014
Weighted average remaining contracted life (years)	**5**	5	**–**	1	**5**	5
Weighted average fair value of awards granted (£)	**4.49**	3.01	**–**	–	**5.12**	4.12

All awards are equity-settled.

The exercise price for the Performance Share Plan and Restricted Share Plan is £nil (2014 £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

	2015	2014
Range of share price at date of grant (£)	**4.38 – 5.43**	4.12 – 4.51
Expected option/award life (years)	**3 – 10**	3 – 10
Volatility (%)	**20 – 21**	21 – 24
Risk free interest rate (%)	**0.5 – 0.9**	1.0 – 1.2

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 £4.87 (2014 £4.33).

Notes to the Group accounts
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29. Related party transactions

The Group has a related party relationship with its directors and key management personnel (see below), equity accounted investments (note 11) and pension schemes (note 20).

Transactions occur with the equity accounted investments in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party[1]		Management recharges[1]	
Related party	**2015 £m**	2014 £m	**2015 £m**	2014 £m	**2015 £m**	2014 £m	**2015 £m**	2014 £m	**2015 £m**	2014 £m
Advanced Electronics Company Limited	**22**	9	**46**	56	**–**	–	**–**	–	**–**	–
CTA International SAS	**15**	3	**–**	–	**11**	2	**–**	–	**–**	–
Eurofighter Jagdflugzeug GmbH	**1,417**	1,087	**–**	11	**37**	64	**65**	77	**–**	–
FADEC International LLC	**72**	74	**–**	–	**–**	–	**–**	–	**–**	–
Gripen International KB	**–**	–	**–**	–	**19**	15	**14**	14	**–**	–
MBDA SAS	**23**	22	**286**	90	**6**	6	**367**	403	**17**	17
Panavia Aircraft GmbH	**53**	34	**47**	44	**2**	5	**–**	–	**–**	–
Saudi Development and Training Company Limited (SDT)[2]	**n/a**	–	**n/a**	8	**n/a**	n/a	**n/a**	n/a	**n/a**	–
	1,602	1,229	**379**	209	**75**	92	**446**	494	**17**	17

1. Also relates to disclosures under IAS 24, Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2015, £405m (2014 £453m) was owed by BAE Systems plc and £41m (2014 £41m) by other Group subsidiaries.
2. 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 73 to 86. Total emoluments for directors and key management personnel charged to the Consolidated income statement were:

	2015 £'000	2014 £'000
Short-term employee benefits	**14,831**	14,383
Post-employment benefits	**2,021**	1,678
Termination benefits	**–**	1,702
Share-based payments	**4,144**	3,320
	20,996	21,083

30. Contingent liabilities and commitments

Guarantees and performance bonds
The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business 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:

	2015 £m	2014 £m
Payments due:		
Not later than one year	**222**	213
Later than one year and not later than five years	**710**	678
Later than five years	**779**	810
	1,711	1,701
Total of future minimum sublease income under non-cancellable subleases	**139**	159

Capital commitments
Capital expenditure contracted for but not provided for in the accounts is as follows:

	2015 £m	2014 £m
Property, plant and equipment[1]	**264**	142
Intangible assets	**8**	3
	272	145

1. Includes £99m (2014 £nil) at Barrow-in-Furness, UK, relating to the Successor submarine programme funded by the UK government.

Notes to the Group accounts continued

31. Information about related undertakings

In accordance with Section 409 of the Companies Act 2006, a full list of subsidiaries and equity accounted investments as at 31 December 2015 is disclosed below. Unless otherwise stated, the Group's shareholding represents ordinary shares held indirectly by BAE Systems plc, the year end is 31 December and the address of the registered office is Warwick House, PO Box 87, Farnborough Aerospace Centre, Farnborough, Hampshire GU14 6YU, United Kingdom. No subsidiary undertakings have been excluded from the consolidation.

Subsidiaries – wholly-owned

4219 Lafayette, LLC[21]
4219-120 Lafayette Center Drive, Chantilly VA 20151, United States

Aerosystems International Limited
Lupin Way, Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Alabama Dry Dock and Shipbuilding, LLC[21]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

Alvis Pension Scheme Trustees Limited

Alvis Limited

Alvis Vickers Limited

Armor Holdings Inc.[6]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

Armstrong Whitworth Aircraft Limited[1]

Atlantic-Alabama Holding Company, LLC[21]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

Australian Marine Engineering Corporation (Finance) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Avro International Aerospace Limited[1]

BAE Systems (Aberdeen) Limited[13,15]
Saltire Court, 20 Castle Terrace, Edinburgh EH1 2EG, United Kingdom

BAE Systems (Al Diriyah C4i) Limited[1]

BAE Systems (Aviation Services) Limited

BAE Systems (Bristol House) Limited[1,11,15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems (Canada) Inc.
220 Laurier Avenue West, Suite 1200, Ottawa ON K1P 5Z9, Canada

BAE Systems (Combat and Radar Systems) Limited
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

BAE Systems (Consultancy Services) Limited

BAE Systems (Corporate Air Travel) Limited

BAE Systems (CS&SI – Qatar) Limited[1]

BAE Systems (Defence Systems) Limited

BAE Systems (Dynamics) Limited

BAE Systems (Farnborough 1) Limited

BAE Systems (Farnborough 2) Limited

BAE Systems (Farnborough 3) Limited

BAE Systems (Finance) Limited

BAE Systems (Funding Two) Limited

BAE Systems (Funding Three) Limited

BAE Systems (Gripen Overseas) Limited

BAE Systems (Hawk Synthetic Training) Limited

BAE Systems (Holdings) Limited[1]

BAE Systems (Insurance) Limited

BAE Systems (International) Limited

BAE Systems (Jersey) Limited[1]
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

BAE Systems (Kazakhstan) Limited

BAE Systems (Land and Sea Systems) Limited[11]

BAE Systems (Malaysia) Sdn Bhd
16th Floor, Wisma Sime Darby, Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia

BAE Systems (MEH) Limited

BAE Systems (Military Air) Overseas Limited

BAE Systems (Moose Jaw) Inc.[1,5]
LeBlanc Nichols, The Chambers, 1000-300 Terry Fox Drive, Ottawa ON K2K 0E3, Canada

BAE Systems (Nominees) Limited[1]

BAE Systems (Oman) Limited

BAE Systems (Operations) Limited[10]

BAE Systems (Operations) Singapore Pte Limited
One Marina Boulevard #28-00, Singapore 018989, Singapore

