



Annual Report 2018

BAE SYSTEMS

■ Who we are

At BAE Systems, our **advanced defence technology** protects people and national security, and keeps critical information and infrastructure secure.

We search for new ways to provide our customers with a competitive edge across the **air, maritime, land** and **cyber** domains. ⁺⁴³ Segmental review

We employ a skilled workforce of **85,800 people**¹ in more than **40 countries**, and work closely with local partners to support economic development by transferring knowledge, skills and technology. ⁺²² How our business works

Further information can be found online by visiting **baesystems.com**

⁺²²⁰ Shareholder information



1. Including share of equity accounted investments.

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Financial statements

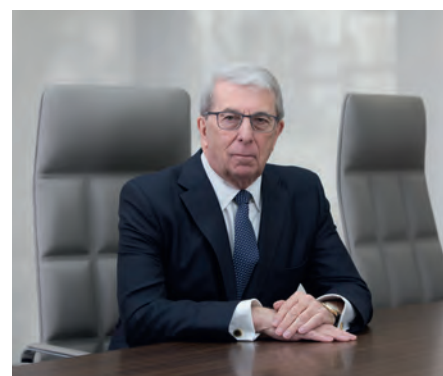
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+08 Operational and strategic highlights



+43 Segmental review



+76 Board governance

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

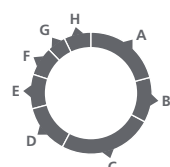
Our business at a glance

BAE Systems has strong, established positions in the air, maritime, land and cyber security domains.



Air

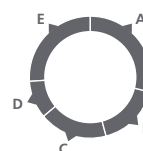
- Manufacture, development, upgrade and in-service support of Typhoon combat aircraft
- Workshare partner for the design and manufacture of major sub-assemblies and systems, and provision of support for F-35 Lightning II combat aircraft
- Design, manufacture and support of electronics equipment for military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



A	Typhoon	21%
B	F-35 Lightning II	12%
C	Defence electronics	25%
D	Tornado	13%
E	Commercial avionics	9%
F	Weapon systems	8%
G	Hawk	5%
H	Other	7%

Maritime

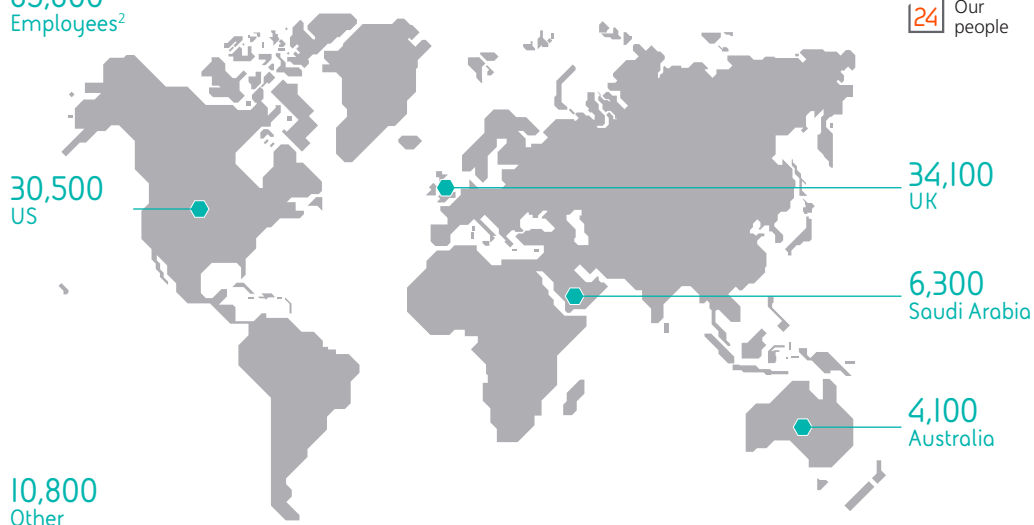
- Design and manufacture of submarines
- Design and manufacture of complex warships
- Provision of naval ship repair and modernisation services in the US
- Provision of in-service support to surface ships and facilities management in the UK
- Design and manufacture of naval gun systems, torpedoes, radars,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



A	Submarines	29%
B	Complex warships	17%
C	US naval ship repair	18%
D	UK naval support	10%
E	Other	26%

Employees by location

85,800
Employees²



1. Revenue plus the Group's share of revenue of equity accounted investments.

2. Including share of equity accounted investments.

3. Includes £0.7bn (4%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

2018 sales¹

£18,407m

2018 revenue

£16,821m

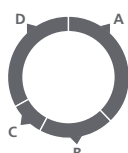
+04 Our key products and services

+35 Group financial review



Land

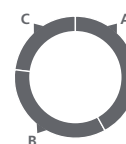
- Design, manufacture, upgrade and support of tracked and amphibious combat vehicles
- Manufacture of ammunition and precision munitions for US, UK and other armed forces
- Design and manufacture of electric and hybrid electric drive systems
- Design and manufacture of artillery systems and missile launchers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



A	Combat vehicles	38%
B	Munitions	20%
C	Commercial	9%
D	Weapon systems/other	33%

Cyber

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



A	US government	42%
B	UK and other governments	35%
C	Commercial	23%

Sales¹ by destination

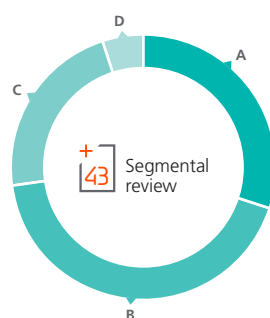
BAE Systems has leading positions in its principal markets – the US, UK, the Kingdom of Saudi Arabia and Australia – as well as established positions in a number of other international markets.



A	US	42%
B	UK	21%
C	Saudi Arabia	14%
D	Australia	3%
E	Other international markets ³	20%

Sales¹ by activity

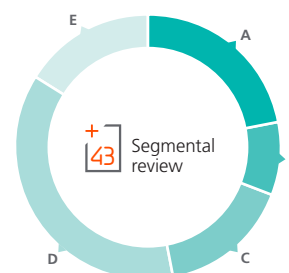
BAE Systems has a diverse portfolio, broadly balanced between an enduring services and support business, long-term platform and product programmes, electronic systems, and activities in cyber and intelligence.



A	Platforms	30%
B	Military and technical services and support	43%
C	Electronic systems	22%
D	Cyber	5%

Sales¹ by reporting segment

BAE Systems reports its performance through five principal reporting segments.



A	Electronic Systems	22%
B	Cyber & Intelligence	9%
C	Platforms & Services (US)	16%
D	Air	37%
E	Maritime	16%

Our key products and services

BAE Systems has strong, established positions supplying defence equipment, electronics and services, as well as cyber, intelligence and security solutions for governments.



Typhoon and Hawk manufacture and capability development

Manufacture of major Typhoon assemblies for European partner nations and other export customers. Aircraft assembly for the Royal Air Force and Royal Saudi Air Force. Supply of Typhoon and Hawk aircraft with support and training package to Qatar. Expansion of the capabilities of the aircraft.

F-35 Lightning II design and manufacture

Design and manufacture of sub-assemblies in the UK, including the aft fuselage and empennage. Provision of equipment in the US, including the electronic warfare suite. 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 joint investment with the UK government and industry in next-generation combat air systems. The Tempest programme has been launched in support of the UK Combat Air Strategy, announced in July.



Complex warships

Design and manufacture of two 65,000-tonne aircraft carriers, five Offshore Patrol Vessels, and Type 26 frigates for the Royal Navy. The first Type 26 is expected to enter service in the mid-2020s. Contract signed with the Australian government that provides the framework for the design and manufacture of Hunter Class frigates.

Defence electronics

Design, manufacture and support of avionics equipment across a range of US and other allied nations' military aircraft programmes, including a leadership position in the electronic warfare market.

Commercial avionics equipment

Design, manufacture and support 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 leading supplier of engine controls for GE, and is a major supplier of flight control electronics for Boeing and other aircraft platforms.

We also have a growing position in adjacent commercial markets, including avionics and cyber security.



Submarines

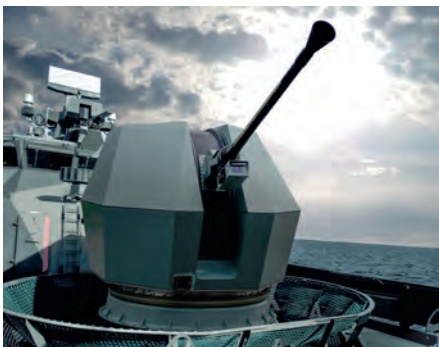
Design and manufacture of seven Astute Class nuclear-powered attack submarines for the Royal Navy. The first three Astute Class submarines are in operational service with the Royal Navy, with the remaining four boats in build. The final boat is expected to enter service in the middle of the next decade. Design and manufacture of four Dreadnought Class nuclear-powered submarines to carry the UK's Trident ballistic missiles. Manufacture of the first Dreadnought Class boat, Dreadnought, commenced in 2016.

Combat vehicles

Upgrade of tracked vehicles, including Bradley Fighting Vehicles; design and manufacture of the M109 self-propelled howitzer and Armored Multi-Purpose Vehicle; and development of light combat vehicles under the Mobile Protected Firepower programme for the US Army. Manufacture of amphibious vehicles for the US Marine Corps and international customers. Design, manufacture and support of the CV90 and BvS10 combat vehicles for international customers. Vehicle upgrade and support to the British Army.

Air support and training

Provision of support to operational capability, including maintenance, support and training for Typhoon aircraft in service with the UK, Saudi Arabian and Omani air forces. Under the Saudi British Defence Co-operation Programme, delivery of contracts for manpower, logistics and training, training aircraft (including Hawk) and upgrades to Tornado aircraft in Saudi Arabia. Provision of support for Hawk aircraft in service in 14 countries and a range of sustainment services for the F-35 Lightning II aircraft in the Europe and Pacific regions.



Weapon systems and munitions

Design and manufacture of naval gun systems, munitions, torpedoes, radars, naval command and combat systems, artillery systems, missile launchers and, through a 37.5% interest in MBDA, missiles and missile systems. BAE Systems also manages and operates complex ammunition plant operations for the US Army to produce insensitive munitions and propellant grains.

Naval ship repair and support

Provision of naval ship repair and modernisation services in the US and UK, together with support to the navies of the US, UK and Australia. In the US, BAE Systems has facilities located on the Atlantic and Pacific coasts, as well as in Hawaii, to include expanded dry dock facilities in the San Diego shipyard to support the US Navy's increased focus on Asia-Pacific operations.

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.

Group financial highlights

We monitor the underlying financial performance of the Group using alternative performance measures. These measures are not defined in IFRS¹ and, therefore, are considered to be non-GAAP² measures. Accordingly, the relevant IFRS¹ measures are also presented where appropriate.

- Sales³ decreased by £0.1bn but grew 1% excluding the impact of currency translation.
- Underlying EBITA decreased by £46m, a 1% decline on a constant currency basis^{3,4}.
- Underlying earnings per share³ increased by 2% to 42.9p.
- Operating business cash flow decreased by £759m to £993m.
- Net debt increased by £152m compared with 31 December 2017.
- Order intake⁵ of £28.3bn.
- Order backlog^{3,5} of £48.4bn was up 25%.

Financial performance measures as defined by the Group

Sales³

KPI

£18,407m

(2017 £18,487m)

Definition Revenue plus the Group's share of revenue of equity accounted investments.

Purpose Allows management to monitor the sales performance of subsidiaries and equity accounted investments.

Net debt

BONUS

KPI

£(904)m

(2017 £(752)m)

Definition Cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments).

Purpose Allows management to monitor the indebtedness of the Group.

Underlying EBITA³

KPI

£1,928m

(2017 £1,974m)

Definition Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items⁶.

Purpose Provides a measure of operating profitability that is comparable over time.

Order intake⁵

BONUS

KPI

£28,280m

(2017 £20,257m)

Definition Funded orders received from customers including the Group's share of order intake of equity accounted investments.

Purpose Allows management to monitor the order intake of subsidiaries and equity accounted investments.

Underlying earnings per share³

BONUS

KPI

42.9p

(2017 42.1p)

Definition Basic earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items⁶.

Purpose Provides a measure of underlying performance that is comparable over time.

Order backlog^{3,5}

£48.4bn

(2017 £38.7bn)

Definition Funded and unfunded unexecuted customer orders including the Group's share of order backlog of equity accounted investments. Unfunded orders include the elements of US multi-year contracts for which funding has not been authorised by the customer.

Purpose Supports future years' sales performance of subsidiaries and equity accounted investments.

Operating business cash flow

KPI

£993m

(2017 £1,752m)

Definition Net cash flow from operating activities excluding taxation and including net capital expenditure, financial investment and dividends from equity accounted investments.

Purpose Allows management to monitor the operational cash generation of the Group.

KPI

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

BONUS

80% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 107).

Reconciliations from the financial performance measures as defined by the Group to the financial performance measures defined in IFRS¹ are provided in the Group financial review on pages 35 to 41.

- Revenue³ decreased by £0.4bn, a 1% decline on a constant currency basis.
- Operating profit³ increased to £1,605m. The prior year included a £384m non-cash goodwill impairment in Applied Intelligence.
- Basic earnings per share³ increased by 20% to 31.3p.
- Net cash flow from operating activities reduced by £697m to £1,200m.
- Group's share of the pre-tax accounting net pension deficit³ reduced by £0.1bn to £3.9bn compared to 31 December 2017.
- Final dividend of 13.2p making a total of 22.2p per share for the year, an increase of 2% over 2017.

Financial performance measures defined in IFRS¹

Revenue³

£16,821m

(2017 £17,224m)

Definition Income derived from the provision of goods and services by the Company and its subsidiary undertakings.

Operating profit³

£1,605m

(2017 £1,419m)

Definition Profit for the year before finance costs and taxation expense. This measure includes finance costs and taxation expense of equity accounted investments.

Basic earnings per share³

31.3p

(2017 26.0p)

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

Net cash flow from operating activities

£1,200m

(2017 £1,897m)

Definition Net cash flow from operating activities in accordance with International Accounting Standard 7 Statement of Cash Flows.

Other financial highlights

Group's share of the net pension deficit³

£(3.9)bn

(2017 £(4.0)bn)

Definition Net International Accounting Standard 19 Employee Benefits, deficit excluding amounts allocated to equity accounted investments.

Dividend per share

22.2p

(2017 21.8p)

Definition Interim dividend paid and final dividend proposed per share.

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 to the Group accounts for details regarding the restatement.
4. Current year compared with prior year translated at current year exchange rates.
5. Including share of equity accounted investments.
6. Items that are not relevant to an understanding of the Group's underlying performance (see page 35).

Operational and strategic highlights

In 2018, we made good progress across the Group in achieving our strategic objectives.



During the year, BAE Systems' Type 26 frigate was selected for the Commonwealth of Australia's Hunter Class nine-ship Future Frigate programme with the contract which provides the framework for the design and build of the ships being signed in December. The Type 26 was also selected as the design for Canada's Surface Combatant programme, reinforcing its position as one of the world's most advanced anti-submarine warships.



The contract with the Government of the State of Qatar for the supply of 24 Typhoon aircraft and nine Hawk Advanced Jet Trainer aircraft, along with a bespoke support and training package, became effective in September upon receipt of the first contractual payment. Deliveries of the first Hawk aircraft are expected to commence in 2022 and the first Typhoon aircraft in 2023.

We were awarded a \$376m (£295m) contract by the US Army for the development phase of the Mobile Protected Firepower programme, to deliver a rapidly deployable and highly agile armour-protected light combat vehicle.



The US-based Intelligence and Security business secured seven new task orders valued at approximately \$320m (£251m) to provide motion-imagery analysis, training and research support services to the US intelligence community.

The first four UK F-35 Lightning II aircraft arrived at RAF Marham in June and initial operational services were stood up. Additionally, the integration of the F-35 onto the new HMS Queen Elizabeth aircraft carrier commenced, and the first F-35 deck landing was successfully completed in September.

+13 Chief Executive's review

+18 Group strategic framework

+43 Segmental review



In June, BAE Systems and industry teammate Iveco Defence Vehicles were competitively selected for the US Marine Corps' Amphibious Combat Vehicle I.I programme phase. We have commenced work on the production contract for an initial 30 vehicles worth \$198m (£155m), with options for a total of 204 vehicles worth up to \$1.2bn (£0.9bn).

During the year agreement was reached with the Saudi Arabian government to continue to provide support services for Typhoon aircraft in service with the Royal Saudi Air Force.



The UK Combat Air Strategy announced in July is a significant milestone for our Air sector and sends a strong signal of intent about the UK's commitment to retaining a leading position in Combat Air. The strategy will enable long-term planning in a key strategic part of the business as UK government and industry jointly invest in cutting-edge, next-generation combat air systems. The Tempest programme has been launched in support of the strategy.



During the year we secured the full £1.6bn contract for delivery of the seventh Astute Class submarine, and a further £1.3bn of funding on the Dreadnought programme from the UK Ministry of Defence.

Our Advanced Precision Kill Weapon System (APKWS®) is experiencing growing demand in both the US and internationally, with awards totalling nearly \$400m (£314m) in the year, and we continue to ramp-up production capacity towards an annual production level of 25,000 units.

Chairman's letter



Sir Roger Carr
Chairman

"2018 was **another successful year** for the Company under the leadership of Charles Woodburn in his first full year as Chief Executive, strengthening the outlook with significant contract wins."

Our record order book

We added to the strong order book we had built in the previous 12 months to create a record defence order book. Our successes included the completion of financing for the Typhoon and Hawk aircraft for Qatar, continued strong demand for our electronic systems products and the award of a contract for the Hunter Class nine-frigate programme by the Australian government to be built in Adelaide based on the design of the Type 26. This contract, won in the face of fierce competition, demonstrated the cutting-edge anti-submarine warfare capabilities of the Type 26 frigate already ordered by the Royal Navy and the value of the deep partnership we have built in Australia over the last half century.

I visited Australia in November to thank the Australian government for placing this order with the Company and toured the shipyard in which the Hunter Class frigates will be built. The existing site was impressive and the new shipyard under construction will prove to be a world-class facility when it is completed in the early 2020s.

The competitive strength of the Type 26 was further underpinned when the Canadian government selected the design in February 2019.

From the challenge of building a strong order book, I was pleased that management focus in the second half of the year moved to the task of manufacturing and delivering additional volumes of products and services.

Our US Combat Vehicles business further increased both the deep order book and production volumes on a number of programmes. Whilst the sudden increase in pace and incline of the production ramp caused teething problems in the early months, management continues to make steady progress toward establishing production stability in support of expanding requirements.

Increased production volume associated with the F-35 Lightning II aircraft was successfully managed by the Samlesbury team who also celebrated the arrival of the first nine aircraft to the UK squadron and the successful completion of initial F-35 flight trials on the deck of the Queen Elizabeth carrier off the East Coast of the US.

The drumbeat of our submarine production in Barrow continued to increase with the build of the first Dreadnought Class submarine alongside the existing Astute boats.

Recognising the increasing demands on the business, our focus was to ensure the executive team has the skillset, experience and career time horizon to drive change and manage performance as the deep order backlog is converted into finished product and customer service. Our processes and procedures remain vital to the discipline and control of the business, but people make the difference.



Our people and culture

During the course of the year, succession planning and talent management became top priorities for the Executive Committee and the Board. In that context, Charles made a series of changes in his leadership team by promotions from within, supplemented by a number of external recruitments, to ensure fresh thinking is balanced with seasoned industry experience.

These changes are now evident in the leadership of Human Resources, Australia, Maritime sector management, submarine production and the consolidation of our UK Air business with our operations in the Kingdom of Saudi Arabia.

I am pleased to say the benefits of these changes are being seen in improved performance, greater co-ordination, increased sharing of knowledge and stronger focus on technology in line with Charles's business priorities.

I continue to believe that in keeping with our culture and tradition of building home-grown capability, we develop the skills we need in the business by an unwavering commitment to apprenticeships, graduate training and life-long learning.

During 2019, we plan to recruit nearly 700 apprentices and 300 graduates across our UK business, a 30% increase on the previous year and a demonstration of the work we do to nurture talent and develop high-end skills for the future. It is vital we train the next generation of engineers and business leaders to develop the necessary skills needed to drive innovation and solve complex challenges.

Looking forward, our emphasis will remain on ensuring we have a talent pipeline that reflects ambition, enthusiasm, ability and diversity and is committed to the values of the organisation as to how we make money rather than simply how much money we make.

We continue to believe that being performance driven, but values led, should be at the core of our culture.

Our strategy

Our strategy is regularly reviewed, but has remained constant. We are a business that is focused on the provision of technology products and services through government-approved contracts as a world leader in the defence industry.

As with many UK companies, we have been carefully considering and planning for any potential impact that Brexit could have on

the Company, and the Board has been kept informed of this analysis. Whilst we have recognised some potential Brexit impact in our Principal Risks analysis (see page 69), we are fortunate that, given the geographic spread of our operations, the near-term impacts across the business are likely to be limited.

The Middle East remains unstable. In the Gulf region we work primarily with Oman, Qatar, Kuwait and the Kingdom of Saudi Arabia, respecting the importance of the defence and security relationships, and the strength and depth of our economic ties.

To that end, agreement was reached at the end of the year with the Kingdom for us to extend the provision of Typhoon support services.

It should be recognised, however, that the Company is reliant on the approval of export licences by a number of governments in order to continue supplies to Saudi Arabia. In this context, the current position on export licensing adopted by the German government may affect our ability to provide the required capability to the Kingdom. We are therefore working closely with the UK government to minimise the risk of any such occurrence and the impact it would have on financial performance, the supply chain and relationships.

Dividend (pence)

22.2p
+2%



Chairman's letter continued

Recognising the fluctuation in demand patterns, we seek to diversify our markets over a wide geographic area with particular emphasis on the US, the UK, the Kingdom of Saudi Arabia and Australia.

In 2018, the major programme award we received from the Australian government for the advanced anti-submarine warships will serve, over time, to add further attractive balance to our geographic mix.

We continue to operate in all domains of air, maritime, land and cyber. The weighting of maritime activities within our long-term business mix has increased with the considerable orders for Dreadnought Class submarines and Type 26 frigates we have received over the last two years.