BAE Systems (Overseas Holdings) Limited

BAE Systems (Poland) Sp. z o.o.
ul. Abp. A. Baraniaka 88, 61-131 Poznan, Poland

BAE Systems (Projects) Limited

BAE Systems (Property Investments) Limited

BAE Systems (Stanmore) Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems (Sweden) AB[16]
c/o Advokatfirman DLA Nordic KB, Box 7315, SE-103 90 Stockholm, Sweden

BAE Systems (Vehicles and Equipment) Limited

BAE Systems 2000 Pension Plan Trustees Limited[1]

BAE Systems AB[13]
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Al Diriyah Programme Limited[1]

BAE Systems Applied Intelligence (Asia Pacific) Pte Limited
United Square, 101 Thomson Road, #25-03/04, 307591, Singapore

BAE Systems Applied Intelligence (Australia) Pty Limited
Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia

BAE Systems Applied Intelligence (Belgium) NV
Geldenaaksebaan 329, B-3001, Heverlee, Leuven, Belgium

BAE Systems Applied Intelligence Canada Inc.
1959 Upper Water Street, Suite 900, Halifax NS B3J 2X2, Canada

BAE Systems Applied Intelligence (Connect) A/S
Bouet Mollevej 3-5, 9400 Norresundby, Denmark

BAE Systems Applied Intelligence Inc.[5]
5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States

BAE Systems Applied Intelligence GCS Inc.[6]
1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States

BAE Systems Applied Intelligence (GCS) Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence (Integration) Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence (International) Limited
Priestley Road, Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence (Ireland) Limited
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

BAE Systems Applied Intelligence (Luxembourg) SARL
1 Boulevard de la Foire, L-1528 Luxembourg, Luxembourg

BAE Systems Applied Intelligence (Malaysia) Sdn Bhd
16th Floor, Wisma Sime Darby, Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia

BAE Systems Applied Intelligence (Spain) S.A.
Paseo de la Castellana, 141, Cuzco IV, 28046 Madrid, Spain

BAE Systems Applied Intelligence (UK) Limited

BAE Systems Applied Intelligence A/S
Bouet Mollevej 3, 9400 Norresundby, Denmark

BAE Systems Applied Intelligence France SAS
112 Avenue Kleber, 75016, Paris, France

BAE Systems Applied Intelligence Limited
Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom

BAE Systems Applied Intelligence LLC[21]
8200 Greensboro Drive, 9th Floor, McLean VA 22102, United States

BAE Systems Applied Intelligence New Zealand Limited
c/o Russell McVeagh, Vero Centre, 48 Shortland Street, Auckland Central, 1140, New Zealand

BAE Systems Applied Intelligence Pty Limited
Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia

BAE Systems Applied Intelligence US Corp[6]
440 Wheelers Farms Road, Suite 202, Milford CT 06461, United States

BAE Systems Australia Datagate Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Defence Holdings Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Defence Pty Limited[14]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (Electronic Systems) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (NSW) Holdings Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (NSW) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (Singapore) Pte Limited[19]
c/o Koh Choo Services Pte Ltd, 150 Cecil Street #15-01, Singapore 069543, Singapore

BAE Systems Australia Holdings Limited[1]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Logistics Pty Limited[10]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Sea Sentinel Project Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Avionics Overseas Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Avionics Singapore Pte Limited
One Marina Boulevard, #28-00, Singapore 018989, Singapore

BAE Systems Bofors AB
SE-691 80 Karlskoga, Sweden

BAE Systems Bofors Holdings Sdn Bhd
Level 21, Suite 21.01, The Gardens South Tower, Mid Valley City, Lingkaran Syed Putra, 59200 Kuala Lumpur, Malaysia

BAE Systems Capital Limited[1]
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

BAE Systems China (Exports) Limited

BAE Systems C-ITS AB
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Command and Control Limited[10,15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Communications Limited[1]

BAE Systems Communications Solutions, LLC[21]
PO Box 111, Knowledge Oasis Muscat, Building 4, 2nd Floor, Muscat, Oman

31. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Controls Inc.[5]
1098 Clark Street, Endicott NY 13760, United States

BAE Systems Creole Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Datagate Limited

BAE Systems Datagate Holdings Limited

BAE Systems Defence Limited[1]

BAE Systems Deployed Systems Limited[2]

BAE Systems Detica GmbH
Pfingstweidstrasse 3, 60316 Frankfurt am Main, Germany

BAE Systems Display Technologies Limited

BAE Systems do Brasil Ltda
SCN Quadra 5 Bloco A, Ed. Brasilia Shopping, Torre Norte, Sala 426, Brasilia, DF CEP:70715-900, Brazil

BAE Systems Electronic Systems (Overseas) Limited

BAE Systems Electronics Limited

BAE Systems Enterprises Limited

BAE Systems Executive Pension Scheme Trustees Limited[1]

BAE Systems Finance (Ireland)[22]
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

BAE Systems Finance B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

BAE Systems Finance Inc.[6]
45479 Holiday Drive, Sterling VA 20166, United States

BAE Systems Flight Training (Australia) Pty Limited[10]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Funds Management[1,22]

BAE Systems Global Combat Systems Bridging Limited

BAE Systems Global Combat Systems Limited

BAE Systems Global Combat Systems Munitions Limited

BAE Systems Global Mobility LLC[21]
1300 Wilson Blvd., Arlington VA 22209, United States

BAE Systems Global Tactical Systems LLC[21]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Hägglunds AB
SE-691 80, Karlskoga, Sweden

BAE Systems Hawaii Shipyards Inc.[6]
3049 Ualena Street, Suite 915, Honolulu HI 96819, United States

BAE Systems Holdings (South Africa) (Pty) Limited
Central Office Park No. 5, 257 Jean Avenue, Centurion, Gauteng, 0157, South Africa

BAE Systems Holdings B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

BAE Systems Holdings Germany GmbH[7]
c/o Heuking Kühn Lüer Wojtek, Neuer Wall 63, 20354 Hamburg, Germany

BAE Systems Holding GmbH
Hauptstrasse 48, 82433 Bad Kohlgrub, Germany

BAE Systems Holdings Inc.[5]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Holdings International LLC[21]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Imaging Solutions Inc.[5]
1841 Zanker Road, Suite 50, San Jose CA 95112, United States

BAE Systems, Inc.[6]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems India (Services) Private Limited[17]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems India (Homeland Security) Private Limited[17]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems India (Technology) Private Limited[17]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems India (Ventures) Private Limited[17]
2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India

BAE Systems InFlight Systems (Overseas) Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Information and Electronic Systems Integration Inc.[6]
65 Spit Brook Road, Nashua NH 03061, United States