Our continued commitment to the air domain is underpinned by recent orders for Typhoon and Hawk and our decision to work in close partnership with the UK government on the Tempest programme to develop the next generation of military fighter jet.

Our US Combat Vehicles business continues to grow following the award of the Amphibious Combat Vehicle and Mobile Protected Firepower programmes. In the UK the proposed joint venture with Rheinmetall is expected to secure the production and upgrade of vehicles for the British Army for years to come.

In Cyber we have focused investment at the top end of the market, where sophisticated systems for military grade intelligence provide barriers to entry for competitors.

In order to smooth the inevitable fluctuations in demand for our products, our business model has a strong service content, which offers a reliable revenue stream and strengthens the partnership with our major customers.

There are few businesses with such strong order books and with programme visibility extending for several decades, few defence companies that enjoy such a wide geographic spread and even fewer technology and engineering businesses that have the depth of expertise that is embedded in BAE Systems.

It is against this background that I believe our strategy is sound and our emphasis on operational excellence appropriate to ensure the delivery of long-term shareholder value.

Our Board

The Board continues to benefit from a high-quality team that is diverse in gender, skill, experience, country of origin and time served. With Revathi Advaiti joining us at the beginning of 2018, currently 28% have been Board members for up to three years, 36% for between three and six years, and 36% for over six years, with an average tenure of five and a half years.

Board chemistry is excellent with candour, mutual respect and collective commitment providing a healthy dynamic for debate, challenge and decision making.

Board succession planning is key to preserving this position, and to that end we have been fortunate to appoint two new non-executive directors recently, Nicole Piasecki and Stephen Pearce, both of whom will join the Board on 1 June 2019. Nicole is a former senior executive with Boeing who has a strong track record in strategic planning and international operations and relations. Stephen is Finance Director of Anglo American plc at present, and as such has the skills and experience necessary to succeed Nick Rose as Chairman of our Audit Committee from the beginning of next year. I am pleased that Nick has agreed to stay on until then, which will allow us to continue to draw on his experience and his oversight of the new auditor, during what is a period of change and geopolitical turbulence. This will also allow Stephen to develop his knowledge of BAE Systems before taking on the chairmanship of an important Board committee.

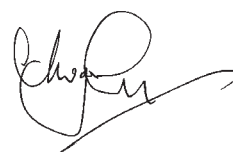
Summary

In summary, we are pleased to have delivered another year of strong performance with sales of £18.4bn and underlying earnings per share of 42.9p, underpinned by an order backlog of £48.4bn.

Whilst the fundamentals of the business are sound, the order backlog substantial and the management team strong, the geopolitics in which we operate have become increasingly challenging and unstable.

As we look forward to 2019 and beyond our focus will be on reinforcing our customer relationships, providing exceptional products and services, preserving our culture, investing in technology and developing our people. By remaining steadfast in our approach, we will seek to continue to deliver for all our stakeholders.

The Board therefore has recommended a final dividend of 13.2p for a total of 22.2p for the full year. Subject to shareholder approval at the May 2019 Annual General Meeting, the dividend will be paid on 3 June 2019 to holders of ordinary shares registered on 23 April 2019.



Sir Roger Carr Chairman

Chief Executive's review



"The Group made **good progress** in strengthening the outlook and geographic base of the business, with a number of **significant contract wins**, leading to a record high defence order backlog."

Introduction

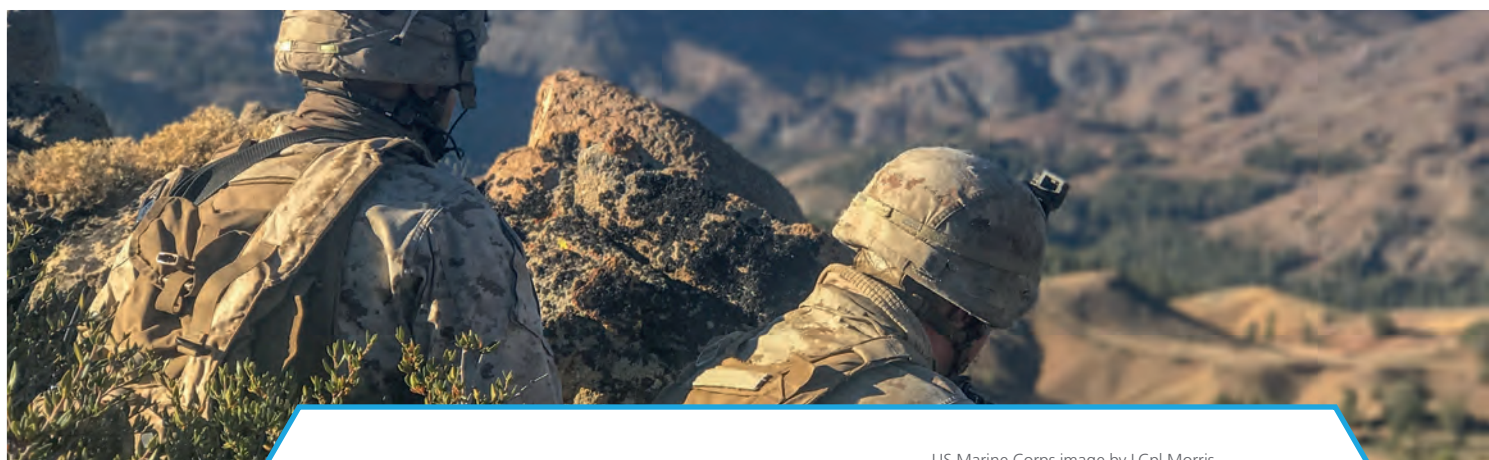
2018 was both a year of geopolitical turbulence and a transition year in terms of earnings for the Group. Production on a number of programmes began ramping-up especially in our Electronic Systems, US Combat Vehicles and Submarines businesses whilst Typhoon and Hawk production stepped down, and the Aircraft Carrier build programme moved towards completion. The order backlog grew by 25% to a record high. Key business wins were secured globally: for example on the Amphibious Combat Vehicle for the US Marine Corps; in Australia for the design and build of nine ships for the Future Frigate programme; in Qatar for the provision of 24 Typhoon and nine Hawk aircraft; and in Canada where the Type 26 design was selected for the Canadian Surface Combatant programme. These wins further strengthened the outlook and the geographic base of the Group.

Governments in our key markets continue to prioritise defence and security, and there is a growing demand for our capabilities, products and services. BAE Systems is a diverse and resilient company, pursuing the right strategy for long-term performance. We have a strong order backlog giving multi-year visibility, a broad portfolio with long-term positions on key programmes with strong customer relationships, and a track record of successful partnerships in international markets to develop local industry, employment and skills.

Within the core strategy, execution on the key strategic objectives of operational excellence, competitiveness and technological innovation is vital for the successful delivery of the order backlog to deliver future growth and in evolving our business to become a stronger, smarter and sharper organisation.

Operational excellence

Raising the bar operationally to improve delivery of the record defence order book remains the priority for the Group, in order to drive growth, strengthen customer relationships and win new and repeat work in the future. Whilst areas of the business are performing strongly and the restructuring actions taken to return the Applied Intelligence business to profitability are gaining traction, there were some disappointments on certain long-standing programmes in our Maritime and Platforms & Services (US) businesses. Steps have been taken to address these operational issues. In Maritime, Andrew Wolstenholme was appointed to lead that business with a clear focus on programme schedule and cost performance. In Platforms & Services (US), the new leadership team is maintaining a keen focus on programme execution as investments are made in operational processes and automation to meet the ramp-to-rate challenges in US Combat Vehicles and position the business for successful programme delivery during its upcoming growth phase.



US Marine Corps image by LCpl Morris.

Competitiveness

The Group continues to take the necessary steps to be competitive. Our customers demand value for money and it is important that we can demonstrate exactly that. The new organisational structure announced in 2017 became effective in 2018. Within procurement, global and national category managers are now in place and efficiencies are being delivered through supply chain rationalisation and enhanced data analytics. Increasing collaboration across the Group, industry partners and academia is becoming more important in delivering competitive offerings. The Group structure and functional councils are in place to ensure this remains a key focus area and we will be relentless in our pursuit of competitiveness and efficiency.

Technological innovation

We have a long heritage of developing and integrating cutting-edge technologies to create complex systems that give our customers a capability advantage. The accelerating pace of technological change is a disruptive force and a key driver of competitive advantage and, increasingly, a determinant for our customers in awarding new business. Coordinated through the Chief Technology Officer, the Group is aiming to increase self-funded research and development spend over time, as well as working with our customers in developing technologies for use today and into the future. In 2018, technology plans were established that supported the sector strategies. The increase in spend will be achieved through a blend of self- and jointly-funded customer programmes, and through a pipeline of investment opportunities and targeted bolt-on acquisitions.

2018 performance

US

On 28 September, the fiscal year 2019 Defense Appropriations bill was enacted. This is the first time since 2008 that the Department of Defense had funding in place by the 1 October start of the fiscal year, and provided near-term clarity for the industry and demonstrated strong bi-partisan support for defence funding under the two-year agreement passed in early 2018.

The enacted Defense Appropriations bill maintains support for our medium-term planning assumptions and positive momentum for military readiness and modernisation programmes. Our US-based portfolio remains well aligned with customer priorities and growth areas with support for many key BAE Systems programmes, including combat vehicles, F-35 Lightning II, electronic warfare programmes, and current and future precision-weapons systems.

Our US electronics business delivered a stand-out operational performance in 2018 especially in our core franchise positions in the high-technology areas of electronic warfare, precision-guided munitions, intelligence, surveillance and reconnaissance, and electro-optics. The business closed with a record order backlog with the portfolio well aligned with the US National Defense Strategy. We continue to leverage these defence electronics capabilities for international programmes.

Platforms and Services (US) worked to address a number of operational challenges in the year, preparing for significant production rate increases in the US Combat Vehicles business. To help position the business to deliver during its upcoming growth phase, management changes have been made and process and automation improvements are being implemented.

Growth in the US-based Combat Vehicles business is underpinned by the ramp-up of production on the Armored Multi-Purpose Vehicle, M109A7 self-propelled howitzer and Bradley upgrade programmes, and the growth outlook was advanced in 2018 with our competitive win on the Amphibious Combat Vehicle 1.1 programme and our selection as one of two companies to proceed to the engineering and manufacturing development phase for the Mobile Protected Firepower programme.

Across our US shipyards, Platforms and Services (US) continues to be a leading supplier of ship repair and modernisation services to the US Navy. The ship repair and our naval gun franchises are well supported by the growth outlook in US Navy budget funding.

In our US-based Intelligence & Security business, whilst market conditions remain highly competitive, the business is maintaining a high level of bid activity, and secured a number of successful wins on recompeted contracts and new business awards in mission-critical areas. The business is delivering on contracts with good programme and financial performance in the period.

We are saddened to report that an accident on 11 June in a nitrocellulose drying facility in Radford resulted in one fatality and injuries to two employees. The health and safety of our employees has always been and continues to be our highest priority.



Our strategy in action

BAE Systems team wins Amphibious Combat Vehicle competition

In June, the US Marine Corps selected our vehicle for its Amphibious Combat Vehicle (ACV) I.I programme. The \$198m (£155m) contract for 30 ACVs has options which, if exercised, could result in a total of 204 vehicles worth \$1.2bn (£0.9bn).

Along with teammate Iveco Defence Vehicles we will provide the Marine Corps with its next generation of vehicles designed to go from ship-to-shore to engage in land combat operations.

The new ACV 1.1 is an advanced 8x8 open ocean-capable vehicle. It provides exceptional mobility in all terrains, and blast mitigation protection for all three crew and 13 embarked Marines, along with other improvements over currently-fielded systems.

The selection of our vehicle further solidifies our 70-year legacy of supplying amphibious capabilities. As a leading provider of combat vehicles, we have produced more than 100,000 systems for customers worldwide.

 Group strategic framework

 More online baesystems.com

UK

Defence and security remain a priority for the UK government. This was reaffirmed in the Modernising Defence Programme and budget updates in the year. In July, the UK government launched its Combat Air Strategy, a significant milestone for our Air sector which sends a strong signal of intent about the UK's commitment to retaining a leading position in Combat Air. The strategy will enable long-term planning in a key strategic part of the business as UK government and industry jointly invest in cutting-edge, next-generation combat air systems.

During 2018 we remained focused on the execution of our long-term contracted positions in Air and Maritime.

In Air, the production ramp-up of rear fuselage assemblies for the F-35 Lightning II aircraft is progressing, and we are on track to achieve full rate production in 2020. The first nine UK F-35 Lightning II aircraft arrived at RAF Marham during the year and initial operational services were stood up. As the UK and global fleets grow, securing a long-term support position on F-35 Lightning II remains a key focus for the Air business.

Following delivery of the final four Typhoon aircraft to the Royal Air Force of Oman, Typhoon production is now focused on the remaining partner nations' deliveries, sub-assembly build on the Kuwait programme and the commencement of the Qatar programme, which sustains production into the next decade. Whilst a degree of geopolitical turbulence exists, the potential pipeline for Typhoon remains positive, with opportunities both with partner nations and through exports. Securing any additional orders would further extend production. Typhoon support continues to be a high-performing line of business for the Group and the Royal Air Force has

declared Typhoon meets the Centurion standard, enabling the transition of capabilities from Tornado to Typhoon as the UK Tornado fleet comes out of service in 2019.

In Maritime, there remains pressure on the Royal Navy's near-term budgets. The Offshore Patrol Vessels programme was impacted in the year by quality issues which led to a provision being taken. Lessons learned are being applied to the other ships in build. The programme is due to complete in 2020. The Type 26 programme is on track for the first of class contractual date in the mid-2020s. Initial flight trials on HMS Queen Elizabeth off the coast of the US were completed successfully and HMS Prince of Wales is due to commence sea trials in the next year.

The strengthened management team in Barrow is delivering improved performance on both the Astute and Dreadnought submarine programmes. The major site development work at Barrow continues, and in November the new Submarines Academy for Skills and Knowledge was opened.

In January 2019, we entered into an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business subject to regulatory approvals. Joining forces with Rheinmetall will bring the strength of both businesses together to be more competitive in the UK and international markets whilst maintaining many jobs in the UK. Rheinmetall will purchase a 55% stake in the existing BAE Systems UK-based combat vehicles business for £28.6m, with BAE Systems retaining 45%.

The final agreement of the terms of the UK's exit from the EU after March 2019 will be important to enable companies to prepare for potential changes in the regulatory environment. There is relatively limited UK-EU trading and movement of EU nationals into and out of BAE Systems'



Our strategy in action

The UK's Combat Air Strategy and Team Tempest

The UK government launched its Combat Air Strategy at the 2018 Farnborough International Airshow. It outlined an ambitious vision for the future and initiated the programme which will deliver the next generation of combat air capability by 2035.

The strategy describes a new and evolutionary approach to developing future combat air systems. The world-leading capabilities and technologies of Typhoon will continue to be developed and deployed and will ultimately transition to a future system, with the aim of providing a seamless integration of the very latest technologies.

As part of Team Tempest, we are working with the UK government and our industry partners Rolls-Royce, Leonardo and MBDA, to develop and invest in technologies which will deliver world-leading capabilities for the future, ensuring that the UK can continue to maintain its operational advantage and freedom of action, while supporting prosperity and international influence.

UK businesses, and the resulting Brexit near-term impacts across the business are likely to be limited. BAE Systems will support the UK government in achieving its aim of ensuring that the UK maintains its key role in European security and defence post-Brexit, and to strengthen bilateral relationships with key partners in Europe.

International

In an uncertain global environment with complex threats, our defence and security capabilities remain highly relevant. 2018 was a strong year in widening our international reach and there are good prospects in existing and new international markets for our products and services in air, maritime, land and cyber.

The contract between BAE Systems and the Government of the State of Qatar for the supply of 24 Typhoon and nine Hawk aircraft to the Qatar Emiri Air Force, along with a bespoke support and training package, became effective in September, and production has commenced.

In Oman, following delivery of the final Typhoons we are delivering on a five-year availability service for their Typhoon and a support package for Hawk aircraft.

In Australia, the Group submitted bids on two significant production contracts. Whilst unsuccessful in the bid for the Land 400 Phase 2 combat vehicle programme, in June, the Commonwealth of Australia selected us as the preferred tenderer for the Hunter Class Frigate programme to deliver nine Future Frigates for the Royal Australian Navy.

The contract providing the framework for the design and build of the ships was signed in December. The build scope is to be negotiated in due course and production of the first ship is expected to commence in South Australia in the early 2020s. This Hunter Class programme is expected, over time, to double the size of the Australian business which is currently underpinned by long-term support and upgrade programmes.

Building on this success, in February 2019, the Canadian government together with Irving Shipbuilding selected Lockheed Martin Canada, using BAE Systems' Type 26 design, as subcontractor for the Canadian Surface Combatant programme.

In Saudi Arabia, BAE Systems continues to address current and potential new requirements as part of long-standing agreements between the UK government and the Kingdom. The Memorandum of Intent signed between the Kingdom of Saudi Arabia and the UK government in March 2018 continues to progress towards reaching an Agreement for a further 48 Typhoon aircraft, support and transfer of technology and capability. This will enable BAE Systems to continue with the Industrialisation of Defence capabilities in the Kingdom of Saudi Arabia, in support of the Saudi Arabian government's National Transformation Plan and Vision 2030.

The final assembly of the Typhoon would follow on from the Hawk programme where the first In-Kingdom final-assembled Hawk aircraft is expected to be delivered to the Royal Saudi Air Force in 2019. Agreement has been reached with the Saudi Arabian government for BAE Systems to continue to provide Typhoon support services to the Royal Saudi Air Force.



It should be recognised that the Group is reliant on the continued approval of export licences by a number of governments in order to continue supplies to the Kingdom of Saudi Arabia. Significant changes in the policies of such governments may affect our own provision of capability to the country and we are liaising closely with the UK government in working to reduce the impact of any such occurrence.

The MBDA joint venture has continued to win orders in both domestic and export markets with the order backlog once again increasing, giving clear visibility of growth in the coming years. The business also continues to invest in new products and is well placed to benefit from defence spend increases in a number of European countries and from export opportunities.

Cyber security

The UK-managed Applied Intelligence business delivered a much-improved performance following restructuring actions taken in 2017 and achieved a break-even position for the year. Focused recruitment in the second half of the year positions the business for a return to growth and profitability as the market develops. The commercial market remains highly competitive; however, cyber security is an increasingly important part of government security and a core element of stewardship for commercial enterprises in a sophisticated and persistent threat environment.

Balance sheet and capital allocation

The Group's balance sheet is 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 expects to continue to meet its pension obligations, invest in research and technology and other organic investment opportunities, and plans to pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings and to make accelerated returns of capital to shareholders when the balance sheet allows. Investment in value-enhancing acquisitions will be considered where market conditions are right and where they would deliver on the Group's strategy.

Pension schemes

The Group's share of the pre-tax accounting net pension deficit reduced to £3.9bn (2017 £4.0bn).

Executive Committee changes

Reflecting the new organisational structure from the start of 2018 there were a number of changes to the Executive Committee. Members appointed as a result of the new structure were Chris Boardman as head of Air, Andrew Wolstenholme as head of Maritime and Julian Cracknell as head of Applied Intelligence. Other new appointments were Karin Hoeing as Group Human Resources Director and at the start of 2019 David Armstrong as Group Business Development Director following Alan Garwood's retirement.

Responsible business

We continue to build a culture where our people are empowered to make the right decisions and know where to go to seek help or guidance.

Recruiting and retaining talented people is a key priority. We want every employee to reach their full potential within a diverse and inclusive work environment. We have programmes in place across the business to support strategic workforce planning, career development and retention, as well as to improve diversity and inclusion.

Summary

Our business benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia along with a growing presence in other international markets. Our strategy is working, it is clear and well defined. With governments in our major markets continuing to prioritise defence and security there is a strong demand for our capabilities. Through improved programme execution and maintaining the strategy and capital allocation policy, BAE Systems is well placed to maximise opportunities, manage the challenges and continue to generate good shareholder returns.

Charles Woodburn
Chief Executive

Group strategic framework

We have shared values:
Trusted, Innovative, Bold
– these give us the right emphasis for our culture, behaviours, relationships and reputation.

Our strategy is comprised of **five key long-term areas of focus** that will help us achieve our vision and mission. It is centred on maintaining and growing core franchises and securing growth opportunities. **Our three strategic priorities** which are embedded throughout the Group provide the link between our longer-term strategy and near-term business objectives for all our employees.

Our vision

To be the premier international defence, aerospace and security company

Our mission

To provide a vital advantage to help our customers protect what really matters

Our strategy

- 1 Maintain and grow our defence businesses
- 2 Continue to grow our business in adjacent markets
- 3 Develop and expand our international business
- 4 Inspire and develop a diverse workforce to drive success
- 5 Enhance financial performance and deliver sustainable growth in shareholder value

Our strategic priorities

Drive operational excellence

Continuously improve competitiveness and efficiency

Advance and further leverage our technology

Our values

Trusted, Innovative, Bold

Our markets



Supporting our customers

Our strategy is focused on providing a vital advantage to our customers across the US, UK and international markets. In particular, we have built strong positions aligned with our core defence platforms to support our customers in our four principal markets. These principal markets – the US, UK, the Kingdom of Saudi Arabia and Australia – have been identified as having a significant and sustained commitment to defence and security. BAE Systems has established strong and enduring relationships in these markets and is recognised as playing a key role in the industrial capability of each of these countries.

Our unique position and capabilities

Our strong position in the US through the Special Security Agreement, together with our standing as the leading defence contractor in the UK, provides us with unique capabilities that can be leveraged across the Group to support our customers. In addition, our diverse portfolio of capabilities in the air, maritime, land and cyber domains, provides us with a comprehensive offering for our customers around the world making us one of the broadest and most geographically diverse major defence companies.

Responding to changes in defence and security requirements

Our business continues to respond to geopolitical and technology trends that will influence and shape our customers' defence and security requirements now and into the future. Our excellence in complex engineering, developing cutting-edge technology and seeking innovative solutions enables us to respond to our customers' requirements for greater agility, global reach, and advanced technology products and services.

Growth aspirations

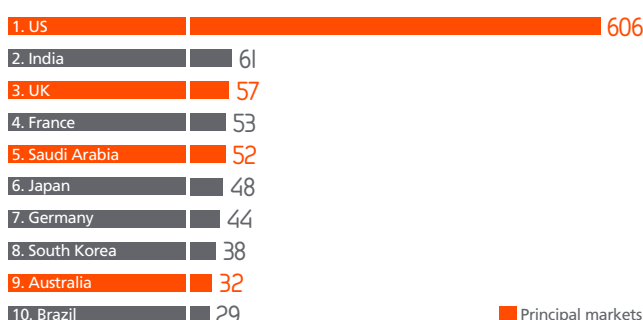
A number of key markets for the Group have either grown or stabilised spending in response to an increasingly uncertain security environment.

We have a significant international presence supported by long-standing customer relationships and the ability to leverage our range of capabilities around the Group. Following a number of significant wins in the last two years we continue to see further opportunities in a number of international markets.

BAE Systems has leading positions in its principal markets – in the **US, UK**, the **Kingdom of Saudi Arabia** and **Australia** – as well as established positions in a number of other international markets. We are one of the largest global defence companies.

Accessible global defence markets¹

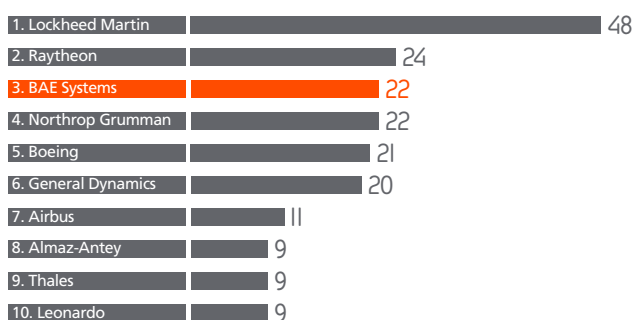
Top ten global defence markets accessible for business by the Group (\$bn)



Source: 2017 US budget as shown in the Department of Defense Fiscal Year 2019 Budget Request and, outside the US, IHS Jane's Defence Budgets (based on 2017 total defence budgets and constant 2018 US dollars).

BAE Systems' global defence market position

Top ten global defence contractors' revenue (\$bn)

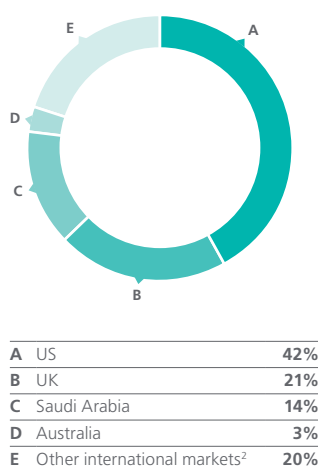


Source: Defense News Top 100 for 2018 (based on 2017 numbers). Exchange rate applied to BAE Systems is \$1.289/£1.

1. Markets inaccessible for business by BAE Systems are excluded.

Our markets continued

Sales¹ by destination



The **US** continues to represent the single largest defence market in the world and BAE Systems remains a **top ten defence supplier** in the US.

On 28 September, the fiscal year 2019 Defense Appropriations bill was enacted. This is the first time since 2008 that the Department of Defense had funding in place by the 1 October start of the fiscal year, which provided near-term clarity for the industry and demonstrated strong bi-partisan support for defence funding as part of the two-year agreement passed in early 2018.

The enacted Defense Appropriations bill maintains support for our medium-term planning assumptions and positive momentum for military readiness and modernisation programmes. The portfolio of the US-based business is well aligned with customer priorities and growth areas, which include combat vehicles, precision-guided munitions, naval ship repair and modernisation services, electronic warfare, and space security. BAE Systems has strong positions on a number of premier defence programmes, including F-35 Lightning II, Paladin self-propelled howitzer, Armored Multi-Purpose Vehicle and Amphibious Combat Vehicle, and we are a leader in advanced electronic systems, real-time intelligence and analysis, naval gun systems and artillery systems.

In addition to our position on US defence programmes, the US-based portfolio is also focused on Foreign Military Sales and direct international sales to allied nations.

We continue to deliver on existing commercial programmes, including engine and flight controls, and electric drive propulsion systems.

BAE Systems remains the largest defence company in the **UK**, with strong and **long-standing relationships** with the Ministry of Defence.

The UK is Europe's largest defence market and, after a period of budgetary decline, defence spending has stabilised. The Autumn Budget reinforced the UK government's commitment to defence and security spending, as well as the continued pledge to maintain spending at 2% of GDP. Additionally, the UK Combat Air Strategy announced in July is a significant milestone, sending a strong signal of intent for the UK's commitment to retaining a leading position in Combat Air. The strategy will enable long-term planning and joint government and industry investment in next-generation combat air systems.

In light of the UK's referendum decision to leave the EU, the government has signalled its intent to continue to play a major role in defence and security co-operation in Europe. The final agreement of the terms of the UK's exit from the EU after March 2019 will be important to enable companies to prepare for potential changes in the regulatory environment. There is relatively limited UK-EU trading and movement of EU nationals into and out of BAE Systems' UK businesses, and the resulting Brexit near-term impacts across the business are likely to be limited. BAE Systems will support the UK government in achieving its aim of ensuring that the UK maintains its key role in European security and defence post-Brexit, and to strengthen bilateral relationships with key partners in Europe.

The UK government provides vital support in the pursuit of international export opportunities, recognising the value that BAE Systems and the defence industry contributes to the UK economy.

BAE Systems plays an important role in providing capabilities to support the UK government and armed forces across the air, maritime, land and cyber domains. Our involvement across the major UK defence programmes, including Typhoon aircraft, Queen Elizabeth Class aircraft carriers, Type 26 frigates, and Astute and Dreadnought Class submarines, maintains our diverse skillsets, allowing us to provide a vital advantage to our customers.

Our UK-managed cyber business has a focused investment strategy to ensure that we support our commercial and government customers as cyber security becomes an increasingly important part of a sophisticated and persistent threat environment.

1. Revenue plus the Group's share of revenue of equity accounted investments.

2. Includes £0.7bn (4%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

The **Kingdom of Saudi Arabia** continues to be a significant military power and one of the largest defence markets globally.

Saudi Arabia has a strong commitment to defence and security spending driven by regional security instability.

Saudi Arabia's Vision 2030 strategy to promote In-Kingdom industrialisation and diversification away from reliance on oil continues to shape our activities in support of Saudi Arabia's national objectives of technology development, local skills, and the development of an indigenous defence industry and capability. Through the restructuring of the Group's portfolio of interests in a number of Kingdom of Saudi Arabia industrial companies along with sustaining current industrialised capability and building on our strong history in Saudi Arabia, we are working in partnership to continue to deliver these priorities with the Saudi Arabian Military Industries (SAMI) organisation to explore how we can collaborate to deliver further In-Kingdom Industrial Participation.

We remain well placed as a leading in-country contractor in support of air defence platforms and training systems for the Royal Saudi Air Force, as well as support for mine countermeasure vessels for the Royal Saudi Naval Forces.

BAE Systems is one of the largest defence companies in **Australia**, with strong activities across all domains.

Regional instability and the pace of military modernisation in the Asia-Pacific region continue to drive the government's commitment to defence spending, with major recapitalisation programmes under way in the air, maritime and land domains.

The government has indicated its intent to grow defence spending by committing to spend 2% of GDP by 2020/21. As part of this commitment, the government has made clear its objective to build a stronger and more sustainable domestic defence industry, ensuring that over time the nation has in place a sovereign industrial base that has the skills, knowledge and capability to manage and support the platforms and systems it has invested in.

We are well positioned to support this through an established business and a workforce based at more than 25 sites across the country, in addition to our ability to leverage our international positions within the Group to support domestic Australian products in export markets.

We currently provide support to the Australian Defence Force through engineering, programme management and sustainment solutions, including the Jindalee Operational Radar Network upgrade, Hawk Lead-In Fighter support, F-35 Lightning II sustainment, and Anzac frigate support and upgrade. The award to BAE Systems Australia in 2018 of the nine-ship Hunter Class Frigate programme, to be built at the ASC shipyard facility in Adelaide, will in time give the business a balanced portfolio of build and support work.

BAE Systems has many strong and enduring relationships in **other international markets**.

Regional security tensions, the growing emphasis on indigenous capabilities and varying economic conditions continue to influence defence spending internationally. In Asia-Pacific and the Middle East, BAE Systems has developed and seeks to further relationships with partners and customers in a number of countries.

In Qatar, the contract to provide Typhoon and Hawk aircraft along with a bespoke support and training package became effective in September.

In Oman, where we completed the delivery of the final Typhoons in 2018, we provide support to Typhoon and Hawk aircraft and naval vessels.

We have a strong presence in Sweden through our BAE Systems Hägglunds business supplying and supporting tracked vehicles for international customers.

In Turkey we are collaborating on the first development phase of an indigenous fifth-generation fighter jet, TF-X, for the Turkish Air Force and we maintain our position in armoured combat vehicles through the FNSS joint venture.

In India, we have long-established relationships with local industry partners Hindustan Aeronautics Limited on Hawk aircraft and with Mahindra Defence Systems on M777 ultra-lightweight howitzers.

In Malaysia, we are a supplier to the armed forces, both directly and through joint ventures. We have set up a Global Engineering Centre in Kuala Lumpur focusing on local delivery and global support of our cyber and financial crime detection services.

Our US businesses export combat vehicles and precision weapon systems to a number of international customers and leverage further international markets through our partnerships in defence and commercial electronics.

Through our shareholding in MBDA, our position in the missiles and missile systems market continues to grow in European and other international markets.

How our business works

We provide **advanced technology defence, aerospace and security solutions** that aim to give our customers a **competitive edge**.

We aim to deliver...

...products and services that provide a vital advantage to help our customers protect what really matters:

Our largest customers are governments, but we also sell to large prime contractors and commercial businesses. We take on and solve some of our customers' most complex and challenging engineering and technology projects to give them a competitive edge, helping them protect what matters most.

+04 Our key products and services

We create value through...

- Established positions on long-term programmes
- Strong and collaborative relationships with governments and commercial customers
- Our position as a trusted supplier allows us to identify emerging trends and opportunities for growth

...identifying customer needs

...services, sustainment and upgrade

- Understanding our customers to provide competitive services that add value
- Technical expertise acquired through product design and development
- Flexibility and responsiveness to maximise availability of our customers' products

Our business model is underpinned by...

...our values

Our values of Trusted, Innovative and Bold are at the heart of everything we do and provide the right focus and framework for our employees to aspire to and live by, now and into the future.

...our people

We have a diverse range of talented people. We invest in education and training for our existing workforce, including apprenticeship and graduate programmes, and work with education sectors to help shape the workforce of the future.

+18 Group strategic framework

+24 Our people

Non-financial information statement

This section of the Strategic report, entitled 'How our business works', constitutes the Non-Financial Statement as required by the Companies Act 2006 as amended.

- Strategic focus on technological capabilities which drive innovation
- Partnerships with small and medium-sized enterprises and academia to develop new solutions
- Early-stage research which is self-funded and then developed further with customer funding

...research and development



...bidding and contracting

- Critical skills in identifying risk, whilst focusing on value for customers
- Record of delivery on complex projects
- Partnerships with local companies supporting economic development

...advanced manufacturing, commissioning and integration



...designing and developing

- Investment in advanced manufacturing facilities and techniques
- Focus on operational excellence with safety as a key priority
- Management of complex projects and collaboration across global supply chains

- Engineering expertise in developing cutting-edge products and services
- Product safety embedded in our designs to maximise safety in the construction and use of our products
- Products designed to be easily maintained and upgraded as technology evolves

...our technology

We focus on technology innovation and engineering excellence, prioritising and investing in next-generation research and development programmes to deliver competitive solutions to meet our current and future customers' needs.

+26 Our technology

...our partners and key relationships

We have close relationships with suppliers, universities and governments which help us to create best-in-class, cost-effective equipment, goods, services and solutions.

+31 Our partners and key relationships

...responsible sourcing and impact

We take pride in managing our operations responsibly and we require our employees to conduct business in an ethical way under our Code of Conduct to enable us to earn and maintain the trust of our stakeholders.

+33 Responsible sourcing and impact

...our governance framework

Our robust governance framework sets out the way we do business. It details our policies and processes which, together with our culture, enable us to deliver operational excellence in a clear, accountable and consistent way.

+76 Board governance

Our people

How our business works continued

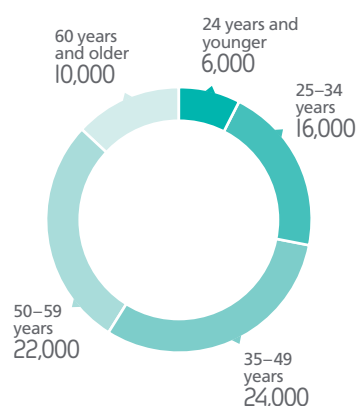


Creating an **inclusive culture** where everyone can **fulfil their potential** is a key priority for BAE Systems.

Gender diversity

	Male	Female
Board	7	4
	64%	36%
Senior managers^{1,2}	276	58
	83%	17%
Total employees^{3,4}	62,000	16,000
	79%	21%

Age diversity^{3,4}



1. Senior managers are defined as employees (excluding executive directors) 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.
2. Excludes executive directors.
3. Excluding share of equity accounted investments and rounded to the nearest thousand employees.
4. See summary of Deloitte LLP assurance on page 34.

We value our employees and the contribution they make, and we are committed to creating an inclusive culture where everyone can give their best. This is essential if we are to attract and retain talent and drive innovation to solve our customers' complex challenges.

Our approach

BAE Systems' business strategy is dependent on its ability to recruit and retain people with appropriate talent and skills, and we have identified this as a principal risk (see page 71). Our Human Resources Strategy prioritises identifying, attracting and developing talent through robust succession planning, as well as engaging and rewarding employees.

Our Group Human Resources Director reports directly to the Chief Executive and chairs the Global HR Council ensuring our Human Resources Strategy supports the Integrated Business Plan and People Policy.

Diversity and inclusion

BAE Systems is committed to being an inclusive organisation with a diverse workforce that reflects the communities in which we work. Diversity and inclusion is not just the right thing to do, it will differentiate and strengthen us for the future.

We recognise that employees from varied backgrounds, beliefs and life experiences bring innovation in all that we do. We know people perform at their best when they truly can be themselves.

We are determined to increase the number of women in senior executive positions in our industry by working on the attraction and retention of more women within the Company. Our businesses own and drive strategies to support these priorities and we have measures in place to track progress. We have signed up to the Women in Aviation Charter and are launching a leader-led gender equity network in the US to provide mentoring and coaching for junior to mid-level women.

Identifying and recruiting talent

We must recruit a diverse range of professionals to deliver excellence to our customers, including engineers, designers, software developers and project managers.

We have focused our recruitment on the next generation to mitigate Science, Technology, Engineering and Mathematics (STEM) skills shortages, and to accelerate diversity within our leadership.

We regularly provide high-quality training for thousands of apprentices and graduates across our business. We have partnered with Cranfield University in the UK and multiple colleges, universities and trade schools throughout the US to create innovative apprenticeship and technical-development programmes to attract and retain great talent and boost high-end skills.

In the Kingdom of Saudi Arabia our technical training programmes are revered for their contribution to the economy through the development of indigenous capability. We are responsible for qualifying more than 1,200 people annually in teaching and engineering professions.

Training and development

We want all of our employees to reach their full potential, evolving their skills to meet our customers' current and future requirements. We support this through comprehensive career frameworks, development programmes and gaining experience from the breadth of our global operations. From deploying more than 1,500 expatriates and investing in our local Saudi workforce through a range of overseas assignments, to equipping our production-floor supervisors in the US with the skills to lead growing teams in an advanced technological environment, continual improvement of competence and skills transfer helps us to develop world-leading technologies, giving our customers a critical advantage.



Our strategy in action

Employee Resource Groups

BAE Systems' Employee Resource Groups (ERGs) are voluntary, employee-led groups that serve as a resource for members and organisations by fostering a diverse, inclusive workplace aligned with our organisation mission, values, goals, business practices and objectives.

They play an important role in BAE Systems' commitment to diversity and inclusion. Our ERGs provide programmes to enhance personal growth and professional development, help support business priorities, and allow employees to expand their internal and external networks. In alignment with our diversity and inclusion strategy, the ERGs are grassroots efforts that work to positively impact our workforce, workplace and the community. Each network has a formal structure, periodic meetings, objectives, and in most cases an executive sponsor. Our ERGs include: Outlink in the UK and US for our Lesbian, Gay, Bisexual, Transgender and Questioning community which strives to promote equality through education; ENabled Disability Network in the UK (called ABLE in Saudi Arabia and the US) which draws upon the experience of its members to provide relevant guidance and support regarding disability issues; Women's Network in Australia, Saudi Arabia, the UK and the US which aims to foster an inclusive community focused on the needs and interests of women in the workplace and the community; and our Veteran's Support Network in the US whose mission it is to help connect former service members, active duty members, reservists and those who are supportive of our armed forces.

Responsibility for development is led by each employee, in partnership with their manager and with support from the Company. We encourage each employee to have conversations with their manager to create a meaningful plan to ensure their professional development.

Reward

We provide our employees with competitive reward packages which reflect their individual responsibilities and contribution to business performance, and we recognise individual and team successes.

We have published our second annual gender pay gap report in line with UK regulations. For 2018, the average gender pay gap for our UK workforce was 9.0% (2017 11.2%), which is lower than the current UK national average of 17.9%. We have a gender pay gap because we employ around four times more men than women and a greater proportion of our senior leadership population is male. We rely on employing large numbers of employees with STEM qualifications and we, like other companies, face challenges recruiting females with these qualifications because there are significantly fewer women who study and work in these fields.

Employee engagement

Employee engagement is a primary focus for our leaders and managers – connecting employees to our strategy and purpose, empowering them to contribute to improving business performance and creating an environment in which everyone can fulfil their potential.

We keep employees informed about what is happening across the business through our intranet and email, podcasts, newsletters, and leadership blogs and briefings.

In 2018, we conducted a Group-wide survey to measure employees' views on key engagement factors and our current ways of working. The results of this survey will help us to build on our strengths and focus on areas where we can further evolve our ways of working to support future success.

Our global Chairman's Awards programme recognises individuals and teams for their outstanding contribution to the success of the Group.

We encourage employees to become shareholders in BAE Systems and, in some markets, offer share schemes to support this.

We seek to maintain constructive relationships with trade unions in Australia and the UK, and labour unions in the US. 55% of our UK employees are members of a trade union with 69% covered by a collective bargaining agreement. In the UK, we retain excellent relationships with the main organisations involved and organise regular meetings through our Corporate Consultation Committee. We have structures in place to work with trade union representatives in our local markets, where it is appropriate and legally acceptable.

Employee Engagement groups exist across the businesses, in order to provide engagement forums for those not covered by collective bargaining.

Our technology

How our business works continued



Our strategy in action

Insights into causes of conflict for military planning

We are developing technology for the US Defense Advanced Research Projects Agency (DARPA) and US Air Force Research Laboratory that will aid military planners in understanding and addressing the complex dynamics that drive conflicts around the world.

Through the Causal Exploration of Complex Operational Environments programme, we are developing software that models different political, territorial and economic tensions that often lead to conflicts, helping planners to avoid unexpected outcomes.

This original software, called Causal Modeling for Knowledge Transfer, Exploration and Temporal Simulation, is intended to create an interactive model of an operational environment, allowing planners to explore the causes of a conflict and assess potential approaches.

This solution aims to replace today's time-consuming and labour-intensive approaches, to give planners a quicker and deeper understanding of conflicts to help avoid unexpected and counter-intuitive outcomes.¹

This and other programmes are managed by our Electronic Systems FAST Labs™ business area. The team collaborates across the Company's global enterprise to create and develop advanced technology capabilities in advanced electronics, autonomy, cyber, electronic warfare, and sensors and processing. Our scientists and engineers solve some of the toughest challenges in the defence, aerospace, power and propulsion, and security domains. The team is also partnering with universities and commercial technology companies to leverage innovation for powerful new capabilities for our customers.

Our technology provides customers with a **competitive edge** across air, maritime, land and cyber to help them to **protect what matters most**.

In the complex and fast-changing environment in which we work, harnessing technology and innovation is key to developing the most effective and efficient solutions for our customers. We are addressing this pace of change by ensuring that our products are designed, built and supported in a way that provides for future flexibility with the ability to upgrade in an agile manner.

Technology and innovation are central to our business. They underpin our strategy and the development of our products and services, helping to make our products more cost-effective, including the operational and through-life costs of current and future systems.

Our planning process starts with the business strategy informing a product strategy which in turn defines the capabilities and technologies that are required.

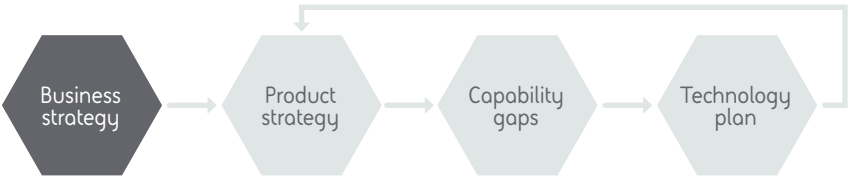
This structured approach ensures we have a clear focus for our research and development (R&D) spend and that of our customers, to maximise future product and service capabilities and the way we work.

A collaborative approach

The Technology team, part of the Chief Technology Officer organisation, works with the BAE Systems businesses to develop the technology plans. Our people are encouraged to innovate and embrace disruptive technologies focused on those that will ensure our customers are equipped to face present and future threats. We employ highly skilled engineers, technologists and scientists who enable us to deliver the most cutting-edge technology.

We are focused on improving collaboration across the business, increasing connections and identifying opportunities and projects where we can leverage the power of the Group including across areas such as autonomy, maritime battlespace, future combat air, cyber and advanced manufacturing. In advanced manufacturing, we continue to invest in our additive manufacturing capabilities across the business and developing partnerships with universities and supply chain companies with a particular focus on a reduction of the design-to-manufacture time.