BAE Systems Information Solutions Inc.[6]
8201 Greensboro Drive, McLean VA 22102, United States

BAE Systems Insurance (Isle of Man) Limited
Tower House, Loch Promenade, Douglas, IM1 2LZ, Isle of Man, United Kingdom

BAE Systems Insyte Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Integrated System Technologies (KSA) Limited

BAE Systems Integrated System Technologies (Overseas) Limited

BAE Systems Integrated System Technologies GmbH
Hans-Stießberger-Str. 2b, 85540 Haar, Germany

BAE Systems Integrated System Technologies Limited

BAE Systems International Inc.[5]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Land & Armaments Holdings Inc.[6]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land & Armaments Inc.[6]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land & Armaments L.P.[21]
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

BAE Systems Land Systems ATF Limited

BAE Systems Land Systems (Finance) Limited

BAE Systems Land Systems FMTV International Inc.[7]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Land Systems (Investments AVG) Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

BAE Systems Land Systems (Investments South Africa) Limited

BAE Systems Land Systems (Investments) Limited

BAE Systems Land Systems (Logistics) Limited

BAE Systems Land Systems Pinzgauer Limited

BAE Systems Land Systems Pinzgauer (Holdings) Limited

BAE Systems Land Systems (Ranges) Limited

BAE Systems Land Systems (Singapore Investments) Limited

BAE Systems Logistica Ltda
SCN Quadra 5 Bloco A, Ed. Brasilia Shopping, Torre Norte, Sala 426, Brasilia, DF CEP:70715-900, Brazil

BAE Systems Marine (Holdings) Limited

BAE Systems Marine (YSL) Limited

BAE Systems Marine Limited

BAE Systems Maritime Engineering & Services Inc.[6]
7330 Engineer Road, Suite A, San Diego CA 92111, United States

BAE Systems Norfolk Ship Repair Inc.[6]
750 West Berkley Avenue, Norfolk VA 23523, United States

BAE Systems Oman LLC[21]
PO Box 74, Postal Code 111, Seeb, Oman

BAE Systems Ordnance Systems Inc.[6]
4509 West Stone Drive, Kingsport TN 37660-9982, United States

BAE Systems Overseas Inc.[6]
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems PAMCO Services International Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Pension Funds CIF Trustees Limited[1]

BAE Systems Pension Funds Investment Management Limited[1,18]

BAE Systems Pension Funds Trustees Limited[1]

BAE Systems Project Services Limited

BAE Systems Projects (Canada) Limited

BAE Systems Properties Limited

BAE Systems Protection Systems Inc.[7]
7822 South 46th Street, Phoenix AZ 85044, United States

BAE Systems Quest Limited[1]

BAE Systems Regional Aircraft (Japan) KK[6]
Minami Azabu T&F Building 8th Floor, 4-11-22 Minami Azabu, Minato-ku, Tokyo, Japan

BAE Systems Regional Aircraft Colombia SAS
c/o Brigard & Urrutia, Calle 70 A No. 4-41, Bogota, Colombia

BAE Systems Resolution Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems RO Defense Inc.[6]
1801 Electronics Drive, Anniston AL 36207, United States

BAE Systems Rokar International Limited
PO Box 45059, 11 Hartom Street, Mount Hotzvim, 91450 Jerusalem, Israel

BAE Systems S&S Holdings Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems S&S Operations Inc.[6]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems San Diego Ship Repair Inc.[6]
2205 East Belt Street, Foot of Sampson Street, San Diego CA 92113, United States

BAE Systems San Francisco Ship Repair Inc.[6]
Foot of 20th Street at Illinois Street, San Francisco CA 94107-7644, United States

BAE Systems Saudi Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

BAE Systems Saudi Arabia (Maintenance and Equipment Services) Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

BAE Systems Saudi Arabia (Vehicles and Equipment Holdings) Limited[1]

BAE Systems Saudi Arabia (Vehicles and Equipment Nominees) Limited[1]

BAE Systems Shared Services Inc.[6]
11215 Rushmore Drive, Charlotte NC 28277, United States

BAE Systems Shared Services (Overseas) Limited

BAE Systems Share Plans Trustee Limited[1]

BAE Systems Ship Repair Inc.[6]
750 West Berkley Ave., Norfolk VA 23523, United States

BAE Systems Southeast Shipyards Alabama LLC[21]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

BAE Systems Southeast Shipyards AMHC Inc.[6,21]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Southeast Shipyards Jacksonville LLC[21]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Southeast Shipyards Mayport LLC[21]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems SSY Alabama Property Holdings LLC[21]
PO Box 3202, Main Gate, Dunlap Drive, Mobile AL 36652, United States

BAE Systems SSY Floating Dry Dock Holdings LLC[21]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems SSY Florida Property Holdings LLC[21]
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Surface Ships (Holdings) Limited

BAE Systems Surface Ships Limited

BAE Systems Surface Ships (Projects) Limited

BAE Systems Surface Ships Intermediate Holdings Limited

BAE Systems Surface Ships Integrated Support Limited

BAE Systems Surface Ships International Limited[13]

BAE Systems Surface Ships Maritime Limited

BAE Systems Surface Ships Portsmouth Limited[13]

BAE Systems Surface Ships Projects (Malaysia) Sdn Bhd
Level 14, West Block, Wisma Selangor Dredging, 142-C, Jalan Ampang, 50450 Kuala Lumpur, Malaysia

BAE Systems Surface Ships Property Services Limited

BAE Systems Surface Ships Support Limited[10]

BAE Systems Surface Ships Hellas A.E.[16]
3 Strategiou Tombra Street, Aghia Paraskevi, GR 153 42 Athens, Greece

Notes to the Group accounts continued

31. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Surface Ships (Overseas) Limited

BAE Systems SWS Defence AB
SE-691 80 Karlskoga, Sweden

BAE Systems Tactical Vehicle Systems LP[21]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Technology Solutions & Services Inc.[6]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Training Services Limited

BAE Systems TVS Holdings Inc.[6]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems TVS Holdings LLC[21]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems TVS Inc.[7]
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Zephyr Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Fifth Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Fourth Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Second Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

BAE Systems Zephyr Third Corporation[5]
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

Brabazon Limited

British Aerospace (Far East) Limited[20]
Level 54, Hopewell Centre, 183 Queen's Road East, Hong Kong

British Aerospace (Malaysia) Sdn Bhd[20]
Unit 30-01, Level 30, Tower A, Vertical Business Suite, Avenue 3, Bangsar South, No.8, Jalan Kerinchi, 59200 Kuala Lumpur, Malaysia