As well as taking a collaborative approach within our own business we work with a range of partners including our customers, defence and security industry partners, other industry partners, small and medium-sized enterprises and academia. Often we work with others to develop embryonic technology before selecting and maturing it for use in our own products and services.



1. The views, opinions and findings expressed are those of BAE Systems and should not be interpreted as representing the official views or policies of the Department of Defense or the US government.



Our strategy in action

Mixed reality cockpit

BAE Systems' specialist team of Human Factors engineers collaborate with pilots to better understand and anticipate their needs. These insights shape the intuitive technologies that the team is developing for the cockpit of the future.

One area of focus is on technologies that enable pilots to control the cockpit in new ways. An example is the 'wearable cockpit' which removes many of the physical elements of current cockpit design, and replaces it with a virtual display, projected through the pilot's helmet. This provides the pilot with a software-only cockpit that is upgradeable, adaptable and reconfigurable.

We have integrated our virtual reality cockpit with the Striker® II helmet and are now working to evaluate its effectiveness in a range of simulated scenarios.

As military domains become more contested and technologies become more complex, we are focusing on the controls that are critical to the pilot and how these can become easier to manage. Eye-tracking technology will allow the pilot to physically look and highlight an object, and then make a gesture to 'press' a button, rather than having a series of physical buttons on the aircraft.

In the US, UK and Australia we forge strong relationships and partnerships with universities to enable us to identify and learn about new technologies that can help our customers.

We also assess the utility of our existing technology to determine if we can create value through licences and sales of rights to the technology to other organisations.

Horizon scanning

Part of the role of our Technology team is to scan the developments in science and engineering happening across the world and to bring to our attention the latest advances that may have utility in the defence, aerospace and security markets.

We work hard to identify key trends that will shape our future business, taking into account the increasing pace of technological change and the huge growth in R&D spend in the commercial and consumer-focused sectors that has applicability for our business. Work in this area includes the virtual training environment where we are developing virtual platforms and their support environments by leveraging commercial gaming technologies.

The use of technology, innovations and advanced manufacturing techniques across our business is essential in driving greater efficiency and increased productivity. A good example of this is the work we are doing to develop an intelligent, self-optimising and adaptable digital factory for future platforms that will integrate intelligent robotic technologies to support manufacturing and assembly. Aligned to this is our investment in intelligent robotic technologies, such as collaborative robots (or Cobots), which are powerful enablers for reduced manufacturing costs, improved productivity and the safety of manufacturing environments.

We are also investing in digital twin technology to evaluate the potential of a product digital twin that can facilitate virtual testing to be undertaken in a digital environment, significantly reducing the requirement and cost of physical testing.

Our investment

We continue to invest in a wide range of R&D activities that are targeted in customer priority areas and in programmes that will give us a competitive advantage. In 2018, we spent £1.5bn (2017 £1.6bn) on R&D, of which £222m (2017 £238m) was funded by BAE Systems. In addition, the Group's share of the R&D expenditure of its equity accounted investments in 2018 was £0.2bn (2017 £0.1bn).

We protect our investments in technologies and have a portfolio of patents and patent applications covering approximately 2,500 inventions worldwide.

In order to accelerate our R&D programmes we make value-adding investments or acquisitions in key and emergent new technologies. In 2018 we announced a collaboration with Prismatic to invest in the development and flight testing of the PHASA-35™ system, a new solar electric unmanned aerial vehicle which has the potential to fly for up to a year, and a further investment in Reaction Engines.

Research and development expenditure¹

£1.7bn (2017 £1.7bn)

1. Including share of equity accounted investments.

Our values and responsible behaviour

How our business works
continued



We are a business that operates **responsibly** and with **integrity**, supporting **sustainable long-term performance** by managing non-financial risks that can impact reputation and shareholder value.

The Board delegates the detailed oversight of responsible behaviour matters to the Corporate Responsibility Committee, which is chaired by a non-executive director (see page 87). The Corporate Responsibility Committee meets as part of the Board's annual schedule of meetings (see page 80), and agrees the Group's responsible business priorities relating to our employees, trust and integrity, health and safety, and resource efficiency.

The Chief Executive is responsible for ensuring that we meet our own standards. He is supported by the Managing Director Operational Governance with guidance and oversight from the Board via the Corporate Responsibility Committee. The performance review process is used to flow down corporate responsibility objectives through the Group.

For information about how our business model is underpinned by our commitment to corporate responsibility, see page 23.

Our Operational Framework (see page 76) sets out the way we do business. We set Group-wide policies, which are enacted at a local level by our businesses, and help business leadership to make informed decisions.

Our Operational Framework is underpinned by our Operational Assurance Statement (OAS) which is a six-monthly process used to monitor compliance with the Operational Framework and policies. The OAS also requires a report showing the key financial and non-financial risks for each business and Group function completed by the line and functional leaders.

The Internal Audit Director owns the OAS Policy, and is responsible for the consolidation and reporting of the OAS submissions from the businesses to the Group Audit Review Board, the Audit Committee and the Corporate Responsibility Committee. The Internal Audit Director reports functionally to the Audit Committee and, for day-to-day operations, to the Chief Executive. The Corporate Responsibility and Audit Committees hold a joint meeting each year to review the OAS and assurance matters as both committees are concerned with both financial and non-financial risk.

The Board has overall responsibility for determining the nature and extent of the risk that the Group is willing to take and for ensuring that risks are managed effectively across the Group. The Board reviews risk as a regular agenda item and as part of its annual strategy review process.

Our corporate responsibility programmes focus on:

- continuously improving employee wellbeing and standards of safety for employees and those we work with, to ensure that everyone goes home safely (see page 30);
- developing an inclusive, diverse workplace to drive innovation and enhance the performance of our employees (see page 24);
- engaging with our communities by supporting projects and employee volunteering (see page 31);

Our strategy in action

Training our
Ethics Officers

Each year, BAE Systems holds two two-day forums (one in the US, and a global one in the UK) to provide training and updates for our Ethics Officers.

In 2018, these included introductions from Jerry DeMuro, President and Chief Executive Officer of BAE Systems Inc. and Charles Woodburn, Chief Executive of BAE Systems stressing the importance of the role our Ethics Officers play.

The global ethics conference focused on providing our Ethics Officers with additional training on supporting people who raise concerns, aiming to further normalise the Speak Up process. The US conference provided our Ethics Officers with training on the importance of culture and the skills related to investigations.

- supporting our employees in making the right decisions and doing the right thing (see page 29);
- managing the environmental impacts of our facilities and products to improve efficiencies and cost savings (see page 33); and
- working with suppliers to deliver excellence and innovation to support our businesses in delivering on their objectives (see page 31).

Trust and integrity

We aim to be a recognised leader in business conduct which helps us to earn and maintain stakeholder trust and sustain business success.

We consider it fundamental to maintain a culture focused on embedding responsible business behaviours. All employees are expected to act in accordance with the requirements of the Group's policies, including the Code of Conduct, at all times. As well as being the right thing to do, this reduces the risk of compliance failure and supports us in attracting and retaining high-calibre employees.

We work to build a culture where our people are empowered to make the right decisions and know where to go to seek help or guidance. Our Code of Conduct sets out clear expectations on ethical conduct and we offer training and support to help people understand the right thing to do.

During 2018, we rolled out face-to-face ethics training that covered realistic, issue-based scenarios. This training, delivered by line managers to their teams across the Group, was designed to stimulate conversations around difficult issues faced by employees in their workplace. Certain employees received additional training according to their role, such as anti-bribery and anti-corruption, and export control training.

Employees can speak up via our network of over 160 Ethics Officers or by contacting our 24-hour Ethics Helpline by phone, email or an external website to ask for support or report a concern, anonymously if preferred.

We collect data on ethics enquiries and dismissals for reasons relating to unethical behaviour (see opposite). In 2018, there were 1,286¹ ethics enquiries, an increase of 0.5% on 2017. This positive trend reflects our efforts to encourage our people to speak up and we will continue to communicate to our employees the methods for making contact. Our 2018 anonymity rate of 28% compares favourably with international benchmarks.

In 2018, 48% of the ethics enquiries received were requests for guidance and advice, which we believe reflects our employees coming to us before a situation has worsened and requires investigation.

We encourage employees to contact us as early as possible when a potential incident can still be prevented by timely advice.

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.

Anti-bribery and anti-corruption

We have well-established anti-bribery and anti-corruption policies aimed at ensuring adherence to the associated legal and regulatory requirements in light of the bribery and corruption risk faced by the Company. Our commitment to comply with all applicable laws and regulations, including those addressing anti-bribery and anti-corruption, and our commitment never to offer, give or receive bribes or inducements is also clearly set out in our Code of Conduct.

The policies referred to above include the following:

- **Advisers Policy** – which governs the appointment, management and payment of third parties who are engaged to assist with our sales and marketing activities or the strategic development of the Group;
- **Gifts and Hospitality Policy** – which governs the offering, giving or receipt of gifts or hospitality;
- **Conflict of Interest Policy** – designed to ensure that personal conflicts of interest do not impair employees' judgement and damage the Group's integrity and interests; and
- **Facilitation Payments Policy** – designed to ensure that Facilitation Payments are not paid and that the Group and its employees seek to eliminate the practice of facilitation payments.

Other policies, including our Finance Policy, Fraud Prevention Policy, Export Control Policy, Lobbying, Political Donations and Other Political Activity Policy, Offset Policy and Procurement Policy include measures to address bribery and corruption risks.

Risk-based due diligence procedures have been implemented to address bribery, corruption and other financial and non-financial risk, and our Policies include processes for risk-based internal and external approvals, ongoing monitoring and repeat due diligence.

For the principal risks relating to compliance with anti-bribery and anti-corruption regulations and how the risk is mitigated, see the laws and regulations risk description on page 70.

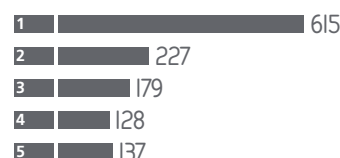
Total ethics enquiries¹



Anonymity rate

28% (2017 24%)

2018 ethics enquiries by type¹



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

Dismissals for reasons relating to unethical behaviour²



1. See summary of Deloitte LLP assurance on page 34.
2. Verified by BAE Systems Internal Audit.



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

Our values and responsible behaviour

How our business works

continued

+68 Our principal risks

+76 Operational framework

Human rights

We are committed to respecting human rights. This applies equally to our employees, our suppliers and business partners, all of whom are expected to adopt the same or similarly high standards of ethical behaviour. We are committed to conducting business responsibly and to maintaining and improving systems and processes to reduce the risk of slavery and human trafficking in our business or supply chain.

Our Code of Conduct and other global policies and processes mandated under the Operational Framework, together with our supporting principles and guidance on responsible trading and suppliers, support our commitment to human rights. This results, for example, in due diligence being carried out during the supplier evaluation stage against non-financial risks, including human rights, working hours, harassment and unlawful discrimination, anti-whistleblowing, slavery, human trafficking and child labour.

Suppliers are regularly reviewed throughout their contractual relationships against such non-financial risks. In 2018, we published our response to the UK Modern Slavery Act and a statement in response to the California Transparency in Supply Chain Act on our website.

Health and safety

Our collective focus on employee wellbeing and the health and safety of employees and those who work on, or visit, our sites is a contributory factor to the success of our organisation. Our safety culture and our employees demand high standards for all aspects of health and safety. This is supported both by our mandated Health and Safety Policy and the principles contained within our Code of Conduct for employees.

Employee wellbeing

We promote wellbeing through a wide variety of programmes, ranging from exercise and fitness promotion to occupational health checks. We know that good mental and physical health contributes to better decision-making, greater productivity and higher levels of employee satisfaction. We run campaigns to encourage employees to take responsibility for their health. Our Employee Assistance Programme is a confidential service available to employees and includes support and advice on personal matters.

Safety

Our business is highly complex and our employees are exposed to many risks. These range from slips, trips and falls in an office environment, confined space working and machinery hazards within manufacturing to fire and explosion risks associated with the manufacture and storage of munitions. Many of our employees operate heavy equipment, work at height or do physically demanding work in high-risk environments.

In order to ensure consistency, all businesses are required to comply with our Health and Safety Policy, which outlines and prescribes the responsibilities and arrangements in place for ensuring safety. It is the responsibility of individual business leaders to ensure that their organisations comply with the policy. We aim to mitigate or manage safety risks by finding new ways to enhance safety standards, increase awareness and continually drive a strong safety culture.

Due to the varied risk profiles and work environments within the Group, we operate safety management systems within each business, many of which are externally accredited to the OHSAS¹ 18001 or ISO² 45001 standard. These systems identify and control risk, and are used to assure that the processes and procedures are protecting our people and others who may be affected by our operations. Teams of safety specialists assist management in ensuring safety management systems are effective and the operational control of risk is maintained. Health and safety specialists provide expert advice and tools to put our safety policies into practice.

Some employees may be exposed to long-term health risks from hazardous substances and other physical hazards. We aim to reduce exposure levels to hazardous substances and to seek alternatives, where possible. We provide our employees with health surveillance to understand and reduce the impact of workplace health risks.

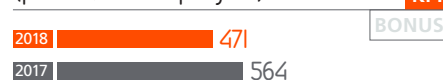
We use the Recordable Accident Rate as a key performance indicator to measure workplace injuries. This metric, along with the number of major injuries, is used to determine an element of executive bonus (see page 107). In 2018, there was a 16% decrease in the Recordable Accident Rate. The overall number of major injuries recorded increased to 37 compared with 28 in 2017, and sadly, an accident on 11 June in a facility in Radford resulted in one fatality and injuries to two employees. The health and safety of our employees has always been and continues to be our highest priority.

We continue to focus on reducing risk and embedding a strong safety culture to drive improvements.

2019 priorities

We will continue to drive towards a world-class level of safety performance; focus on the management and reduction of safety risk; and drive a strong safety culture through communication, awareness and visible leadership. We will target a 10% reduction in the Recordable Accident Rate. We will roll out our annual Business Conduct scenario-based training to all employees. This forms part of our continuing efforts to build a culture of responsible behaviour and ethical decision-making.

Recordable Accident Rate (per 100,000 employees)³



Major injuries recorded^{3,4}



BONUS

5% of the UK executive directors' bonuses are based on the achievement of safety KPIs (see page 107).

1. Occupational Health and Safety Assessment Series.
2. International Organisation for Standardization.
3. See summary of Deloitte LLP assurance on page 34.
4. The definition of a major injury was updated in 2017 to more closely align with the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 2014.

Our partners and key relationships



We engage regularly with our partners and **listen** and **inform** in equal measure through formal mechanisms and **ongoing dialogue**.

Suppliers

We create best-in-class products and services through extensive collaboration with more than 20,000 suppliers worldwide.

We work with suppliers and their supply chains to provide fully compliant, cost-effective equipment, goods, services and solutions. Our supplier relationships are often long term due to the length of our product lifecycles, so we aim to work with suppliers who share our values and who embrace standards of ethical behaviour consistent with our own.

Our policy is to identify and select suppliers who meet our standards, and to support them by managing risks throughout the lifecycle of any commercial arrangement. We manage risk with our suppliers in accordance with our Procurement Policy, our Lifecycle Management Framework and our Supplier Principles – Guidance for Responsible Business. Our business leaders and the Global Procurement Council oversee compliance with the policies and principles, and our Procurement teams assess suppliers against the Principles, including anti-corruption criteria.

After selection, we continue to engage with our suppliers for ongoing assurance at all stages of a project. Our key supplier and procurement policies are compliant with national and international laws. In 2018, we reconfirmed our commitment to the enhanced UK Government Prompt Payment Code and were one of the inaugural signatories to the Australian Small Business Supplier Payment Code.

Partners

We continue to work with peers across the defence industry to improve ethical standards. During 2018 we continued to participate in the International Forum on Business Ethical Conduct's Council and worked with the Institute of Business Ethics to set up a UK Defence Practitioners Group. This group met several times in 2018 to share experiences and best practice on ethical issues of particular concern to the industry and to receive expert briefings.

The BAE Systems, Inc. business continued strong support of the Defense Industry Initiative by participating in the Working Group, webinars and the annual Best Practices Forum. In addition, BAE Systems, Inc. is on the governing board for the Capital Area Business Ethics Network (CABEN). CABEN provides members who are professionals in ethics, compliance and corporate social responsibility fields, in the greater Washington, D.C. area, with a forum for sharing best practices and networking opportunities to exchange information.

BAE Systems, Inc. also contributed to a Best Practices Paper with Ethics and Compliance Initiative on Using Your Organization's Performance Evaluation System to Drive Ethical Conduct.

Community investment

Giving back to the communities in which we operate, and to charities that have meaning to our business is vitally important to our Company and our employees, allowing us to make a positive difference and have an impact where it counts.

During 2018 the Group contributed more than £11m³ to local, national and international charities and not-for-profit organisations through our community investment programme. This includes charitable sponsorships, donations, employee fundraising and volunteering.

Our strategy in action

UK:
Movement
to Work

BAE Systems is a founder supporter of the Movement to Work (MtW) initiative in the UK, an employer-led initiative to tackle youth unemployment.

MtW is designed to help provide a pathway into work for young people by providing them with quality work experience and employability skills training, and our funding and support provides 98 new placements per year.

So far, we have provided 431 placements and 259 young people have gone on to full employment or further education as a direct result of this programme. Of these, 113 have succeeded in gaining an apprenticeship with BAE Systems.

Our approach

Pursuant to our Community Investment Policy, our Global Community Investment Strategy aims to build and nurture mutually beneficial relationships between our business, our people and local stakeholders. We partner with organisations that align to our strategy which allows us to support initiatives that have meaning and impact to our business and employees.

Our strategy outlines primary focus areas, where measurable impact can be demonstrated and these are defined as:

- **Armed forces** – supporting active service personnel, veterans and their families;
- **Education and skills** – inspiring young people to consider Science, Technology, Engineering and Maths (STEM) subjects and careers; and
- **Local community** – working to support the communities in which we operate.

Our partners and key relationships

How our business works

continued



Our strategy in action

Australia: Soldier On

In 2018, we announced an enhanced partnership to support the health, employment and rehabilitation of Australia's veterans and their families.

Our commitment will support the expansion of Soldier On's health and wellbeing, education, employment and social programmes, and will complement BAE Systems' employee fundraising and volunteering activities. These programmes are vitally important to the veteran community, with one in four veterans experiencing a mental health issue each year. Soldier On's programmes focus on the prevention and treatment of these issues by providing physical and mental health rehabilitation, education, employment and career transition support, as well as creating meaningful connections and a sense of belonging. Together, BAE Systems Australia and Soldier On are creating and supporting a legacy for Australia's service community and their families.

Each market develops its own programme which is in support of the Global Community Investment Strategy, and is relevant to their lines of business, charitable needs, culture and local communities.

Community investment is not paid to third-party fundraisers or directly to individuals. As part of our due diligence procedures, prior to a charitable sponsorship or donation being committed, the charity is vetted through a recognised external organisation to ensure that the funding will be used for charitable purposes.

To avoid the risk of conflicts of interest, any community investment activity is tested against the principle that it does not place, or does not appear to place, actual or potential customers, suppliers or government officials under any obligations.

The Global Community Investment Committee reports to the Executive Committee on all community investment activities, including employee fundraising activities. All such expenditure and any associated employee fundraising is reported through an online system and validated by an external assurance provider.

Our impact

We collaborate with organisations that can demonstrate a positive impact locally and encourage our employees to volunteer in support of their work. These include not-for-profit organisations and education providers.

We use the London Benchmarking Group methodology to define the value of our support and its impact on our community partners, in comparison with our peers and other organisations.

As well as donations, sponsorship and employee fundraising, we develop and support structured education programmes and enable our employees to volunteer their

skills and time. Our communications team also supports awareness-raising efforts, promoting projects and community causes through our website, social media channels, intranet and media outlets.

We have strong ties with armed forces charities across a number of our markets, and an important strand of our strategy is support for organisations that assist active service personnel, veterans and their families. In the UK we have Gold Award status in the Employer Recognition Scheme, managed by the UK Ministry of Defence. The scheme, first run in 2014, is the highest accolade for organisations that have signed the Armed Forces Covenant and demonstrated outstanding commitment to active and former service personnel. As a winner, we demonstrated a proactive commitment to advocate and support our armed forces, a positive attitude towards service personnel during recruitment and full support of employee reservists. In the US, we partner with The Mission Continues, which empowers veterans to continue their service in transformative ways within their communities and supports their transition to new careers that draw upon their military service.

Volunteering remains an important part of our employees' career journey and can be pursued as a personal development goal. In the Kingdom of Saudi Arabia and the UK, our education ambassadors have offered their time to encourage school age children to pursue STEM subjects and careers.

Based on local practices, we apply matched funding and offer volunteering opportunities during company time for a number of our employee groups, encouraging them to support our charitable partners and communities in alignment with our Community Investment strategy and focus areas.

Responsible sourcing and impact



Our strategy in action

Energy savings

We are **committed** to **minimising** the **environmental impact** of our operations and products.

As a major manufacturer, we recognise that our operations have an impact on the environment – from the energy and resources we use, to the products we manufacture and the waste that we generate. As an organisation, we are committed to reducing the environmental impact of our operations and products, minimising our environmental footprint and, in turn, decreasing our operational costs.

Governance

As owner of the Environmental Policy, the Chief Executive has been assigned overall responsibility for environment, inclusive of issues relating to climate change. He is supported by the Corporate Responsibility Committee in ensuring that appropriate policies, systems, reporting structures and metrics are in place to achieve the Group's environmental performance objectives as well as ethical and social objectives.

Our Environmental Policy outlines our commitment to improving standards of environmental management, and compliance with the Policy is directed by environmental teams across the Group. Through our bi-annual Operational Assurance Statement process, business unit compliance with the Policy is also monitored.

Strategy

We recognise that environmental and climate risks could directly impact our ability to meet our strategic priorities. Matters which are considered likely to influence our organisation and future strategic decisions include:

- constrained supply and volatile prices of fuel and the associated taxes;
- availability of critical materials;
- increasing stringency of environmental legislation;
- impact of climate change on the operability of our products; and
- contribution towards UN Sustainable Development Goals.

Risk management

The business acknowledges that there are significant environmental and climate risks that are likely to influence our operations, products and facilities. The underlying principles of the Group's risk management processes are that risks are monitored continuously, associated action plans reviewed, appropriate contingencies provisioned and that information is reported through established management control procedures. The overall responsibility for climate risk identification, analysis, evaluation and mitigation rests with the business units and detailed risk registers and self-assessments are completed to ensure the effective management of environmental risks.

More than 10,000 solar panels at BAE Systems' sites in the UK and Sweden aid the reduction of our carbon emissions and deliver savings for our customers.

The solar array installed at BAE Systems Hägglunds, in Örnköldsvik, Sweden is the largest of its kind in any Nordic country. The array has produced a monthly average rate of 18 MWh and more than 200 MWh annually. The 2,500m² array has produced more than 600 MWh since becoming operational in 2015 and has saved BAE Systems Hägglunds more than SEK600,000 in energy costs so far while reducing carbon emissions by around 500 tonnes.

The solar array installed at BAE Systems in Samlesbury, UK is exceeding its targets. The array has produced a monthly average rate of 197 MWh and more than 2,300 MWh annually.

The array, consisting of more than 17,000m² of solar panel area, has produced about 9,046 MWh since becoming operational in 2015. It has saved the Company more than £870,000 in energy costs so far, and attracted more than £590,000 of Feed-in-Tariff payments back into the Company, giving a total saving to date of more than £1.4m which is more than 50% of the cost of installation. The solar array has reduced the site's carbon emissions by more than 3,357 tonnes, which is equivalent to the annual electricity use of more than 2,150 UK homes.

Responsible sourcing and impact

How our business works

continued

Greenhouse gas emissions data from 1 November 2017 to 31 October 2018 (tonnes CO₂e)

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

2018  506,248
2017  525,032

Electricity and steam purchased for BAE Systems use (Scope 2 – location-based)¹

2018  514,187
2017  528,411

Business travel in non-BAE Systems vehicles (Scope 3)¹

2018  151,280
2017  147,125

Total greenhouse gas emissions¹

2018  1,171,715
2017  1,200,568

Total greenhouse gas emissions per employee²

2018  14
2017  16

1. See summary of Deloitte LLP assurance below.
2. Excluding share of equity accounted investments.

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 published at www.gov.uk/government/collections/conversion-factors-for-company-reporting.

For the 2018 reporting cycle, the 2018 emissions factors have been utilised as opposed to the 2017 factors. In previous years the emissions factors used for the Group's greenhouse gas emissions reporting have been a year behind, mainly due to the factors not being released in time for half year assurance (for example, 2016 emissions factors used for 2017 reporting cycle). Going forward, the emissions factors used will coincide with the year of the reporting cycle as these are the latest factors available for the majority of the Group's reporting period.

The CO₂e 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 travel suppliers' procurement records.

Emissions from joint ventures and pension scheme properties not occupied by the Group are not included. Where a business or facility is acquired during a reporting year, it will be included in our reporting in the next full reporting year after the change.

The Scope 2 greenhouse gas emissions associated with the Greenhouse Gas Protocol 'market-based' method have been calculated as 533,031 tonnes CO₂e. Supplier-specific emission factors have been sought for our most significant operating regions, but were either deemed of insufficient quality to use at present or were unavailable. Therefore, in line with the Greenhouse Gas Protocol guidance, this figure has been calculated using residual-mix emission factors where available for our UK, US and Swedish operations. In our other significant operating regions, residual-mix emission factors are either unavailable or the resulting absolute emissions at Group level are within the margin of error and, therefore, country-specific emissions factors have been used in line with the GHG Protocol Guidance.

Metrics and targets

Due to the differences in geography and function, each business unit implements its own environmental goals and initiatives which broadly focus on materials resilience, energy and climate change, and waste, emissions and discharges. In all cases, we aim for the efficient use of resources and a reduction in waste across the full lifecycle of our products, from design through to manufacturing, use and end-of-life.

As a business, we are continually improving energy efficiency and de-carbonising our energy supply to reduce greenhouse gas (GHG) emissions. In the 12 months to 31 October 2018, Group-wide GHG emissions have decreased by 2%.

In 2018 our ten largest sites accounted for approximately 68% of total energy consumption. All of these sites operate an environmental management system, with 100% certified to ISO* 14001, with an aim to reduce their energy consumption and in turn direct and indirect GHG emissions. A full Basis of Reporting on our GHG emissions is available on our website.

2019 priorities

We will continue to drive improvements in the management of materials and resources across all businesses and will develop our environmental policy further alongside progressing our alignment to the UN Sustainable Development Goals.

*International Organisation for Standardization.

Deloitte LLP assurance

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

Diversity – total employees split by gender and age;

Ethics – employee and third-party enquiries to Ethics Officers and the Ethics Helpline;

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

Environment – greenhouse gas emissions (total, and Scope 1, 2 and 3); and

Community – total value of Community Investment programme donations.

More online

To see Deloitte LLP's unqualified assurance statement visit baesystems.com/deloitteassurancestatement

To see our Basis of Reporting 2018 visit baesystems.com/2018crdata

Group financial review



Peter Lynas
Group Finance
Director

We monitor the underlying financial performance of the Group using the alternative performance measures defined on page 6.

These measures are not defined in IFRS¹ and, therefore, are considered to be non-GAAP² measures. Accordingly, the relevant IFRS¹ measures are also presented where appropriate.

Financial performance

Measures as defined by the Group	Measures defined in IFRS ¹
Sales³ ↑36 KPI £18,407m (2017 £18,487m)	Revenue³ ↑36 £16,821m (2017 £17,224m)
Underlying EBITA³ ↑36 KPI £1,928m (2017 £1,974m)	Operating profit³ ↑36 £1,605m (2017 £1,419m)
Underlying earnings per share³ ↑37 BONUS 42.9p (2017 42.1p)	Basic earnings per share³ ↑37 31.3p (2017 26.0p)
Operating business cash flow ↑38 KPI £993m (2017 £1,752m)	Net cash flow from operating activities ↑38 £1,200m (2017 £1,897m)
Net debt ↑39 BONUS £(904)m (2017 £(752)m)	
Order intake⁴ ↑37 BONUS £28,280m (2017 £20,257m)	
Order backlog^{3,4} ↑37 £48.4bn (2017 £38.7bn)	

Accounting change

With effect from 1 January 2018, the Group adopted IFRS 15 Revenue from Contracts with Customers, which outlines principles for the measurement and recognition of revenue from contracts with customers. Comparative financial information has been restated accordingly. IFRS 9 Financial Instruments was also adopted from 1 January 2018; however no adjustments were required to prior years.

+06 Alternative performance measure definitions

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.
4. Including share of equity accounted investments.

BONUS

80% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 107).

Group financial review

continued

Income statement

Sales¹ decreased by £0.1bn to £18.4bn (2017 £18.5bn) as the expected reduction in Typhoon production activity was largely offset by growth in our US businesses.

Underlying EBITA¹ decreased by £46m to £1,928m (2017 £1,974m), giving a return on sales of 10.5% (2017 10.7%). There was an adverse exchange translation impact of £34m.

Revenue¹ decreased by £0.4bn to £16.8bn (2017 £17.2bn), a 1% decline on a constant currency basis.²

Operating profit¹ increased by £186m to £1,605m (2017 £1,419m). 2017 included a £384m impairment in respect of the Applied Intelligence business, which is excluded from underlying EBITA. There was an adverse exchange translation impact of £31m.

Non-recurring items in 2018 of £154m comprises a Guaranteed Minimum Pension equalisation charge of £114m, and a loss on disposal of the Mobile, Alabama, shipyard of £40m. Non-recurring items in 2017 of £13m represented a loss on the disposal of the BAE Systems San Francisco Ship Repair business.

Amortisation of intangible assets is in line with the prior year at £85m (2017 £86m).

Impairment of intangible assets in 2018 related to Silversky customer-related intangibles in the Applied Intelligence business. In 2017, the charge represented the impairment of goodwill in Applied Intelligence reflecting the future level and timing of expected returns from the business.

Net finance costs, including equity accounted investments, were £394m (2017 £380m). The underlying interest charge, excluding pension accounting, and fair value and foreign exchange adjustments on financial instruments and investments decreased to £215m (2017 £245m). Net interest expense on the Group's pension deficit was £106m (2017 £173m). There was a charge in respect of fair value and foreign exchange adjustments of £73m (2017 £38m credit) on exchange translation of US dollar-denominated bonds.

Income statement

Financial performance measures as defined by the Group	2018 £m	2017 (restated) ¹ £m
Sales	KPI 18,407	18,487
Underlying EBITA	KPI 1,928	1,974
Return on sales	10.5%	10.7%

Financial performance measures defined in IFRS ³	£m	£m
Revenue	16,821	17,224
Operating profit	1,605	1,419
Return on revenue	9.5%	8.2%

Reconciliation of sales to revenue	£m	£m
Sales	KPI 18,407	18,487
Deduct Share of sales by equity accounted investments	(2,812)	(2,534)
Add Sales to equity accounted investments	1,226	1,271
Revenue	16,821	17,224

Reconciliation of underlying EBITA to operating profit	£m	£m
Underlying EBITA	KPI 1,928	1,974
Non-recurring items	(154)	(13)
Amortisation of intangible assets	(85)	(86)
Impairment of intangible assets	(33)	(384)
Financial expense of equity accounted investments	(13)	(34)
Taxation expense of equity accounted investments	(38)	(38)
Operating profit	1,605	1,419
Net finance costs	(381)	(346)
Taxation expense	(191)	(216)
Profit for the year	1,033	857

Underlying interest expense ⁵	(215)	(245)
Net interest expense on retirement benefit obligations	(106)	(173)
Fair value and foreign exchange adjustments on financial instruments and investments	(73)	38
Net finance costs (including equity accounted investments)	(394)	(380)

Exchange rates

Average	2018	2017
£/\$	1.335	1.289
£/€	1.130	1.141
£/A\$	1.786	1.681

Sensitivity analysis

Estimated impact on sales of a ten cent movement in the average exchange rate	£m
\$	600
€	90
A\$	35

Taxation expense¹, including equity accounted investments, of £229m (2017 £254m) reflects the Group's underlying effective tax rate for the year of 18% which reduced from 21% in 2017, benefiting from the reductions to federal taxes in the US.

The calculation of the underlying effective tax rate is shown in note 6 to the Group accounts on page 158.

The underlying effective tax rate for 2019 is expected to increase from 18% to around 20%, with the final rate dependent on the geographical mix of profits.

Looking beyond 2019, 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 tax positions.

Earnings per share

Underlying earnings per share¹ for the year increased by 2% to 42.9p (2017 42.1p).

Basic earnings per share¹ was 31.3p (2017 26.0p).

Orders

Order intake⁴ increased by £8.0bn to £28,280m (2017 £20,257m). The most significant order intakes were for the Qatar Typhoon and Hawk aircraft and support package (£5.1bn), Saudi Arabian Typhoon support continuation (£3.2bn) and a £1.1bn initial contract for the Australian Hunter Class frigate programme.

Order backlog^{1,4} increased by £9.7bn to £48.4bn (2017 £38.7bn) following the year's record order intake.

Earnings per share

Financial performance measures as defined by the Group	2018	2017 (restated) ¹
Underlying earnings	£1,370m	£1,338m
Underlying earnings per share	KPI 42.9p	42.1p

Financial performance measures defined in IFRS³

Profit for the year attributable to equity shareholders	£1,000m	£827m
Basic earnings per share	31.3p	26.0p

Reconciliation of underlying EBITA to underlying earnings

	£m	£m
Underlying EBITA	1,928	1,974
Underlying net interest expense (including equity accounted investments) ⁵	(215)	(245)
	1,713	1,729
Taxation expense (at the underlying effective tax rate)	(310)	(361)
Non-controlling interests	(33)	(30)
Underlying earnings	1,370	1,338

Reconciliation of underlying earnings to profit for the year attributable to equity shareholders

	£m	£m
Underlying earnings	1,370	1,338
Impact of US tax reform enacted in December 2017	–	58
Non-recurring items, post tax	(126)	(10)
Amortisation and impairment of intangible assets, post tax	(97)	(68)
Impairment of goodwill	–	(384)
Net interest expense on retirement benefit obligations, post tax	(87)	(137)
Fair value and foreign exchange adjustments on financial instruments and investments, post tax	(60)	30
Profit for the year attributable to equity shareholders	1,000	827
Non-controlling interests	33	30
Profit for the year	1,033	857

Orders

Financial performance measures as defined by the Group

	2018	2017 (restated) ¹
Order intake ⁴	KPI £28,280m	£20,257m
Order backlog ⁴	£48.4bn	£38.7bn

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.

2. Current year compared with prior year translated at current year exchange rates.

3. International Financial Reporting Standards.

4. Including share of equity accounted investments.

5. Underlying net interest expense is defined as finance costs for the Group and its share of equity accounted investments, excluding net interest expense on retirement benefit obligations and fair value and foreign exchange adjustments on financial instruments and investments.

Group financial review

continued

Cash flow

Operating business cash flow was £993m (2017 £1,752m), which includes cash contributions in respect of pension deficit funding, over and above service costs, for the UK and US schemes totalling £330m on a funding basis.

On the Qatar contract there was a net inflow of approximately £400m to be utilised in 2019. Timing benefits of £400m seen in 2017 on the Saudi support contract and UK VAT payment reversed in 2018. In the Platforms & Services (US) business there has been working capital growth on utilisation of advance payments on international programmes, some late customer receipts, delivery delays to be recovered in the near term and new business ramp-up.

Taxation payments decreased to £200m (2017 £227m) primarily reflecting lower payments in the US due to the reduction in the US federal tax rate.

Net capital expenditure and financial investment was £464m (2017 £444m). Planned capital investment was made to support production ramp-up in Electronic Systems.

Dividends received from equity accounted investments of £57m (2017 £72m) was primarily receipts from MBDA, FNSS and Advanced Electronics Company.

Interest received was £25m (2017 £23m).

The cash inflow in respect of **acquisitions and disposals** in 2018 of £41m reflects the reduction in the Group's shareholding in Overhaul Maintenance Company (£17m), cash acquired as part of the ASC Shipbuilding acquisition (£14m) and cash received on the sale of the Mobile, Alabama, shipyard (£12m), offset by purchases of equity accounted investments. The cash outflow in 2017 of £11m reflected costs incurred in respect of the disposal of BAE Systems San Francisco Ship Repair and the acquisition of IAP Research, Inc.

Interest paid was £203m (2017 £204m).

Equity dividends paid in 2018 represents the 2017 final (£415m) and 2018 interim (£288m) dividends.

Dividends paid to non-controlling interests increased to £28m (2017 £8m), reflecting a higher payment by Saudi Maintenance & Supply Chain Management Company, in which the Group has a 51% shareholding.

There was a **cash inflow from matured derivative financial instruments** of £6m (2017 £83m outflow). The prior year outflow arose from rolling hedges relating to balances within the Group's subsidiaries and equity accounted investments.

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

Cash flow

	2018 £m	2017 £m
Financial performance measures as defined by the Group		
Operating business cash flow	KPI 993	1,752
Financial performance measures defined in IFRS ¹	£m	£m
Net cash flow from operating activities	1,200	1,897
Reconciliation from operating business cash flow to net cash flow from operating activities	£m	£m
Operating business cash flow	KPI 993	1,752
Add back Net capital expenditure and financial investment	464	444
Deduct Dividends received from equity accounted investments	(57)	(72)
Deduct Taxation	(200)	(227)
Net cash flow from operating activities	1,200	1,897
Net capital expenditure and financial investment	(464)	(444)
Dividends received from equity accounted investments	57	72
Interest received	25	23
Acquisitions and disposals	41	(11)
Net cash flow from investing activities	(341)	(360)
Interest paid	(203)	(204)
Net sale/(purchase) of own shares	1	(1)
Equity dividends paid	(703)	(684)
Dividends paid to non-controlling interests	(28)	(8)
Cash flow from matured derivative financial instruments (excluding cash flow hedges)	6	(83)
Movement in cash collateral	2	(15)
Net cash flow from loans	(7)	–
Net cash flow from financing activities	(932)	(995)
Net (decrease)/increase in cash and cash equivalents	(73)	542
Add back Net cash flow from loans	7	–
Add back Cash classified as held for sale	–	2
Foreign exchange translation	(188)	301
Other non-cash movements	102	(55)
(Increase)/decrease in net debt	(152)	790
Opening net debt	(752)	(1,542)
Net debt	KPI (904)	(752)
Operating business cash flow	993	1,752
Interest paid, net of interest received	(178)	(181)
Taxation	(200)	(227)
Free cash flow (as defined by the Group)²	615	1,344

† I92 and I93 Notes 25 and 27 to the Group accounts

1. International Financial Reporting Standards.

2. Free cash flow is defined as operating business cash flow less interest paid (net) and taxation.

Balance sheet

The £0.3bn increase in **intangible assets** to £10.7bn (2017 £10.4bn) mainly reflects exchange translation.

Property, plant and equipment, and investment property is £2.0bn (2017 £2.0bn).

Equity accounted investments and other investments¹ increased to £442m (2017 £328m) mainly reflecting the Group's share of profit for the year (£140m) and reduced pension allocation from the lower deficit (£8m), less dividends received (£57m).

The **Group's share of the net IAS 19 pension deficit** reduced to £3.9bn (2017 £4.0bn³) mainly reflecting a decrease in liabilities due to an increase in the discount rate in the UK and US, partly offset by lower returns on scheme assets. The major movements in the net pension deficit are shown in the bridge chart below.

Details of the Group's pension schemes are provided in note 22 to the Group accounts on page 178.

Balance sheet

	2018 £m	2017 (restated) ¹ £m
Summarised balance sheet		
Intangible assets	10,658	10,378
Property, plant and equipment, and investment property ²	2,017	1,977
Equity accounted investments and other investments	442	328
Working capital ²	(3,288)	(3,595)
Group's share of the net IAS 19 pension deficit (see below)	(3,932)	(4,022)
Net tax assets and liabilities	449	413
Net other financial assets and liabilities	70	18
Net debt	KPI (904)	(752)
Net assets held for sale	106	10
Net assets	5,618	4,755

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 to the Group accounts for details regarding the restatement.
2. Funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme included in working capital in the Consolidated balance sheet is presented here in property, plant and equipment, and investment property.

Components of net debt	£m	£m
Cash and cash equivalents	3,232	3,271
Debt-related derivative financial instrument assets	163	60
Loans – non-current	(3,514)	(4,069)
Loans and overdrafts – current	(785)	(14)
Net debt	KPI (904)	(752)

Exchange rates

Year end	2018	2017
£/\$	1.274	1.353
£/€	1.114	1.126
£/A\$	1.809	1.730

Accounting net pension deficit – bridge (£bn)³

2017 ³	(4.0)
Add back 2017 allocation ⁴	(0.3)
Change in mortality assumptions	0.2
Actual return on assets	(0.7)
Interest on liabilities	(0.8)
Real discount rate	1.6
Other	(0.2)
Deduct 2018 allocation ⁴	0.3
2018	(3.9)

[†] 178 Note 22 to the Group accounts

Maturity of the Group's borrowings (£bn)

2018	(4.3)
2019	(3.5)
2020	(3.1)
2021	(2.7)
2022	(2.3)
2023	(2.3)
2024	(1.7)
2025	(1.1)
2026	(1.1)
2027	(0.7)
2028	(0.7 ⁵)

[†] 176 Note 20 to the Group accounts

3. The prior year deficit has been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes.

4. Amounts allocated to equity accounted investments.

5. Repayable in 2041 (£0.3bn) and 2044 (£0.4bn).

Group financial review

continued

A net deferred tax asset of £0.7bn (2017 £0.7bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

In aggregate, there was a £0.3bn increase in **working capital** largely reflecting the reversal of 2017 timing benefits, costs incurred against provisions, advance payment utilisation, delivery timings and new business ramp-up, partly offset by the Qatar net inflow.

The Group's **net debt** at 31 December 2018 is £904m, a net increase of £152m from the position at the start of the year, of which £86m relates to exchange translation. In June 2019, a \$1.0bn (£0.8bn) bond will become due for repayment. The maturity of the Group's borrowings is shown in the chart on the previous page.

Cash and cash equivalents of £3,232m (2017 £3,271m) are held primarily for the repayment of debt securities, pension deficit funding, payment of the 2018 final dividend and management of working capital.

Net assets held for sale represent the UK-based combat vehicles business, where the Group has entered into an agreement with Rheinmetall to form a joint military land vehicle design, manufacturing and support business, in which BAE Systems will retain a 45% stake, and also the Group's 75.6% shareholding in Aircraft Accessories and Components Company, the disposal of which completed in January 2019.

Accounting policies

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 2018)
See note 1 to the Group accounts

Carrying value of goodwill

Goodwill £10.2bn (at 31 December 2018)
See note 8 to the Group accounts

Deferred tax asset on retirement benefit obligations

Deferred tax asset on pension/retirement scheme deficits £0.7bn (at 31 December 2018)
See note 14 to the Group accounts

Tax provisions

Tax provisions £361m (at 31 December 2018)
See note 16 to the Group accounts

Retirement benefit obligations

Group's share of the net IAS 19 pension deficit £3.9bn (at 31 December 2018)
See note 22 to the Group accounts

 [142](#) For more information

Changes in accounting policies

Effective 1 January 2019, BAE Systems adopted IFRS 16 Leases. The Group's results announcement for the half year ending 30 June 2019 will be the first to be prepared under IFRS 16. The Group will transition in accordance with the modified retrospective approach, and prior year information will not be restated.

IFRS 16 requires a lessee to recognise assets and liabilities for almost all leases. In the income statement, operating lease charges will be replaced by depreciation and interest expenses. The estimated impact on the Group in 2019 is expected to be an increase in EBITA of £50m, offset by an increase in finance costs of £50m, with an immaterial impact on profit after tax and underlying earnings. On transition, right-of-use assets will be recognised on the balance sheet of £1,300m with a lease liability of £1,486m and a transition adjustment of £92m will be recognised as a debit to retained earnings. The Group will also recognise a finance lease receivable balance of £70m, a reduction in our investment in equity accounted investments of £11m and a deferred tax asset of £2m. Details of the impact of IFRS 16 are provided in note 38 to the Group accounts on page 210.