British Aircraft Corporation (Pension Fund Trustees) Limited[1]

British Aircraft Corporation Limited[1]

Buckfield Properties Limited

Camtro Limited[12,15]
15 Canada Square, London E14 5GL, United Kingdom

Cashhold Limited[1,10]

CPS International, Inc.[7]
c/o Benedetti & Benedetti, Comosa Building, 21st Floor, Ave. Samuel Lewis, PO Box 850120, Panama 5, Panama

Creole (Nigeria) Limited[10]
Tapa House (2nd Floor), 45, Imman Dauda St (Abosede Kuboye Crescent Entrance) Surulere, Lagos, Nigeria

Detica B.V.
Luna ArenA, Herikerbergweg 238, 1101 CM Amsterdam, Netherlands

Detica Group Holdings (Ireland) Limited
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

Detica Group Limited

Detica Holdings Limited[15]
8 Salisbury Square, London EC4Y 8BB, United Kingdom

Detica Ireland Limited[13]
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

Detica Mexico S. de R.L. de C.V.
Torre Esmeralda II, Blvd Manuel Avila Camacho No. 36 Piso 18, Lomas de Chapultepec, 11000 D.F., Mexico

Detica Patent Limited
Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland

Detica Services, Inc.
8200 Greensboro Drive, 9th Floor, McLean VA 22102, United States

ETI Engineering, Inc.[6]
1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States

Gloster Aircraft Limited[1]

Granada Enterprises Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

Hägglunds Vehicle GmbH
Ernst-Grote Strasse 13, 30916 Isernhagen, Germany

Hawker Siddeley Aviation Limited[1]

Hawker Siddeley Dynamics Limited[1]

H-B Utveckling, H-B Development AB
Nybrogatan 7, SE-114 34 Stockholm, Sweden

Hertfordshire Estates Limited[10]

HSA/HSD Pension Fund Trustees Limited[1]

Hunter Aerospace Corporation Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

International Military Sales Limited

Jetstream Aircraft Limited[1]
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Kalamind Limited

Land Services Arabia Ltd.
Business Gate Building 7, Floor 1, Riyadh 11482, Saudi Arabia

Lemacrown Limited[12]

m.a. International Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

MES Holdco Limited
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

MES Interco[22]

MES Nominees Limited

Meslink Limited

Muiden Chemie International B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Newcombe Properties Limited

Overhaul and Maintenance Company Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

PAMCO Servicios Internationales de Mexico, S. de R.L. de C.V.[7]
c/o Gonzalez Calvillo y Forastieri, S.C., Centro Empresarial Lomas, Monte Peloux No. 111, Piso 5, Lomas de Chapultepec, 11000 D.F., Mexico

Piper Group plc

Pitch Technologies AB
Repslagaregatan 25, SE-582 22 Linköping, Sweden

Port Solent Limited

Port Solent Marina Limited

PT. BAE Systems Services[6]
Wisma 46, Kota BNI, 34th Floor, Suite 34.01.A, Jl. Jenderal Sudirman Kavling 71, Jakarta 10220, Indonesia

Reflectone UK Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

Representaciones SSTS, CA[7]
Ave Francisco de Miranda, Centro Lido El Rosal Oficina 71B, Caracas, Venezuela

Royal Ordnance B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Royal Ordnance (Crown Service) Pension Scheme Trustees Limited

Royal Ordnance Maschinen und Anlagenbau Gmbh[16]
Heckler & Koch Straße 1, D-78727 Oberndorf a.N, Germany

Royal Ordnance Senior Staff Pension Scheme Trustees Limited

Royal Ordnance Speciality Metals Limited[1]

RPL (Electronics) Limited[15]
15 Canada Square, London E14 5GL, United Kingdom

RWT Limited[1]

Salford Electrical Instruments Limited

Scentcivil Limited

Scottish Aviation Limited[1]
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Sepia, LLC[21]
4219-120 Lafayette Center Drive, Chantilly VA 20151, United States

Shipbuilding (MSF) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Shipbuilding (VIC) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Stephen Howe Systems Limited
Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Stewart & Stevenson Operations (Nigeria) Limited[7]
Tapa House (2nd Floor), 45, Imman Dauda St (Abosede Kuboye Crescent Entrance), Surulere, Lagos, Nigeria

Stewart & Stevenson TVS UK Limited

Stratsec.net Sdn Bhd
c/o MSCMS Corporate Services Sdn Bhd, Unit C-01-15, SME Technopreneur Centre 2, 2260 Jalan Usahawan 1, 63000 Cyberjaya, Selangor Darul Ehsan, Malaysia

Support Solutions General Services and Contracting Company/Limited Liability company[16,21]
House No. 145, Street No. 1, Qtr. 611, Al Andulous Area, Al Mansour, Baghdad, Iraq

TDS International Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

TDS International Holdings Pty Limited[8]
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Tenix Philippines Inc.[16,19]
1605 Tower One, Ayala Triangle, Ayala Avenue, Makati City, 1226, Philippines

The Blackburn Aeroplane & Motor Co Limited[1]

The Bristol Aviation Company Limited[1]

The British & Colonial Aeroplane Co. Limited[1]

The Leeds Partnership Limited[10]

The Supermarine Aviation Works Limited[1,11]

Thomas Sopwith Aviation Company Limited[1]

VSEL Birkenhead Limited

Warship Design Services Limited

Westover Controls Incorporated[6]
1098 Clark Street, Endicott NY 13760, United States

Subsidiaries – not wholly-owned

Aircraft Accessories & Components Co Limited (85.7%)
PO Box 13532, Jeddah 21434, Saudi Arabia

Aircraft Research Association Limited (87.1%)[1]
Manton Lane, Bedford MK41 7PF, United Kingdom

BAE Systems Saudi Development and Training Company Limited (99%)[3]
PO Box 67775, Riyadh 11517, Saudi Arabia

BAE Systems SDT (UK) Limited (99%)

Flight Control System Management GmbH (66.6%)[4]
PO Box 801109, 81663 Munich, Germany

Hägglunds Foremost Inc. (66.7%)[5]
1616 Meridian Road N.E., Calgary AB T2A 2PL, Canada

International Systems Engineering Company Limited (90.6%)
PO Box 54002, Riyadh 11514, Saudi Arabia

Saudi Maintenance & Supply Chain Management Company Limited (51%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Saudi Technology & Logistics Services Limited (65%)[1]
PO Box 1732, Riyadh 11441, Saudi Arabia