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 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:

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

 [190](#) Note 24 to the Group accounts

Dividends

As part of the Group's capital allocation policy, the Group plans to pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings.

The Board has recommended a final dividend of 13.2p per share making a total of 22.2p per share for the year, an increase of 2% over 2017. At this level, the annual dividend is covered 1.9 times. Subject to shareholder approval at the 2019 Annual General Meeting, the dividend will be paid on 3 June 2019 to holders of ordinary shares registered on 23 April 2019. The ex-dividend date is 18 April 2019.

At 31 December 2018, the Company had retained earnings of £2.8bn (2017 £2.6bn), the non-distributable portion of which is £701m (2017 £649m) (see page 212). Total external dividends relating to 2018 are £710m (2017 £695m), including the interim dividend paid during the year of £288m (2017 £280m) and the final dividend proposed of approximately £422m (2017 £415m). On an annual basis, the Company receives dividends from its subsidiaries to increase further its distributable reserves and, accordingly, the Company expects to have sufficient distributable reserves to support its dividend policy.

The Group's dividend policy is underpinned by its viability and going concern statements (see pages 81 and 82).

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 April 2023 is available to meet 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 strong 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:
 - (a) the income statements or balance sheets of foreign subsidiaries; and
 - (b) equity accounted investments it regards as long-term investments.

 195 Note 29 to the Group accounts

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 does not tolerate activities designed to facilitate tax evasion offences.

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. In the UK, the Group is subject to an annual risk assessment by HM Revenue & Customs and strives to achieve as low a risk rating as can be achieved by a group of BAE Systems' size and complexity.

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 regard 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/cbi-prod/assets/File/pdf/statement-of-tax-principles.pdf).

 157 Note 6 to the Group accounts

Guidance for 2019

Whilst the Group is subject to geopolitical uncertainties, the following guidance is provided on current expected operational performance.

For the year ending 31 December 2019, we expect the Group's underlying earnings per share to grow by mid-single digit compared to the full-year underlying earnings per share in 2018 of 42.9p, assuming a US\$1.30 to sterling exchange rate.

The guidance is based on the measures used to monitor the underlying financial performance of the Group. Reconciliations from these measures to the financial performance measures defined in International Financial Reporting Standards for 2018 are provided in the Group financial review on pages 35 to 41.



Electronic Systems

- Sales, in US dollar terms, are expected to show mid-single digit growth driven by a number of electronic warfare contracts and APKWS® volumes. Some 70% of projected sales are in the 2018 closing order backlog, similar to the prior year.
- Margin¹ is expected to remain in a range of 14% to 16%.

Cyber & Intelligence

- In aggregate, sales, in US dollar terms, are expected to be relatively stable. The US business, which represented some 70% of this segment in 2018, is expected to be largely unchanged.
- In the Applied Intelligence business we expect to see some top line growth, coming from both the Government and Financial Services areas.
- Margin¹ in 2019 is expected to improve to be around 7%. The US business is expected to contribute around the 8% to 9% mark. In Applied Intelligence, we expect the business to move back into profitability, albeit at an initial low margin.

Platforms & Services (US)

- Sales growth, in US dollar terms, is expected to be mid- to high-single digit with increasing volumes from the US Combat Vehicles and Weapon Systems businesses, as well as higher ship repair activity. More than 80% of guidance is within the closing order backlog, a stronger starting point than at this time last year.
- Margin¹ is expected to improve to the 8% to 9% range, after the charges taken in 2018.



Air

- Sales are expected to be some 10% higher, for activity on the new Qatar Typhoon and Hawk programme and the continued ramp-up on F-35. More than 85% of guidance is within the closing order backlog.
- Margin¹ is expected to be lower than 2018, towards the bottom end of our 11% to 13% range. There will be minimal profit recognition on the Qatar sales, given the early stage of the programme, and company-funded research and development expenditure increases for the Tempest future combat air programme.

Maritime

- Sales are expected to be stable. Activity levels on the Carrier programme will decline as it moves towards completion. This is expected to be largely offset by increases on the Dreadnought submarine and Type 26 programmes. Around 95% of guidance is already covered by the order backlog.
- Following the charges taken on the Offshore Patrol Vessels programme in 2018, margin¹ levels are expected to improve back into the 8% to 9% range.

HQ

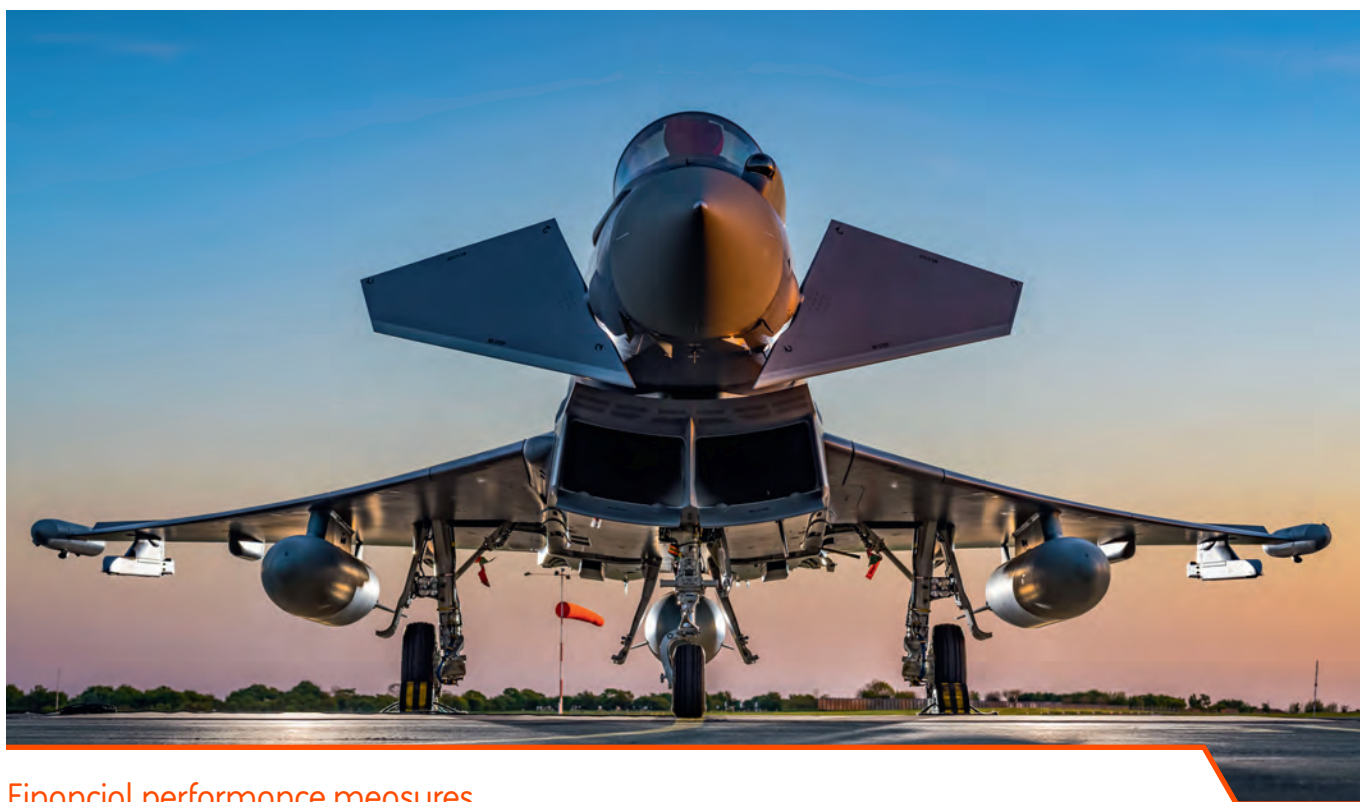
- HQ costs are expected to be slightly higher than 2018.
- Underlying finance costs are expected to be slightly lower with six months of benefit from the maturing \$1bn (£0.8bn) bond which carries a 6.3% coupon.
- The underlying effective tax rate is expected to increase from 18% to around 20%, with the final rate dependent on the geographical mix of profits.
- The expected increase in In-Kingdom ownership and workshare into our Saudi companies will lead to an increase in the non-controlling interest expense to the Group.
- The adoption of IFRS 16 Leases is expected to increase both EBITA and finance costs by an estimated £50m, but is expected to have no material impact on earnings per share².
- The Group has delivered £2bn of free cash flow in the period 1 January 2017 to 31 December 2018, and is targeting in excess of a further £3bn of free cash flow over the three-year period 2019 to 2021, assuming a US\$1.30 to sterling exchange rate. Free cash flow generation will, however, not be linear over the three-year period and, in 2019, the cash profile of the Typhoon Qatar contract and capital expenditure required to support our growing US businesses will mean that we would expect the Group's net debt at 31 December 2019 to increase slightly from the net debt at 31 December 2018.

1. Underlying EBITA as a percentage of sales.

2. The EBITA impact by segment is provided in note 38 to the Group accounts on page 210.

Segmental review

The Group reports its performance through five principal reporting segments.



Financial performance measures

	As defined by the Group						Defined in IFRS ²			
	KPI	KPI		KPI	KPI					
Year ended 31 December 2018	Sales £m	Underlying EBITA £m	Return on sales %	Operating business cash flow £m	Order intake ¹ £m	Order backlog ¹ £bn	Revenue £m	Operating profit/(loss) £m	Return on revenue %	Net cash flow from operating activities £m
Electronic Systems +44	3,965	606	15.3	431	4,624	5.4	3,965	590	14.9	575
Cyber & Intelligence +48	1,678	111	6.6	85	1,802	1.9	1,678	59	3.5	96
Platforms & Services (US) +52	3,005	210	7.0	(30)	3,693	5.4	2,864	161	5.6	31
Air +56	6,712	859	12.8	666	14,845	27.4	5,579	810	14.5	719
Maritime +60	2,975	209	7.0	67	3,513	9.0	2,940	191	6.5	190
HQ ³	350	(67)		(226)	358	0.1	41	(206)		(211)
Deduct Intra-group	(278)				(555)	(0.8)	(246)			
Deduct Taxation ⁴										(200)
Total	18,407	1,928	10.5	993	28,280	48.4	16,821	1,605	9.5	1,200

With effect from 1 January 2018, the Group revised its reporting segments to reflect the organisational changes announced in 2017. The five principal reporting segments are Electronic Systems, Cyber & Intelligence, Platforms & Services (US), Air and Maritime. These align with the strategic direction of the Group. Financial information for 2017 has been re-presented to reflect these new segments.

We use financial performance measures as defined by the Group to monitor the underlying financial performance of the Group's reporting segments. Reconciliations from these measures to the financial performance measures defined in IFRS² are provided in the Group financial review on pages 35 to 41. Reconciliations by reporting segment for revenue and operating profit are included in note 1 to the Group accounts (see page 148) and for net cash flow from operating activities in note 25 to the Group accounts (see page 192).

1. Including share of equity accounted investments.

2. International Financial Reporting Standards.

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

4. Taxation is managed on a Group-wide basis.

Electronic Systems

Segmental review
continued



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, precision guidance and seeker solutions, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems.

Electronic Combat provides a depth of capability in advanced electronic warfare solutions for airborne applications, including electronic support, electronic attack, and electronic protection technologies.

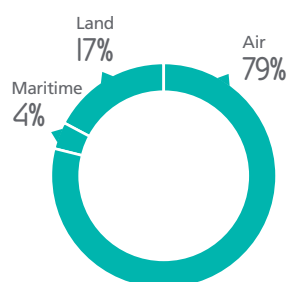
Survivability, Targeting & Sensing exploits the electro-optical and infrared spectrum to provide leading threat warning and infrared countermeasures systems, precision guidance and seeker solutions, advanced targeting solutions, head-up displays, and state-of-the-art tactical imaging systems.

C4ISR Systems 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 resiliency products.

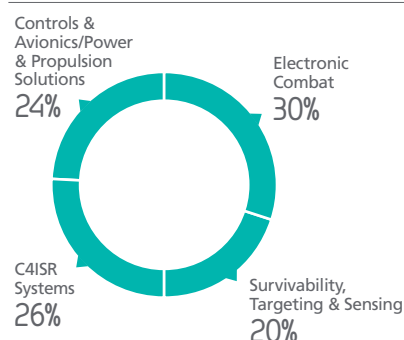
Controls & Avionics develops and produces electronics for military and commercial aircraft, including fly-by-wire flight controls, full authority digital engine controls, flight deck systems, cabin management systems, and mission computers.

Power & Propulsion 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.

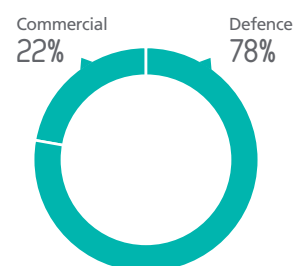
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Defence and commercial (%)



Employees¹

15,900



Our strategy in action

**APKWS® –
ramping-up to
meet increased
demand**

We are delivering APKWS® laser-guided rockets to meet customer demands while maintaining an unwavering commitment to quality.

Our state-of-the-art precision guidance system manufacturing facilities in New Hampshire and Texas, along with a strong supplier network, have enabled us to accelerate full-rate production, exceed manufacturing expectations, and deliver units to meet the increased customer demand.

APKWS® is experiencing growing demand, and our Survivability, Targeting & Sensing team continues to ramp-up production capacity as it builds toward an annual production level of 25,000 units.

Operational and strategic key points

- Continued production ramp-ups on F-35 Lightning II hardware, with initial funding on Low-Rate Initial Production Lot 13
- Further awards for APKWS® laser-guided rockets secured worth nearly \$400m (£314m) and production capacity ramping towards 25,000 units per annum
- Continued growth in classified work, increasing to 11% of the business
- New facilities being established in Huntsville, Alabama, and Manchester, New Hampshire to increase capacity and expand operations
- Delivered the 10,000th electric hybrid bus system and continue to pursue expanding capabilities in the air and maritime domains

Financial performance

Financial performance measures as defined by the Group

		2018	2017 (restated) ²
Sales	KPI	£3,965m	£3,598m
Underlying EBITA	KPI	£606m	£541m
Return on sales		15.3%	15.0%
Operating business cash flow	KPI	£431m	£450m
Order intake ¹	KPI	£4,624m	£4,175m
Order backlog ¹		£5.4bn	£4.8bn

- Sales compared to 2017, in US dollar terms, were up 14% at \$5.3bn (£4.0bn). The growth came in the electronic warfare business from the F-35 programme as well as increasing classified activity. As expected, sales of the APKWS® product doubled over the year and now represent one of the top three sales lines in the segment. Commercial sales of engine and flight controls, and hybrid electric drive units also grew, and amount to some 22% of the segment.
- Underlying EBITA was up to \$809m (£606m), delivering a return on sales of 15.3%, within our guidance range.

Financial performance measures defined in IFRS³

	2018	2017 (restated) ²
Revenue	£3,965m	£3,598m
Operating profit	£590m	£521m
Return on revenue	14.9%	14.5%
Cash flow from operating activities	£575m	£569m

- As expected, cash conversion of EBITA improved in the second half of the year and was at 81% for the full year excluding pension deficit funding. Capital expenditure in the business amounted to some \$200m (£150m).
- Order backlog was secured at a record high of \$6.9bn (£5.4bn), following awards for further F-35 systems, classified electronic warfare activity and APKWS® units.

+ 06 Alternative performance measure definitions

1. Including share of equity accounted investments.
2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.
3. International Financial Reporting Standards.

Segmental review continued

Operational performance

Electronic Combat

BAE Systems continues to sustain its leadership position in the US electronic warfare market with production continuing to ramp-up across a number of programmes, some of which are classified.

Low-Rate Initial Production Lot 11 hardware deliveries continue on the F-35 Lightning II programme. We have received initial Lot 12 and 13 funding, and are currently negotiating Lots 12, 13 and 14 with an anticipated final award value exceeding \$1bn (£0.8bn). BAE Systems is also executing an Electronic Warfare Performance Based Logistics contract from Lockheed Martin to provide material availability and support for the F-35 programme over a five-year period.

Following our 2015 selection 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 (EPAWSS) programme to upgrade up to 200 F-15E aircraft, we are currently executing the \$194m (£152m) engineering and manufacturing development contract, with a critical system delivery completed in 2018.

Under a contract by Boeing and Warner Robins Air Logistics Complex totalling more than \$1bn (£0.8bn), BAE Systems completed the installation of the Digital Electronic Warfare System (DEWS) on new F-15 aircraft, and continues to upgrade existing F-15 aircraft and provide spare units and modules for an international customer. We are also executing a \$311m (£244m) contract to provide DEWS to support the sale of new F-15 aircraft to another international customer.

Production of BAE Systems' sensor technology for the Long Range Anti-Ship Missile (LRASM) continues with orders from prime contractor Lockheed Martin. We provided the sensor technology that supported several successful tests of LRASM leading to a successful Early Operational Capability on the B1-B platform. We have also been awarded the LRASM Radio Frequency Sensor 110 Production Build valued at over \$75m (£59m).

For over a decade, we have provided full-lifecycle support as the prime mission system integrator for the US Air Force's EC-130H Compass Call stand-off electronic attack platform, and we will continue to sustain the existing EC-130H electronics. We also execute multiple contracts to cross-deck the mission electronics onto a new Gulfstream G550 business jet for the US Air Force.

Due to the sensitive nature of electronic combat systems and technology, many of our programmes are classified. As a world leader in electronic warfare, we continue to experience growth in these increasingly important areas.

Survivability, Targeting & Sensing

Our Advanced Precision Kill Weapon System (APKWS®) laser-guided rocket is experiencing growing demand, with over 25,000 units produced as at year end. In addition to expanding US military use, the system is generating strong international attention, with 20 nations expressing formal interest. The programme has received awards totalling nearly \$400m (£314m) this year, as part of a 2016 Indefinite Delivery, Indefinite Quantity contract. Production capacity is set to increase from 10,000 units per annum to 25,000 units per annum to meet the increased demand for cost-effective guided munitions for US armed forces and allied international customers.

We are developing a next-generation missile warning system for the US Army under the Limited Interim Missile Warning System programme awarded in 2017. Critical design reviews and initial prototypes have been completed on schedule.

The US Army's Family of Weapon Sights – Crew Served programme is in development testing. This seven-year contract awarded in 2016 has a potential value of up to \$384m (£301m).

Both fixed and rotary-wing demonstrations of our Striker® II helmet-mounted display (HMD) are ongoing and we continue to validate it as a readily accessible HMD for existing aircraft with analogue-based or digital electronic systems.

The LiteHUD® Head-Up Display has completed development testing and has been selected by critical launch customers for integration on multiple platforms, including the Textron Scorpion jet.

C4ISR Systems

As a leading provider of space-qualified subsystems and components, we continue to experience growth in the areas of integrated on-board processors, reconfigurable processing payloads and secure communications.

We continue to execute the Network Tactical Common Data Link programme to provide the US Navy with the ability to simultaneously transmit and receive real-time intelligence, surveillance and reconnaissance data over multiple data links for a system to be fielded on various surface ship types. The programme completed Critical Design Review in 2018.

Since winning the Geospatial Data Services Foundational GEOINT Content Management programme in 2014, we have been awarded orders valued at \$240m (£188m) and are meeting delivery requirements in assisting US intelligence community customers with the development of advanced geospatial intelligence data collection and processing solutions.

As a provider of signals intelligence capabilities, user acceptance under the \$132m (£104m) Tactical Signals Intelligence Payloads programme for the US Army's Gray Eagle unmanned aircraft is complete. Follow-on awards are expected in 2019.

Work continues on state-of-the-art processing capabilities for the US Navy's P-8A Poseidon maritime surveillance aircraft programme which is expected to be worth \$1.2bn (£0.9bn) over its life. We have delivered our hundredth system.

Controls & Avionics

BAE Systems is a major supplier of full authority digital engine controls (FADECs), fly-by-wire flight controls, vehicle management systems, mission systems, and cabin and flight deck systems.

The development of the integrated flight control electronics and remote electronic units for Boeing's next-generation 777X aircraft is progressing, with all hardware in qualification and systems integration testing to support a 2019 first flight.

Flight testing of the Boeing 737 MAX 7 aircraft is continuing with our spoiler controls, flight deck systems and utilities electronics, with entry into service planned for 2019. Initial development has begun on the changes required for the MAX 10 variant.



Our strategy in action

Improving reliability

In the commercial aircraft industry, extending the life of ageing assets is essential to airlines operating at peak efficiency. We offer cost-effective overhaul and asset management programmes designed to keep fleets flying.

These programmes include overhaul options for flight controls and full authority digital engine controls, and lease and exchange arrangements that ensure spare parts are available when needed. Programmes can be tailored to meet the needs of each customer and are a proven discriminator in the success of the aftermarket segment of the business.

One such programme is for Slat/Flap Control Computers (SFCC), launched in autumn 2018. SFCCs are essential avionics used during take-off and landing to control speed on more than 4,000 Airbus A320s. This system was our second product-specific aftermarket programme launched during the period, following the 777 Actuator Control Electronics Exchange programme.

18 Group strategic framework

More online
baesystems.com

Development of our civil active inceptors for the Gulfstream G500 and Embraer KC390 aircraft is complete and aircraft certification has been received. A derivative of the active inceptors, the LinkEdge™ (Active Parallel Actuation Subsystem), is being developed for the Chinook CH-47 and is currently in integration testing.

FADEC Alliance, a joint venture between GE Aviation and FADEC International (our joint venture with Safran Electronics & Defense), has broadened its agreement with GE Aviation to include collaboration on system architectures and technologies for future engines. FADEC Alliance will develop, produce and support FADECs for all future GE Aviation commercial engines. The GE9X FADEC for the Boeing 777X has completed certification testing and Low-Rate Initial Production will begin in 2019.

Development has begun on the next-generation advanced digital flight control computer for the F-16 aircraft for the United Arab Emirates.

On the F-35 Lightning II programme, Low-Rate Initial Production Lot 11 is ongoing for the vehicle management computer and active inceptor system equipment, and a successful systems requirements review was held on the competitively-awarded F-35 vehicle management computer technology refresh.

Power & Propulsion Solutions

This year we achieved a major milestone, delivering our 10,000th electric hybrid bus system and we continue to pursue expanding our capabilities for application in the maritime domain, and for the airborne market by marrying our safety-critical know-how from the Controls & Avionics business with our hybrid electric expertise. As transit operators in cities such as San Francisco, Boston, Montreal, London and Brussels lean toward more electric power, our solutions meet operational goals towards totally emission-free operations. We are prepared for the future of transit with zero emission solutions as early providers of battery-electric propulsion solutions and hydrogen fuel cell-based systems. Paris has recently become the latest city to commit to battery-electric vehicles powered by our technology and in the US more than 20 hydrogen fuel cell transit buses are operating with our propulsion systems, which are expected to pave the way for the world's first passenger vessel powered by hydrogen in 2019.

We are also using our clean technology to power passenger vessels, research vessels, and inland towboats to address the increased demand for environmentally friendly marine vessels.

Looking forward

Forward-looking information for the Electronic Systems reporting segment is provided later in this report.

64 Segmental looking forward

Cyber & Intelligence

Segmental review
continued



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.

Intelligence & Security comprises the three US-based Intelligence & Security businesses.

Air Force Solutions focuses on providing the US Air Force and its combatant commands with innovative solutions to help modernise, maintain, test, and cyber-harden aircraft, radars, missile systems, and mission applications that detect and deter threats to national security.

Integrated Defense Solutions provides the US Army, Navy, and federal civilian markets with systems engineering, integration, and sustainment services for C4ISR systems and enterprise IT networks that enhance mission effectiveness. Our solutions are deployed across platforms and networks in the air, maritime, land and cyber domains.

Intelligence Solutions provides innovative mission-enabling solutions and services to enhance the collection, analysis, and processing of data across the US civilian and military intelligence communities. Our business also develops and deploys high-assurance networks that facilitate the secure sharing of data amongst intelligence agencies in support of national security.

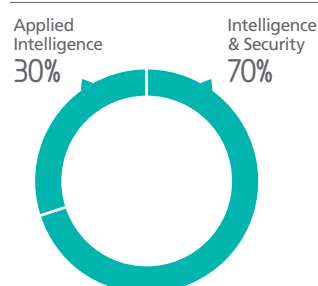
Applied Intelligence provides data intelligence solutions which enable governments and commercial organisations to defend against national-scale threats, protect their networks and data against sophisticated attacks and operate successfully in cyberspace. Our solutions are delivered as licensed technologies, software-as-a-service subscriptions, through outsourced managed services, and via consulting and systems integration projects.

Government is focused on delivering national security and intelligence solutions to the UK government and allied international governments. The business also delivers enterprise-level data and digital services to UK government departments.

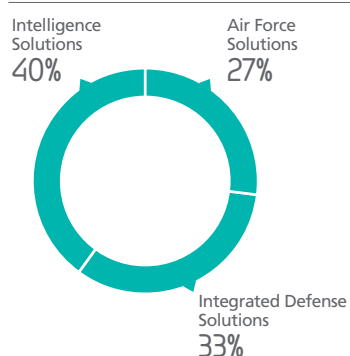
Financial Services delivers anti-fraud and regulatory compliance solutions to banking and insurance customers across Europe, North America, the Middle East, Africa and Asia-Pacific.

Technology & Commercial provides security advisory and managed security services to a range of commercial customers in the UK and North America.

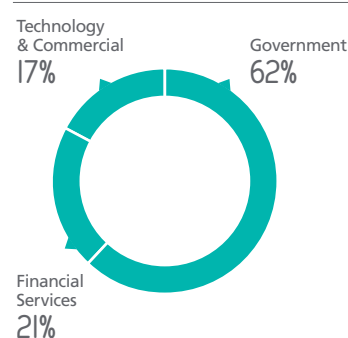
Sales by business (%)



Sales analysis: Intelligence & Security (%)



Sales analysis: Applied Intelligence (%)



Employees¹
10,300



Our strategy in action

Collaborating
on cloud

In April, we announced the first in a series of strategic collaboration agreements to market the first scalable, hybrid cloud solution of its kind to the US government.

The federated secure cloud, developed by BAE Systems and Dell EMC, is designed from the ground up to meet both the mission needs and security requirements for any US intelligence community, Department of Defense, or federal/civilian government organisation.

The federated secure cloud has the flexibility to deploy to public, on-premise or hybrid cloud environments, to include smaller tactical deployments. The solution enables rapid deployment of secure cloud services without the costly delay of long security engineering and authorisation cycles.

Additional market collaborations with Splunk Inc. and Flexera reflect our strategy to drive the best commercial cloud technologies on the market to the US government.

Operational and strategic key points

Intelligence & Security

- New awards valued at approximately \$320m (£251m) to provide motion-imagery analysis, training and research support services to the US intelligence community
- Secured a five-year, \$90m (£71m) US Navy contract to provide engineering and technical support for fixed, airborne and mobile intelligence collection platforms

- Awarded additional change proposals worth \$55m (£43m) to support the US Air Force ICBM Integration Support Contractor programme

Applied Intelligence

- 2017 restructuring programme completed, returning the business to break-even

Financial performance

Financial performance measures as defined by the Group

		2018	2017 (restated) ²
Sales	KPI	£1,678m	£1,818m
Underlying EBITA	KPI	£111m	£58m
Return on sales		6.6%	3.2%
Operating business cash flow	KPI	£85m	£116m
Order intake ¹	KPI	£1,802m	£1,859m
Order backlog ¹		£1.9bn	£2.1bn

- In aggregate sales were 5% lower on a constant currency basis at \$2.2bn (£1.7bn). The US Intelligence & Security business saw a 4% decrease, largely as a result of the customer's decision to end a shared IT services environment contract. In the Applied Intelligence business, sales declined by 9% as pursuit of sales growth was tempered to enhance profit performance.
- Despite the sales reduction, the aggregate return on sales for the sector was improved to 6.6%. In the US business return on sales was similar to last year at 9.0%. The Applied Intelligence business returned to break-even as the cost reduction actions under the 2017 restructuring programme delivered to plan.

Financial performance measures defined in IFRS³

	2018	2017 (restated) ²
Revenue	£1,678m	£1,818m
Operating profit/(loss)	£59m	£(361)m
Return on revenue	3.5%	(19.9)%
Cash flow from operating activities	£96m	£127m

- Cash conversion of EBITA for the year was at 95%, excluding pension deficit funding.
- In aggregate, order backlog reduced to \$2.4bn (£1.9bn). In the US Intelligence & Security business, order backlog was adjusted for the closed out service contract.

+06 Alternative performance measure definitions

1. Including share of equity accounted investments.
2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.
3. International Financial Reporting Standards.

We secured a three-year, \$37m (£29m) contract to continue providing the US Air Force with obsolescence management support for which we have been the provider of choice since 1991.

Also in the maritime domain, we received a five-year, \$90m (£71m) US Navy contract to continue providing engineering and technical support for a variety of fixed, airborne, and mobile intelligence collection platforms. The business also secured a four-year, \$44m (£35m) contract to provide munitions handling and management support for the US Navy's Pacific fleet



Our strategy in action

Data analytics trial assisting child protection work

In partnership with UK child protection and law enforcement agencies, we undertook a trial to implement our data analytics technology into the child protection system.

High profile cases of child abuse and neglect in the UK have highlighted poor data sharing as a key reason why abuse and neglect is not identified sooner. Through predictive analytics and visualisation with our NetReveal™ software, we created an innovative, joined-up view of risk around vulnerable children, driving a safer, fairer and faster response to concerns raised about children's welfare.

The project took three years' worth of disparate, historical data sets and analysed them in just four hours, allowing practitioners to research cases significantly faster and presented a rich and complete analysis of the information in a visually engaging way.

The next stage will see the technology move beyond the successful proof of concept to an operational trial, where the true extent of the benefits can be evaluated in a live setting.

18 Group strategic framework

More online
[baesystems.com](https://www.baesystems.com)

Applied Intelligence

Applied Intelligence delivered a full year break-even position as a result of significant benefits from the restructuring activity undertaken at the end of 2017. This improvement in profitability has been delivered through removing surplus delivery capacity, relocating roles to lower cost international delivery centres, exiting certain unprofitable markets and improving the organisational structure. Following the embedding of the organisational changes, the second half of the year has seen an increase in headcount and focused investment initiatives to drive higher levels of growth in the future.

Government

The Government business has delivered growth in orders from key accounts across UK government customers as demand for our national security and intelligence offerings remains strong. There has been an increased focus on investment in our people throughout the year to enhance capability required to support specialist customer requirements while also improving employee retention in a competitive labour market.

Financial Services

The business has continued to see steady demand for anti-fraud and regulatory compliance products across multi-national financial institutions. Strong customer loyalty has been maintained through a number of product upgrades with established key accounts. Investment in product engineering, primarily NetReveal® and Managed Security Services, has increased in the year to drive higher levels of demand in 2019 and beyond. Emerging product offerings, such as broader data and digital services, are also proving to be in demand.

Technology & Commercial

The business has won a number of significant multi-year Managed Security Services deals with UK and US commercial customers in the year, facilitated by investment in the product offering to enhance customer experience. We continue to see high levels of demand for the outsourcing of security monitoring through specialist operations centres, driven in the main by the increasing importance companies are placing on mitigating ever-increasing cyber risks. The level of customer churn with US small and medium-sized businesses has increased in the year, contributing to reduced revenue levels in this area.

Looking forward

Forward-looking information for the Cyber & Intelligence reporting segment is provided later in this report.

64 Segmental looking forward

■ Platforms & Services (US)

Segmental review
continued



Platforms & Services (US), with operations in the US, UK and Sweden, manufactures combat vehicles, weapons and munitions, and delivers services and sustainment activities, including naval ship repair, and the management and operation 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.

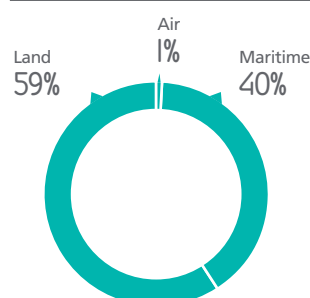
Weapon Systems focuses on naval weapons, artillery, advanced weapons, precision munitions, high explosives and propellants for US, UK and international customers. Services include complex munition site management and operation of the US Army's Holston and Radford facilities.

US Ship Repair is a major provider of non-nuclear ship repair, modernisation, overhaul and conversions to the US Navy, government and commercial maritime customers. It has four operational sites in the US located on the Atlantic and Pacific coasts and Hawaii.

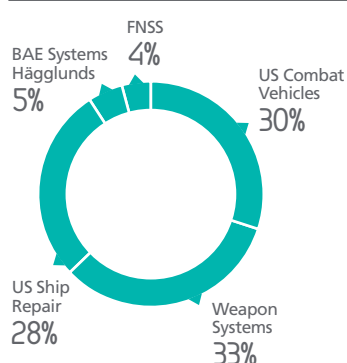
BAE Systems Hägglunds focuses on the tracked vehicle market for Swedish and international customers.

FNSS, the Turkish land systems business in which BAE Systems holds a 49% interest, produces and upgrades tracked and wheeled military vehicles for Turkish and international customers.

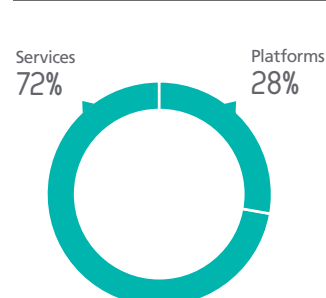
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



Employees¹

11,900



Our strategy in action

Supporting
US Navy cruiser
modernisation

BAE Systems continues to play a key role in supporting the modernisation of the US Navy's fleet of 22 guided-missile cruisers.

Major modernisation work aboard the USS Gettysburg under a contract awarded to our Norfolk, Virginia, shipyard in 2018 begins in early 2019. In addition to the Gettysburg, across our four US shipyards, we are working aboard four other cruisers in various phases of the modernisation programme.

For the Gettysburg, our scope of work includes upgrading the ship's weapons and engineering equipment; supporting the installation of a new Aegis combat system, communications suite and tactical network; and renovation of the crew's living spaces.

The Gettysburg is scheduled to be completed in mid-2020 and rejoin the operational fleet soon thereafter. The work is expected to extend the life of the 28-year-old warship to 2035.

Operational and strategic key points

- Selected by the US Marine Corps for the Amphibious Combat Vehicle I.I programme
- One of two competitors selected for the US Army's Mobile Protected Firepower programme
- Deliveries of the first batch of M777 ultra-lightweight howitzers to the Indian Army
- Continued to deliver Mk45 Gun Systems to US and international customers
- Secured \$1.3bn (£1.0bn) in new orders across the four US shipyards
- In commercial shipbuilding, activities continue to complete the final ship
- Divested the Mobile, Alabama shipbuilding yard
- Management changes made and investment in process and automation improvements to position the business for its upcoming growth phase
- An accident in a nitrocellulose drying facility at Radford sadly resulted in one fatality and injuries to two employees

Financial performance

Financial performance measures as defined by the Group

		2018	2017 (restated) ²
Sales	KPI	£3,005m	£2,951m
Underlying EBITA	KPI	£210m	£237m
Return on sales		7.0%	8.0%
Operating business cash flow	KPI	£(30)m	£222m
Order intake ¹	KPI	£3,693m	£3,542m
Order backlog ¹		£5.4bn	£4.2bn

- Sales in the year, in US dollar terms, were up 5% to \$4.0bn (£3.0bn) but growth was behind guidance, due to the delayed Paladin production order award, and the Ship Repair customer requirement to award each ship individually, rather than multi-ship awards, meant we have not been able to maximise shipyard utilisation.
- Return on sales for the year was at 7.0% following the charges taken in the first half of the year on the remaining commercial shipbuilding contract and for the subcontractor performance issues on the Radford facilities construction programme. There were no further charges taken on those programmes in the second half of the year. The charges impacted return on sales by 150bps.

Financial performance measures defined in IFRS³

	2018	2017 (restated) ²
Revenue	£2,864m	£2,848m
Operating profit	£161m	£213m
Return on revenue	5.6%	7.5%
Cash flow from operating activities	£31m	£286m

- Cash flow performance in the year reflects advance payment utilisation on international programmes, some late customer receipts, delivery delays to be recovered in the near term, and new business ramp-up.
- Order backlog increased to \$6.8bn (£5.4bn), supportive of future growth expectations. Key awards in the year included Low-Rate Initial Production for the Amphibious Combat Vehicle for the US Marine Corps, the Armored Multi-Purpose Vehicle, Low-Rate Initial Production on Paladin, and the Mobile Protected Firepower engineering and manufacturing development phase for the US Army, as well as growth in Ship Repair.

⁺
06 Alternative performance
measure definitions

1. Including share of equity accounted investments.
2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.
3. International Financial Reporting Standards.



Our strategy in action

India receives
its first M777s

Operational performance

US Combat Vehicles

The business continues to address manufacturing and execution challenges on some programmes as it ramps-up production levels. Measures undertaken in the period include management changes and investments in modernising facilities and manufacturing technologies, to include automation and robotic welding.

In June, BAE Systems and industry teammate Iveco Defence Vehicles were selected to supply Amphibious Combat Vehicles (ACV) for the US Marine Corps under the competitively-awarded ACV 1.1 programme phase. Low-Rate Initial Production has begun under a contract initially valued at \$198m (£155m) for 30 vehicles, with options for a total of 204 vehicles worth up to \$1.2bn (£0.9bn). A second, \$140m (£110m) contract for Low-Rate Initial Production 2 for an additional 30 vehicles was awarded in December.

In December, the US Army awarded us a \$376m (£295m) contract under the Mobile Protected Firepower programme for the engineering and manufacturing development phase for rapid prototyping efforts and with Low-Rate Initial Production options included. We were one of two competitors selected for this phase. The Army is expected to down select to a single contractor for the Low-Rate Initial Production phase in the first half of 2022.

On the US Army's Armored Multi-Purpose Vehicle programme, we received a \$298m (£234m) contract to procure long-lead material to support Low-Rate Initial Production. Including the engineering and manufacturing development phase with options for 280 to 300 vehicles under Low-Rate Initial Production, the programme has a potential

cumulative value of \$1.2bn (£0.9bn). In 2019 we have been awarded contract modifications worth up to \$575m (£451m) for Low-Rate Initial Production options.

Work continues on a \$365m (£287m) contract for the fourth Low-Rate Initial Production phase for 48 Paladin self-propelled howitzer and ammunition carrier vehicles sets, with an option for an additional 12. A full-rate production decision is expected in 2019.

The business is nearing completion on a \$322m (£253m) engineering and manufacturing development contract to address the space, weight, power and cooling limitations of the Bradley family of vehicles and to prepare the vehicle for communication network upgrades. In June we received a \$348m (£273m) contract, initially funded at \$132m (£104m), to upgrade 164 vehicles to the Bradley A4 configuration.

We continue to work on US Army contracts awarded in 2017 for upgrades and sustainment of M88 recovery vehicles, to include upgrades to the Heavy Equipment Recovery Combat Utility Lift Evacuation Systems (HERCULES) configuration. In July, we received a \$114m (£90m) contract for the follow-on production.

Internationally, we completed deliveries in 2018 of 41 Assault Amphibious Vehicles (AAVs) to Japan under contracts totalling \$165m (£130m). We continue to work on an additional 11 vehicles for Japan. All of the 23 AAVs ordered by Brazil under an \$82m (£64m) contract were also delivered, and work has begun on an \$84m (£66m) contract with Taiwan for 36 AAVs.

We continue to execute a \$54m (£42m) contract to provide 32 upgraded self-propelled howitzers to the Brazilian Army, with first deliveries to take place in 2019.

The first M777 ultra-lightweight howitzers have been delivered to India under the landmark Foreign Military Sale agreement between the US and Indian governments.

We will deliver 145 M777A2 gun systems under a \$542m (£426m) contract issued in January 2017. Deliveries began in the second half of 2018, with the first batch transferred during an official ceremony in November.

BAE Systems is building the first 25 guns fully assembled, the remaining 120 guns will be assembled in India by Mahindra Defence Systems Limited under an arrangement designed to support defence industrial co-operation and promote local economic growth.

The delivery of the M777s marks a key step toward modernising and strengthening the Indian Army's artillery capabilities.

 Group strategic framework

 More online [baesystems.com](https://www.baesystems.com)

Weapon Systems

We have delivered the first M777 ultra-lightweight howitzers to the Indian Army under a \$542m (£426m) Foreign Military Sale contract to provide 145 M777s. We are building the first 25 guns in our facilities, with the remaining systems assembled in India by Mahindra Defence Systems, our selected supplier, who has established an assembly and integration facility in India.

We are executing on a \$47m (£37m) contract modification from the US Navy in December 2017 to deliver four additional Mk45 Gun Systems upgraded to increase firepower and extend range. We also received contracts to provide additional 57mm Mk110 gun systems for the Navy's Littoral Combat Ship programme, and the US Coast Guard's National Security Cutter Legend Class and Offshore Patrol Cutter programmes.

In March, we received a contract to provide eight payload tubes for two block V version Virginia Class submarines, each featuring a new payload module for increased firepower.

Work continues under a 2017 contract to deliver 155mm BONUS ammunition to the Swedish Army, and we were awarded a further contract in 2018 for delivery of the round to the US Army. The business is delivering 24 additional Archer artillery systems under a 2016 contract modification with the Swedish government. In December, we received a contract from the Swedish Armed Forces for two of the newest 40 Mk4 gun systems.

We continue to execute on a \$183m (£144m) contract to provide the Maritime Indirect Fire System for the Royal Navy's Type 26 frigate.

We achieved a fifth consecutive award term providing world-wide lifecycle support for the M777 ultra-lightweight howitzers that are in service with the US Marine Corps and Army. This support contract includes engineering maintenance, parts repair/replacement and other field- and depot-level service support. The M777 team, from both the US and UK, has now scored five consecutive 'excellent' ratings, a 100% record, resulting in the contract's extension until May 2023.

In the complex ordnance manufacturing business, we continue to manage and operate the US Army's Radford and Holston munitions facilities under previously-awarded contracts. In September, the Army awarded a \$97m (£76m) contract modification for the construction of a natural gas-fired steam facility at Holston. Also at Holston, we are progressing on modernisation contracts totalling \$135m (£106m) for waste water management and a \$146m (£115m) contract for the construction of a nitric acid recovery facility to produce larger quantities of insensitive munitions. At Radford, subcontractor performance issues and cost overruns on the nitrocellulose facility modernisation programme have been encountered, impacting the financial performance of the sector.

We are saddened to report that an accident on 11 June in a nitrocellulose drying facility in Radford resulted in one fatality and injuries to two employees. The health and safety of our employees has always been and continues to be our highest priority. Investigations concluded the accident likely resulted from a unique set of conditions, and processes were modified to prevent future occurrences.

US Ship Repair

As a leading provider of US Navy ship repair and modernisation services, we are strategically located in four of the US Navy's primary ports, with the homeported fleet projected to grow in San Diego and Jacksonville. Our shipyards are equipped to service a broad range of maritime vessels, to include cruisers, destroyers, amphibious warships and littoral combat ships for the US Navy, as well as select private and commercial vessels.

In 2018, we secured firm orders across our US shipyards totalling approximately \$1.3bn (£1.0bn), including awards to modernise the USS Philippine Sea in Jacksonville; the USS Gettysburg in Norfolk; and the USS Sterett in San Diego.

In commercial shipbuilding, completion, outfitting and delivery activities for the final ship, Hull 113, continued. Hull 112 remains a completed asset held on our balance sheet awaiting the identification of a new buyer and final sea trials.

Earlier in 2018, we ceased operations at our Mobile shipyard and in October, we completed the divestiture of the shipyard.

BAE Systems Hägglunds

With an installed base of nearly 1,300 CV90 vehicles in Sweden and across six other international markets, the business continues to execute and pursue a number of significant CV90 contracts.