U.S. Munitions, LLC (51%)[21]
1713 Burdette Crossing, Blue Springs MO 64015, United States

31. Information about related undertakings continued

Equity accounted investments[23]

Advanced Electronics Company Limited (50%)
PO Box 90916, Riyadh 11623, Saudi Arabia

Air Astana (49%)[5]
Zakarpatskaya Str 4A, 050039 Almaty, Kazakhstan

AMSH B.V. (50%)[9]
Weena 210-212, 3012 NJ Rotterdam, Netherlands

BAeHAL Software Limited (40%)[1,17]
Airport Lane, HAL Estate, Bangalore 560010, India

BHIC Bofors Defense Asia Sdn Bhd (49%)
Suite B, Menara Maxis, Kuala Lumpur City Centre, 50088 Kuala Lumpur, Malaysia

BAE (Consultancy Services) Malaysia Sdn Bhd (49%)
Tkt.11, Wisma Damansara, Damansara Heights, 50490 Kuala Lumpur, Malaysia

CTA International SAS (50%)
13 Route De La Miniere, 78000 Versailles, France

Data Link Solutions L.L.C. (50%)[20,21]
400 Collins Ave, Cedar Rapids IA 52498, United States

Eurofighter Aircraft Management GmbH (33%)[1]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Eurofighter International Limited (33%)[1,9]

Eurofighter Jagdflugzeug GmbH (33%)[1]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

European Aerosystems Limited (50%)[1,8]

FADEC International LLC (50%)[21]
1098 Clark Street, Endicott NY 13760, United States

FAST Holdings Limited (50%)[8,17]

FAST Training Services Limited (50%)[17]

FBV Designs Limited (50%)[8,17]
33 Wigmore Street, London W1U 1QX, United Kingdom

FNSS Savunma Sistemleri A.S (49%)[8]
PK 37, Golbasi 06830, Ankara, Turkey

Gripen International KB (50%)[21]
SE-581 88 Linköping, Sweden

MBDA Holdings SAS (25%)
1 Avenue Réaumur, 92350 Le Plessis-Robinson, France

Nobeli Business Support AB (34%)
SE-691 80 Karlskoga, Sweden

Nurol BAE Systems Hava Sistemleri Anonim Şirketi (49%)[9]
Arjantin Cad. No: 7 06700, Gaziosmanpaşa, Ankara, Turkey

Panavia Aircraft GmbH (42.5%)[1]
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Patria Hägglunds Oy (50%)
Naulakatu 3, Fl -33100 Tampere, Finland

Saab-BAe Systems Gripen AB (50%)[1]
SE-581 88 Linköping, Sweden

Saab Bofors Test Center AB (30%)
SE-691 80 Karlskoga, Sweden

Sandstone Integrated Operations, LLC (20%)[21]
2016 Mt. Athos Road, Lynchburg VA 24504, United States

Seele-Alvis Fenestration Limited (43.5%)[8,19]
Unit A33, Jack's Place, 6 Corbett Place, London E1 6NN, United Kingdom

SIKA International Limited (50%)[8]

Spectrum Technologies Public Limited Company (20%)[1,17]
Western Avenue, Bridgend Industrial Estate, Bridgend, Mid Glamorgan CF31 3RT, United Kingdom

Tirs Mateen & Co LLC (50%)[21]
PO Box 3369, Postal Code 111, Seeb, Oman

Winner Developments Limited (33.3%)

Notes

1. Directly owned by BAE Systems plc.
2. 40% owned by BAE Systems plc.
3. 1% owned by BAE Systems plc.
4. 33.3% owned by BAE Systems plc.
5. Ownership held in common stock.
6. Ownership held in common shares.
7. Ownership held in authorized shares.
8. Ownership held in class of A shares.
9. Ownership held in class of B shares.
10. Ownership held in class of A shares and B shares.
11. Ownership held in class of A shares, B shares and preference shares.
12. Ownership held in ordinary shares and class of A shares.
13. Ownership held in ordinary shares and preference shares.
14. Ownership held in ordinary shares and redeemable preference shares.
15. In members' voluntary liquidation.
16. In liquidation.
17. Year end 31 March.
18. Year end 5 April.
19. Year end 30 June.
20. Year end 30 September.
21. Unincorporated entity for which the address given is the principal place of business.
22. Unlimited company.
23. For companies incorporated outside of the United Kingdom, the country of incorporation is shown in the address.

Company statement of comprehensive income
for the year ended 31 December

	2015 £m	2014[1] £m
Profit for the year	**94**	1,193
Other comprehensive income		
Items that will not be reclassified to the income statement:		
Remeasurements on retirement benefit schemes	**14**	(59)
Items that may be reclassified to the income statement:		
Amounts credited to hedging reserve	**7**	10
Total other comprehensive income for the year (net of tax)	**21**	(49)
Total comprehensive income for the year	**115**	1,144

1. Restated on adoption of Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework.

Company statement of changes in equity
for the year ended 31 December

	Issued share capital £m	Share premium £m	Other reserves £m	Retained earnings[1] £m	Total equity £m
At 1 January 2014 (as previously reported)[2]	89	1,249	290	2,360	3,988
Effect of transition to FRS 101 (note 12)	–	–	(24)	(179)	(203)
At 1 January 2014 (restated on adoption of FRS 101)	89	1,249	266	2,181	3,785
Profit for the year	–	–	–	1,193	1,193
Total other comprehensive income for the year	–	–	10	(59)	(49)
Share-based payments	–	–	–	37	37
Net purchase of own shares	(2)	–	2	(281)	(281)
Ordinary share dividends	–	–	–	(642)	(642)
At 31 December 2014 (restated on adoption of FRS 101)	87	1,249	278	2,429	4,043
Profit for the year	–	–	–	94	94
Total other comprehensive income for the year	–	–	7	14	21
Shared-based payments	–	–	–	39	39
Net sale of own shares	–	–	–	1	1
Ordinary share dividends	–	–	–	(655)	(655)
Non-distributable reserve transfer	–	–	(67)	67	–
At 31 December 2015	**87**	**1,249**	**218**	**1,989**	**3,543**

1. The non-distributable portion of retained earnings is £255m (2014 £196m).
2. Restated for a correction to amounts due to other Group companies, a net increase of £81m to retained earnings.

Company balance sheet
as at 31 December

	Notes	2015 £m	2014[1] £m
Non-current assets			
Intangible assets		**31**	11
Property, plant and equipment		**20**	8
Investments in subsidiary undertakings and participating interests	2	**8,138**	8,169
Other receivables		**5**	9
Retirement benefit surpluses	8	**6**	5
Other financial assets	4	**151**	105
		8,351	8,307
Current assets			
Trade and other receivables	3	**3,221**	3,225
Current tax		**14**	32
Other financial assets	4	**212**	128
Cash and cash equivalents		**2,061**	1,792
		5,508	5,177
Total assets		**13,859**	13,484
Non-current liabilities			
Loans	5	**(1,005)**	(1,197)
Other payables		**(5)**	(12)
Retirement benefit obligations	8	**(259)**	(270)
Other financial liabilities	4	**(98)**	(98)
Provisions	7	**(105)**	(109)
		(1,472)	(1,686)
Current liabilities			
Loans and overdrafts	5	**(237)**	(1)
Trade and other payables	6	**(8,430)**	(7,609)
Other financial liabilities	4	**(165)**	(134)
Provisions	7	**(12)**	(11)
		(8,844)	(7,755)
Total liabilities		**(10,316)**	(9,441)
Net assets		**3,543**	4,043
Capital and reserves			
Issued share capital		**87**	87
Share premium		**1,249**	1,249
Other reserves	9	**218**	278
Retained earnings		**1,989**	2,429
Total equity		**3,543**	4,043

1. Restated on adoption of FRS 101 and for a correction to amounts due to other Group companies.

Approved by the Board on 17 February 2016 and signed on its behalf by:

I G King
Chief Executive

P J Lynas
Group Finance Director

Registered number: 1470151

Notes to the Company accounts

1. Preparation

Basis of preparation

These financial statements were prepared in accordance with Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework. Amendments to FRS 101 (2013/14 Cycle), issued in July 2014 and effective for periods beginning on or after 1 January 2015, has been applied. Amendments to FRS 101 (2014/15 cycle and other minor amendments), issued in July 2015 and effective for periods beginning on or after 1 January 2016, has been early adopted and applied.

In preparing these financial statements, the Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards (IFRS) as adopted by the EU (EU-adopted IFRS), but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of the FRS 101 disclosure exemptions has been taken:

- the requirements of paragraphs 45(b) and 46 to 52 of IFRS 2, Share-based Payment;
- the requirements of paragraphs 62, B64(d), B64(e), B64(g), B64(h), B64(j), to B64(m), B64(n)(ii), B64(o)(ii), B64(p), B64(q)(ii), B66 and B67 of IFRS 3, Business Combinations;
- the requirements of paragraph 33(c) of IFRS 5, Non-current Assets Held for Sale and Discontinued Operations;
- the requirements of IFRS 7, Financial Instruments: Disclosures;
- the requirements of paragraphs 91 to 99 of IFRS 13, Fair Value Measurement;
- the requirement in paragraph 38 of IAS 1, Presentation of Financial Statements, to present comparative information in respect of: paragraph 79(a)(iv) of IAS 1; paragraph 73(e) of IAS 16, Property, Plant and Equipment; paragraph 118(e) of IAS 38, Intangible Assets; and paragraphs 76 and 79(d) of IAS 40, Investment Property;
- the requirements of paragraphs 10(d), 10(f), 16, 38A, 38B, 38C, 38D, 40A, 40B, 40C, 40D, 111 and 134 to 136 of IAS 1, Presentation of Financial Statements;
- the requirements of IAS 7, Statement of Cash Flows;
- the requirements of paragraphs 30 and 31 of IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors;
- the requirements of paragraphs 17 and 18A of IAS 24, Related Party Disclosures;
- the requirements in IAS 24, Related Party Disclosures, to disclose related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member; and
- the requirements of paragraphs 130(f)(ii), 130(f)(iii), 134(d) to 134(f) and 135(c) to 135(e) of IAS 36, Impairment of Assets.

In its transition to FRS 101, the Company has applied IFRS 1, whilst ensuring that its assets and liabilities are measured in compliance with FRS 101. An explanation of how the transition to FRS 101 has affected the Company's reported financial performance and position is provided in note 12 to the Company accounts.

The Company intends to continue to prepare its financial statements in accordance with FRS 101.

The Company is exempt under Section 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements as it and its subsidiary undertakings are included by full consolidation in the Group accounts on pages 106 to 165. Accordingly, these financial statements present information about the Company as an individual undertaking and not as a group.

In accordance with Section 408(3) of the Companies Act 2006, the Company is exempt from the requirement to present its own income statement. The amount of profit for the year of the Company is disclosed in the Company statement of comprehensive income.

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of relevant financial assets and financial liabilities (including derivative instruments).

Significant accounting policies

The significant accounting policies applied in the preparation of these individual financial statements are set out below. These policies have been applied consistently to all the years presented, unless otherwise stated.

Investments in subsidiary undertakings and participating interests

Fixed asset investments in shares in subsidiary undertakings and participating interests are stated at cost less provision for impairment.

Other significant accounting policies

Other significant accounting policies are consistent with the Group accounts and the table below references where they are disclosed.

Significant accounting policy	Page
Loans and overdrafts	137
Pension schemes	139
Provisions	149

2. Investments in subsidiary undertakings and participating interests

	£m
Cost	
At 1 January 2015	8,183
Additions	8
Disposals	(39)
At 31 December 2015	**8,152**
Impairment provisions	
At 1 January and 31 December 2015	**14**
Net carrying value	
At 31 December 2015	**8,138**
At 31 December 2014	8,169

3. Trade and other receivables

	2015 £m	2014 £m
Current		
Amounts owed by subsidiary undertakings	**3,159**	3,182
Amounts owed by Group joint ventures	**5**	5
Prepayments and accrued income	**45**	23
Other receivables	**12**	15
	3,221	3,225

4. Other financial assets and liabilities

	2015		2014	
	Assets £m	**Liabilities £m**	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**8**	**–**	4	–
Other foreign exchange/interest rate contracts	**97**	**(98)**	95	(98)
Debt-related derivative financial instruments – assets[1]	**46**	**–**	6	–
	151	**(98)**	105	(98)
Current				
Cash flow hedges – foreign exchange contracts	**5**	**–**	2	–
Other foreign exchange/interest rate contracts	**207**	**(165)**	126	(134)
	212	**(165)**	128	(134)

1. 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).

The contractual cash flows on derivative financial instruments at the reporting date are shown below, classified by maturity.

	2015 £m	2014 £m
Less than one year	**2**	1
Between one and five years	**9**	3
More than five years	**55**	23
	66	27

Full disclosures relating to the Group's other financial assets and liabilities, and financial risk management strategies are given in notes 13, 26 and 27 to the Group accounts.

Notes to the Company accounts continued

5. Loans and overdrafts

	2015 £m	2014 £m
Non-current		
US$350m 3.5% bond, repayable 2016	–	224
US$500m 4.75% bond, repayable 2021	**339**	320
£400m 4.125% bond, repayable 2022	**398**	398
US$400m 5.8% bond, repayable 2041	**268**	254
Debt-related derivative financial instruments – liabilities	–	1
	1,005	1,197
Current		
US$350m 3.5% bond, repayable 2016	**237**	–
Overdrafts	–	1
	237	1

6. Trade and other payables

	2015 £m	2014[1] £m
Current		
Amounts owed to subsidiary undertakings	**7,824**	6,978
Amounts owed to Group joint ventures	**405**	453
Accruals and deferred income	**100**	46
Other payables	**101**	132
	8,430	7,609

1. Restated for a correction to amounts due to other Group companies.

7. Provisions

	Contracts and other £m
Non-current	109
Current	11
At 1 January 2015	120
Created	2
Utilised	(11)
Net present value adjustments	6
At 31 December 2015	**117**
Represented by:	
Non-current	105
Current	12
	117

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. Retirement benefit obligations

The Company participates in all of the Group's UK pension schemes. Full disclosures relating to these schemes are given in note 20 to the Group accounts.

Amounts recognised on the balance sheet

The table below shows a reconciliation between the gross assets and liabilities of the Group's UK pension schemes and the amounts recognised on the Company's balance sheet after allocation to other participating employers.

	2015 £m	2014 £m
Present value of unfunded obligations	**(59)**	(41)
Present value of funded obligations	**(24,974)**	(26,195)
Fair value of scheme assets	**20,209**	20,170
Total IAS 19 deficit, net	**(4,824)**	(6,066)
Allocated to other participating employers	**4,571**	5,801
Company's share of IAS 19 deficit, net	**(253)**	(265)
Represented by:		
Retirement benefit surpluses	**6**	5
Retirement benefit obligations	**(259)**	(270)
	(253)	(265)

9. Share capital and other reserves

Share capital

Disclosures in respect of the Company's share capital are provided in note 22 to the Group accounts.

Other reserves

	Capital reserve £m	Non-distributable reserve £m	Statutory reserve £m	Capital redemption reserve £m	Hedging reserve £m	Total £m
At 1 January 2014 (as previously reported)	24	67	202	1	(4)	290
Effect of transition to FRS 101 (note 12)	(24)	–	–	–	–	(24)
At 1 January 2014 (restated on adoption of FRS 101)	–	67	202	1	(4)	266
Amounts credited to hedging reserve	–	–	–	–	10	10
Net purchase of own shares	–	–	–	2	–	2
At 31 December 2014 (restated on adoption of FRS 101)	–	67	202	3	6	278
Amounts credited to hedging reserve	–	–	–	–	7	7
Transfer to retained earnings	–	(67)	–	–	–	(67)
At 31 December 2015	**–**	**–**	**202**	**3**	**13**	**218**

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.

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 2015, 1,450,000 (2014 67,417,000) ordinary shares with a nominal value of £nil (2014 £2m) were repurchased and have been subsequently cancelled.

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.

Notes to the Company accounts
continued

10. Share-based payments

Options over shares of the Company 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 73 to 86.

	2015		2014	
	Range of exercise price of outstanding options (£)	**Weighted average remaining contracted life (years)**	Range of exercise price of outstanding options (£)	Weighted average remaining contracted life (years)
Executive Share Option Plan	**3.01 – 5.43**	**8**	2.64 – 4.79	7
Performance Share Plan	**–**	**5**	–	5
Share Matching Plan	**–**	**–**	–	1
Restricted Share Plan	**–**	**5**	–	5

The average share price in the year was £4.87 (2014 £4.33).

11. Other information

Company audit fee
Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,759,000 (2014 £1,669,000).

Employees
The total number of employees of the Company at 31 December 2015 was 1,030 (2014 1,189). Total staff costs, excluding charges for share-based payments, were £98m (2014 £111m).

Related party transactions
Disclosures in respect of related party transactions are provided in note 29 to the Group accounts.

The Company also has a related party relationship with its directors and key management personnel, and pension schemes.

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 £6,949,237 (2014 £6,601,189); 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 the directors from the exercise of share options in 2015 as at the date of exercise was £992,252 (2014 £739,401) and the net aggregate value of assets received by directors in 2015 from Long-Term Incentive Plans as calculated at the date of vesting was £nil (2014 £nil); these amounts are calculated on a different basis from the valuation of share plan benefits under Schedule 8 (2013) in the Annual remuneration report. Retirement benefits are accruing to two directors in respect of defined benefit schemes and to one director in respect of defined contribution schemes.

Company guaranteed borrowings
Borrowings by subsidiary undertakings totalling £2,764m (2014 £2,146m), which are included in the Group's borrowings, have been guaranteed by the Company.

Information about related undertakings
In accordance with Section 409 of the Companies Act 2006, a full list of the Company's subsidiaries and significant holdings is included in note 31 to the Group accounts.

12. Explanation of transition to FRS 101

As stated in note 1, these are the Company's first financial statements prepared in accordance with FRS 101.

The accounting policies set out in note 1 have been applied in preparing the financial statements for the year ended 31 December 2015, the comparative information for the year ended 31 December 2014 and the opening FRS 101 balance sheet at 1 January 2014 (the Company's date of transition).

In preparing its FRS 101 balance sheets, the Company has adjusted amounts reported in financial statements prepared in prior years in accordance with its previous basis of accounting. An explanation of how the transition to FRS 101 has affected the Company's reported financial performance and position is set out in the following tables.

Impact of transition to FRS 101 on the Company statement of comprehensive income

	Year ended 31 December 2014		
	As previously reported £m	Pension schemes adjustment[1] £m	FRS 101 £m
Profit for the year	1,183	10	**1,193**
Other comprehensive income			
Items that will not be reclassified to the income statement:			
Remeasurements on retirement benefit schemes	–	(59)	**(59)**
Items that may be reclassified to the income statement:			
Amounts credited to hedging reserve	10	–	**10**
Total other comprehensive income for the year (net of tax)	10	(59)	**(49)**
Total comprehensive income for the year	1,193	(49)	**1,144**

1. It had been the Company's policy to account for the UK defined benefit pension schemes in which it participates as defined contribution schemes as permitted by FRS 17, Retirement Benefits. Upon transition to FRS 101, the Company has been allocated a share of the assets and liabilities of the Group's UK defined benefit pension schemes using an allocation method intended to reflect a reasonable approximation of its share of the deficit.

Notes to the Company accounts continued

12. Explanation of transition to FRS 101 continued

Impact of transition to FRS 101 on the Company balance sheet

	1 January 2014 (the Company's date of transition)			
	As previously reported[1] £m	Pension schemes adjustment[2] £m	Other transition adjustments £m	FRS 101 £m
Non-current assets				
Intangible assets	–	–	1	**1**
Property, plant and equipment	10	–	(1)	**9**
Investments in subsidiary undertakings and participating interests	8,057	–	–	**8,057**
Other receivables	22	–	–	**22**
Other financial assets	80	–	–	**80**
	8,169	–	–	**8,169**
Current assets				
Trade and other receivables	3,630	–	–	**3,630**
Current tax	32	–	–	**32**
Other financial assets	126	–	–	**126**
Cash and cash equivalents	1,732	–	–	**1,732**
	5,520	–	–	**5,520**
Total assets	13,689	–	–	**13,689**
Non-current liabilities				
Loans	(1,159)	–	–	**(1,159)**
Other payables	(21)	11	–	**(10)**
Retirement benefit obligations	–	(214)	–	**(214)**
Other financial liabilities	(86)	–	–	**(86)**
Provisions	(36)	–	–	**(36)**
	(1,302)	(203)	–	**(1,505)**
Current liabilities				
Loans and overdrafts	(100)	–	–	**(100)**
Trade and other payables	(8,142)	–	–	**(8,142)**
Other financial liabilities	(141)	–	–	**(141)**
Provisions	(16)	–	–	**(16)**
	(8,399)	–	–	**(8,399)**
Total liabilities	(9,701)	(203)	–	**(9,904)**
Net assets	3,988	(203)	–	**3,785**
Capital and reserves				
Issued share capital	89	–	–	**89**
Share premium	1,249	–	–	**1,249**
Other reserves	290	–	(24)	**266**
Retained earnings	2,360	(203)	24	**2,181**
Total equity	3,988	(203)	–	**3,785**

1. Restated for a correction to amounts due to other Group companies.
2. It had been the Company's policy to account for the UK defined benefit pension schemes in which it participates as defined contribution schemes as permitted by FRS 17, Retirement Benefits. Upon transition to FRS 101, the Company has been allocated a share of the assets and liabilities of the Group's UK defined benefit pension schemes using an allocation method intended to reflect a reasonable approximation of its share of the deficit.

12. Explanation of transition to FRS 101 continued

	31 December 2014			
	As previously reported[1] £m	Pension schemes adjustment[2] £m	Other transition adjustments £m	FRS 101 £m
Non-current assets				
Intangible assets	10	–	1	**11**
Property, plant and equipment	9	–	(1)	**8**
Investments in subsidiary undertakings and participating interests	8,169	–	–	**8,169**
Other receivables	9	–	–	**9**
Retirement benefit surpluses	–	5	–	**5**
Other financial assets	105	–	–	**105**
	8,302	5	–	**8,307**
Current assets				
Trade and other receivables	3,225	–	–	**3,225**
Current tax	32	–	–	**32**
Other financial assets	128	–	–	**128**
Cash and cash equivalents	1,792	–	–	**1,792**
	5,177	–	–	**5,177**
Total assets	13,479	5	–	**13,484**
Non-current liabilities				
Loans	(1,197)	–	–	**(1,197)**
Other payables	(25)	13	–	**(12)**
Retirement benefit obligations	–	(270)	–	**(270)**
Other financial liabilities	(98)	–	–	**(98)**
Provisions	(109)	–	–	**(109)**
	(1,429)	(257)	–	**(1,686)**
Current liabilities				
Loans and overdrafts	(1)	–	–	**(1)**
Trade and other payables	(7,609)	–	–	**(7,609)**
Other financial liabilities	(134)	–	–	**(134)**
Provisions	(11)	–	–	**(11)**
	(7,755)	–	–	**(7,755)**
Total liabilities	(9,184)	(257)	–	**(9,441)**
Net assets	4,295	(252)	–	**4,043**
Capital and reserves				
Issued share capital	87	–	–	**87**
Share premium	1,249	–	–	**1,249**
Other reserves	302	–	(24)	**278**
Retained earnings	2,657	(252)	24	**2,429**
Total equity	4,295	(252)	–	**4,043**

1. Restated for a correction to amounts due to other Group companies.
2. It had been the Company's policy to account for the UK defined benefit pension schemes in which it participates as defined contribution schemes as permitted by FRS 17, Retirement Benefits. Upon transition to FRS 101, the Company has been allocated a share of the assets and liabilities of the Group's UK defined benefit pension schemes using an allocation method intended to reflect a reasonable approximation of its share of the deficit.

Shareholder information

Registered office
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Telephone: +44 (0)1252 373232

Company website: **baesystems.com**

Registered in England and Wales, No. 1470151

Registrars
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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 (**help.shareview.co.uk**) includes a comprehensive set of answers to many frequently asked questions relating to managing a shareholding. If you cannot find the answer to your question, there is an online e-mail form, which 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 0371 384 2044 or, from outside the UK, +44 121 415 7058. Lines are open from 8.30am to 5.30pm Monday to Friday, excluding UK Bank holidays.

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 (**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 depositary. If you should have any queries, please contact:

JPMorgan Chase & Co
PO Box 64504
St Paul
MN 55164-0854 USA

Email: **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 **sharegift.org**, by telephone on 020 7930 3737 or by e-mail: **help@sharegift.org**

Share price information
The middle market price of the Company's ordinary shares on 31 December 2015 was 499.6p and the range during the year was 425.5p to 547.0p.

For more information
Visit the Shareholder information section of our website: **investors.baesystems.com**

FINANCIAL CALENDAR	
Financial year end	31 December
Annual General Meeting	4 May 2016
2015 final ordinary dividend payable	1 June 2016
2016 half-yearly results announcement	28 July 2016
2016 interim ordinary dividend payable	30 November 2016
2016 full-year results:	
– preliminary announcement	February 2017
– Annual Report	March 2017
2016 final ordinary dividend payable	June 2017

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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 **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 **scamsmart.fca.org.uk/warninglist**
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 seriously 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 FCA Consumer Helpline on **0800 111 6768**, or the share fraud reporting form at **fca.org.uk/scams**, where you can also find out more about investment scams.

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Designed and produced by Radley Yeldar.

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