We continue to evaluate the opportunity for the CV90 into Australia's LAND 400 Phase 3 competition for a Mounted Close Combat Capability family of vehicles. Our bid with teammate Patria for the LAND 400 Phase 2 Combat Reconnaissance Vehicle was unsuccessful.

We continue to advance local industrial co-operation arrangements with Czech companies in support of an anticipated bid of the CV90 for the country's next fleet of infantry fighting vehicles.

Work continues to refurbish Swedish CV90 vehicles under a contract awarded in 2016, and we are integrating Mjölner mortar systems on 40 Swedish CV90s under a separate contract.

Initial deliveries have begun under a contract for 32 BvS10 all-terrain vehicles for Austria. We are also pursuing opportunities for the BvS10 and its unarmoured sister Beowulf vehicle in the US.

FNSS

FNSS, our land systems joint venture based in Turkey, continues to perform under its \$524m (£411m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army.

Programme deliveries are on schedule under the contract with Oman for PARS Wheeled Armoured Vehicles in 8x8 and 6x6 configurations.

Work progresses under multiple contracts to Turkish Armed Forces, including a €278m (£250m) contract to supply 260 Anti-Tank Vehicles, an €84m (£75m) contract for air defence vehicles, and a €155m (£139m) contract to provide 27 amphibious assault vehicles.

Looking forward

Forward-looking information for the Platforms & Services (US) reporting segment is provided later in this report.

+64 Segmental looking forward

Air

Segmental review continued



Air comprises the Group's UK-based air activities for European and International Markets, and US Programmes, and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the European MBDA joint venture.

Our **UK-based** business includes programmes in European and International Markets for the production of Typhoon combat and Hawk trainer aircraft, support and upgrades for Typhoon, Tornado and Hawk aircraft, and development of next-generation Unmanned Air Systems and defence information systems, as well as US Programmes, primarily the UK-based F-35 Lightning II manufacture, engineering development and support activity.

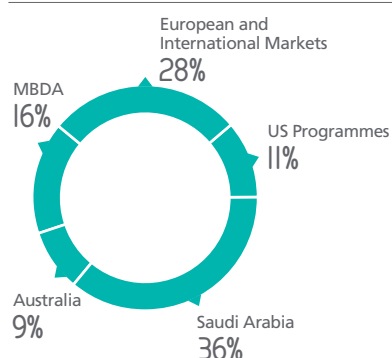
In **Saudi Arabia**, the business provides operational capability support to the country's air and naval forces through UK/Saudi government-to-government programmes. The Saudi British Defence Co-operation Programme and Salam Typhoon project provide for multi-year contracts between the governments.

In **Australia**, the business primarily delivers 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.

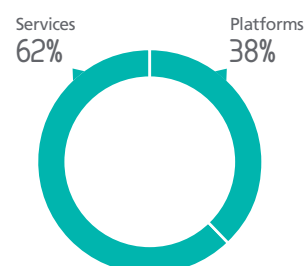
The Type 26 frigate was selected for the Commonwealth of Australia's Hunter Class nine-ship Future Frigate programme, with a framework agreement including the scope for the initial design and production phase signed in December.

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

Sales by line of business (%)



Sales analysis: Platforms and services (%)



Employees¹

27,800



Our strategy in action

State of Qatar becomes ninth country to choose Typhoon

The contract between BAE Systems and the Government of the State of Qatar for the supply of 24 Typhoon and nine Hawk aircraft to the Qatar Emiri Air Force, along with a bespoke support and training package, became effective in September. It represented a significant step in our long-term relationship with the State of Qatar, as it became the ninth country to choose Typhoon.

The proven combination of Typhoon and Hawk will provide the Qatari Armed Forces with the most advanced and flexible multi-role combat aircraft on the market today, along with best-in-class support and training.

With a contract value of around £5bn, deliveries of the first Hawk aircraft are expected to commence in 2022 and the first Typhoon aircraft in 2023. BAE Systems is the prime contractor for both the provision of the aircraft and the agreed arrangements for the in-service support and initial training.

Operational and strategic key points

- Contract with the Qatar government for the supply of 24 Typhoon and nine Hawk aircraft, air and ground training, and ground support became effective in September. MBDA contract for the supply of missiles also became effective
- Signature in March 2018 of a Memorandum of Intent between the Kingdom of Saudi Arabia and the UK government to aim to finalise discussions for the purchase of a further 48 Typhoon aircraft
- RAF declaration of Typhoon Centurion standard, enabling transition of capabilities from Tornado to Typhoon
- Announcement of UK Combat Air Strategy and launch of the Tempest programme
- Completion of the final four of 12 Typhoon deliveries to Oman
- In November the first flight of a Hawk assembled in Saudi Arabia took place
- Integration of F-35 Lightning II onto aircraft carrier HMS Queen Elizabeth commenced, and the first F-35 deck landing completed
- Order intake of £3.2bn for support services up to 2022 in respect of the continuation of Typhoon support in Saudi Arabia
- Current German government position on export licensing may affect the Group's ability to provide capability to Saudi Arabia which may have a consequential impact on the Group's financial performance and relationships
- Type 26 frigate selected for the Commonwealth of Australia's Hunter Class nine-ship Future Frigate programme with the framework agreement including the A\$1.9bn (£1.1bn) scope for the initial design and production phase signed in December

Financial performance

Financial performance measures as defined by the Group

		2018	2017 (restated) ²
Sales	KPI	£6,712m	£7,210m
Underlying EBITA	KPI	£859m	£967m
Return on sales		12.8%	13.4%
Operating business cash flow	KPI	£666m	£832m
Order intake ¹	KPI	£14,845m	£6,128m
Order backlog ¹		£27.4bn	£19.5bn

- Sales were down 7% at £6.7bn. As expected production activity on Typhoon for the European, Saudi and Oman contracts has largely completed. The F-35 programme continues to ramp-up to plan and Middle East support volumes continue to grow.
- The return on sales of 12.8% was at the top end of our guidance. There has been some profit trading on completing the Typhoon Oman contract with minimal sales, and that has generated a 70bps benefit within the reported return on sales.

Financial performance measures defined in IFRS³

	2018	2017 (restated) ²
Revenue	£5,579m	£6,312m
Operating profit	£810m	£918m
Return on revenue	14.5%	14.5%
Cash flow from operating activities	£719m	£888m

- The £666m of cash inflow in the year reflects full consumption of the £300m early receipts seen in 2017 against the Saudi Arabia support programme, utilisation of advances on the residual Typhoon export contracts, and a net advance now held on the Qatar programme.
- Order backlog stands at £27.4bn, significantly higher following the awards for the £5.1bn Qatar Typhoon and Hawk programme, the £1.1bn initial contract under the Australian Hunter Class frigate programme, and in respect of the £3.2bn continuation of Typhoon support through 2022 in Saudi Arabia.

+06 Alternative performance measure definitions

1. Including share of equity accounted investments.
2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.
3. International Financial Reporting Standards.



Our strategy in action

Support for the UK Typhoon fleet

Operational performance

European and International Markets

The contract entered into between BAE Systems and the Government of the State of Qatar, valued at approximately £5bn, for the supply of 24 Typhoon and nine Hawk aircraft became effective during September. The agreement also provides for the supply of ground support and training to the Qatar Armed Forces. The business has begun mobilising resources and supply chain.

The final four out of a total of 12 Typhoon aircraft were delivered to the Royal Air Force of Oman during the year. The five-year availability service contract for the aircraft continues.

Production is ongoing under the Kuwait Typhoon contract, secured by Italian Eurofighter partner Leonardo, with all 28 major units now in work. BAE Systems deliveries will commence in 2019.

In the year, the Royal Air Force accepted seven Typhoon aircraft from the UK final assembly facility. The German, Italian and Spanish Air Forces accepted a total of 15 aircraft, which brings deliveries of Tranche 3 aircraft to 73 of the 88 contracted.

The Royal Air Force declared Typhoon to have met Centurion standard, enabling the transition of capabilities from Tornado to Typhoon. Integration of the Captor E-Scan radar continues to progress as we conduct first flight trials to develop and improve the radar's capability.

In the UK we continue to support the Ministry of Defence Typhoon fleet under a ten-year partnership arrangement which provides flying hours and we also support the European Partner Nations support arrangements at above contractual levels.

Following the £119m contract secured in 2017 for collaboration on the first design and development phase of an indigenous fifth-generation fighter jet for the Turkish Air Force, activity has focused on mobilising resources.

Discussions with the Government of India and Hindustan Aeronautics Limited for the supply of Hawk aircraft kit sets to be used to build additional aircraft under licence in India for the Indian Air Force and Navy, have ceased pending a clearer understanding of their requirements.

Support to the Royal Air Force's UK fleet of Hawk fast jet trainer aircraft continues through the long-term availability contract, along with support to users of Hawk trainer aircraft around the world.

The UK Combat Air Strategy, announced in the year, is a significant milestone for the Air sector and sends a strong signal of intent about the UK's commitment to retaining a leading position in Combat Air. The Tempest programme is a key enabler to deliver this strategy and the business is currently mobilising resources against a contract awarded in July, whilst also engaging with industry partners and the Ministry of Defence to define and mature the technologies and capabilities that are required.

In August, we completed the first two years of an innovative ten-year partnership agreement with the UK Ministry of Defence to transform support of the UK Typhoon fleet.

The Typhoon Total Availability eNterprise (TyTAN) arrangement introduced new ways of working to further reduce the costs of operating the fleet at RAF Coningsby and RAF Lossiemouth. The arrangements will aim to enable an estimated £500m of savings to be reinvested to develop new capability enhancements for the aircraft.

TyTAN involves working with partners across our supply chain to drive improvements and to deliver the lowest possible costs to the Ministry of Defence. The arrangement, which includes a joint avionics solution with Eurofighter partner company Leonardo, aims to reduce the cost of the support service by around one-third while maintaining and improving levels of support to the UK Typhoon fleet.

 Group strategic framework

 More online [baesystems.com](https://www.baesystems.com)

US Programmes

Final price agreement was secured on F-35 Lot 11. Negotiations on Lots 12 to 14 are expected to conclude in the first half of 2019, which will enable an expected ramp-up to full-rate production by 2020. In the year, 110 rear fuselage assemblies were delivered for the Low-Rate Initial Production contracts across Lots 10, 11 and 12.

At RAF Marham in Norfolk, following acceptance of the Lightning Operating Centre, the UK's first four F-35 aircraft arrived in June, and a further five aircraft arrived during September, enabling the UK government to declare Initial Operational Capability in December. The integration of F-35 onto the Queen Elizabeth Aircraft Carrier has commenced, with the initial phase of First of Class Flight trials now complete.

During the second half of the year, contract award for the Performance Based Logistics arrangements for BAE Systems equipment responsibilities was achieved, underpinning a growing contribution by BAE Systems to the F-35 global fleet support.

Saudi Arabia

The Memorandum of Intent signed between the Kingdom of Saudi Arabia and the UK government in March 2018 continues to progress towards reaching an Agreement for a further 48 Typhoon aircraft, support and transfer of technology and capability. This will enable BAE Systems to continue with the Industrialisation of Defence capabilities in the Kingdom of Saudi Arabia. Final assembly of all 48 Typhoon aircraft will be In-Kingdom.

The Typhoon support contracts continue to operate well. Agreement has been reached with the Saudi Arabian government for BAE Systems to continue to provide Typhoon support services to the Royal Saudi Air Force against which we have booked order intake of £3.2bn in December 2018 for support services up to and including 2022.

The Royal Saudi Air Force will receive their first In-Kingdom final-assembled Hawk aircraft in early 2019. The company has delivered 14 of 22 major units on schedule, to meet this final assembly programme and first flight of a Hawk assembled in Saudi Arabia occurred in November.

The Royal Saudi Naval Forces accepted the third and final ship in the Minehunter mid-life update programme in April, with a training services contract signed in the year.

Work continues to reorganise our portfolio of interests in a number of industrial companies in Saudi Arabia. During the year Riyadh Wings Aviation Academy LLC increased its ownership to 11.85% in the Group's Overhaul and Maintenance Company (OMC) subsidiary, and is contracted to acquire a further interest up to 49%. OMC has disposed of its 85.7%

shareholding in Aircraft Accessories and Components Company to Saudi Arabian Military Industries (SAMI) in 2019. These reorganisations are in support of our strategy to develop indigenous supply in Saudi Arabia through our In-Kingdom Industrial Participation programme, promoting training, development and employment opportunities in line with the Kingdom's National Transformation Plan and Vision 2030.

Through the restructuring of the Group's portfolio of interests in a number of Kingdom of Saudi Arabia industrial companies along with sustaining current industrialised capability and building on our strong history in Saudi Arabia, we are working in partnership to continue to deliver these priorities with the SAMI organisation to explore how we can collaborate to deliver further In-Kingdom Industrial Participation.

It should be recognised that the Group is reliant on the continued approval of export licences by a number of governments in order to continue supplies to the Kingdom of Saudi Arabia. Significant changes in policies of such governments may affect our own provision of capability to the country and we are liaising closely with the UK government in working to reduce the impact of any such occurrence.

Australia

In March, the Commonwealth of Australia agreed upgrade and sustainment contracts worth A\$1.0bn (£0.6bn) for the Jindalee Operational Radar Network, to be delivered over an initial ten-year term. Mobilisation of the acquisition and support teams has been completed and support of all radar sites transferred to the business.

In June, the Commonwealth of Australia selected the Group as the preferred tenderer for the design and build of up to nine ships for the Hunter Class programme for the Royal Australian Navy. We subsequently agreed the contract and scope for the initial four-year design and production phase with a value of A\$1.9bn (£1.1bn). The production scope is to be negotiated in due course for the first batch of ships.

We have continued to provide in-service support to the Royal Australian Navy's two Landing Helicopter Docks under the support contract which was extended to run until June 2019. Trials have identified a number of areas where rectifications are in process, with final acceptance of the vessels under the acquisition contract expected in 2019. However, in December, the Commonwealth announced that we had not been selected for the next stage of Landing Helicopter Dock support.

Progress continues on the sustainment and upgrade of the Anzac fleet under the Warship Asset Management Alliance.

The Hawk Mk127 Lead-In Fighter project team continues to maintain the high level of aircraft availability required. The Capability Assurance Programme to upgrade the Hawk fleet to meet the F-35 training requirements remains on schedule.

Mobilisation activity for sustainment of the regional F-35 fleet continues to progress at our Williamtown facility, with the first two aircraft to be supported arriving in Australia in December.

We were notified in March 2018 that we had been unsuccessful in our bid for the Land 400 Phase 2 Combat Reconnaissance Vehicle programme.

MBDA

During the year MBDA secured new contracts for additional Taurus stand-off missiles in South Korea and for Marte Extended Range anti-ship missiles to Qatar. The contract for the supply of missiles to Qatar for the 24 Typhoon aircraft became effective in September.

MBDA also secured the development and manufacture of next-generation MICA air-to-air missiles in France, and further five-year support to the Aster system in France, Italy and the UK.

An amended Request for Proposal was received for the proposed future German ground-based air defence system, TLVS. MBDA is partnered with Lockheed Martin on this opportunity.

MBDA made good progress on development programmes with key test firings successfully achieved in the year for both Sea Venom anti-ship and Land Ceptor air defence missiles.

The Sea Ceptor naval air defence missile system entered into service with the Royal Navy Type 23 frigates in May. Meteor entered into service with the Royal Air Force on Typhoon. The French Army introduced in operations the new fifth-generation land combat missile MMP.

Looking forward

Forward-looking information for the Air reporting segment is provided later in this report.

 Segmental looking forward

Maritime

Segmental review continued

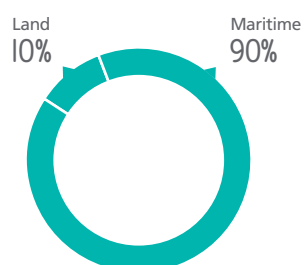


Maritime comprises the Group's UK-based maritime and land activities.

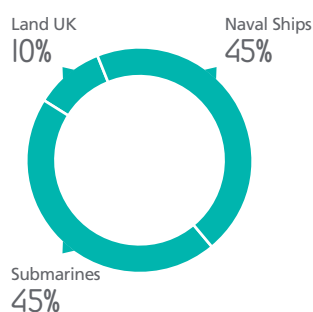
Maritime programmes include the construction of the second of the Queen Elizabeth Class aircraft carriers, five River Class Offshore Patrol Vessels and seven Astute Class submarines for the Royal Navy; as well as the design and production of the Royal Navy's future Dreadnought Class submarine and Type 26 frigate. Additionally the Maritime portfolio includes in-service support, including the delivery of training services and management of HM Naval Base, Portsmouth, and the design and manufacture of combat systems, torpedoes and radars.

Land UK provides combat vehicle upgrades and support to the British Army and international customers, and designs, develops and manufactures a comprehensive range of munitions products servicing its main customer, the UK Ministry of Defence, as well as international customers. The business also develops and manufactures cased-telescoped weapons through its CTA International joint venture.

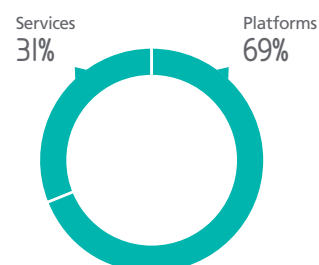
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



Employees¹

16,000



Our strategy in action

Progression
on our submarine
programmes

In March, BAE Systems was awarded a £1.6bn contract (with order intake in the year of £0.7bn) for delivery of the seventh Astute Class submarine. On the Dreadnought submarine programme, £0.9bn order intake was received in March, with a further £0.4bn received in October.

During a visit to Barrow, the Secretary of State for Defence named the seventh and final submarine in the Astute Class, Agincourt. He also formally opened a new state-of-the-art manufacturing facility, marking the latest development in a major infrastructure investment programme at our Barrow site. Certain phases of construction for the Dreadnought Class will take place at the new Central Yard Facility, which includes production, workshop and office facilities.

Construction on the first of four new Dreadnought submarines started in 2016 and this latest funding will support ongoing design and build activities, procurement of materials and investment in new and existing facilities for a further 12 months.

Operational and strategic key points

- HMS Queen Elizabeth has undergone successful initial F-35 Lightning II flight trials
- Cost growth on the Aircraft Carrier programme has resulted in a more conservative trading of contract profitability. Sea trials for HMS Prince of Wales are expected within the next year
- Type 26 selected as the design for the Canadian Surface Combatant programme
- Receipt of the full £1.6bn contract for the seventh Astute Class submarine, Agincourt, with order intake in the year of £0.7bn
- Further £1.3bn funding extension for the Dreadnought programme received
- Offshore Patrol Vessel programme quality issues have required the creation of a £47m loss provision
- Management strengthened across segment to focus on programme schedule, execution and cost performance
- CTA International, BAE Systems' joint venture with Nexter, delivered IIS 40mm cased-telescopic cannons
- In January 2019, entered into an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business, subject to regulatory clearances

Financial performance

Financial performance measures as defined by the Group

		2018	2017 (restated) ²
Sales	KPI	£2,975m	£2,877m
Underlying EBITA	KPI	£209m	£251m
Return on sales		7.0%	8.7%
Operating business cash flow	KPI	£67m	£278m
Order intake ¹	KPI	£3,513m	£4,671m
Order backlog ¹		£9.0bn	£8.5bn

- Sales of £3.0bn are marginally higher than 2017. As expected, whilst the Dreadnought submarine and Type 26 programmes continue to ramp-up, activity levels on the Carrier programme are reducing.
- Return on sales for the year was at 7.0%. Further charges on the five-ship Offshore Patrol Vessels contract were taken and trading on the Carrier programme was at a more conservative level than planned. Performance in the submarines business was ahead of plan on improved milestone achievement and risk retirement.

Financial performance measures defined in IFRS³

	2018	2017 (restated) ²
Revenue	£2,940m	£2,845m
Operating profit	£191m	£240m
Return on revenue	6.5%	8.4%
Cash flow from operating activities	£190m	£396m

- There was an operating cash inflow of £67m. Reported performance reflects the reversal of the £106m VAT timing benefit from last year.
- Order backlog increased to £9.0bn following the awards in the first half of the year for Astute Boat 7 pricing and further funding under the Dreadnought programme.

+ 06 Alternative performance measure definitions

1. Including share of equity accounted investments.
2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.
3. International Financial Reporting Standards.



Our strategy in action

F-35 Lightning II carrier integration

BAE Systems has a unique role in the design, build and support of both the F-35 Lightning II aircraft and Queen Elizabeth Class aircraft carriers.

As the First of Class Flight Trials commenced to bring together the F-35 Lightning II and HMS Queen Elizabeth, BAE Systems' employees were at the heart of the integration.

Two month-long trials took place off the east coast of the United States, involving a unique and complex set of exercises that tested the aircraft's ability to operate safely and effectively from the aircraft carrier in a range of sea states and wind speeds during both day and night. Our F-35 test pilot, the only industry pilot who flew in the trials, made history by performing the world's first F-35 Shipborne Rolling Vertical Landing.



Group strategic
framework



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Operational performance

Maritime Naval Ships

On the aircraft carrier programme, large volume installation activities continue to progress on HMS Prince of Wales, with commissioning of systems continuing through 2019 and sea trials also scheduled to take place in 2019.

Work continues to support HMS Queen Elizabeth. Following the completion of a Capability Insertion Period, successful fixed wing flight trials took place in the second half of 2018, with the first F-35 Lightning II deck landing completed. However, cost growth on the programme has resulted in a more conservative trading of contract profitability in the period.

The first of the five Offshore Patrol Vessels, HMS Forth, completed sea trials in December 2017. However, quality issues have had to be resolved resulting in unanticipated programme cost growth and a £47m loss provision has been recorded in the year. Lessons learned are being applied to the other ships in build. Sea trials on the second ship, HMS Medway, took place in November 2018 and the ship is due to be delivered to the customer in the first quarter of 2019. Construction of the remaining three Offshore Patrol Vessels on the Clyde continues through 2019.

The three Type 26 ships continue in production. The programme currently employs over 1,500 people and activities have continued to build progressively during 2018 on transition from detailed design through to production readiness and the commencement of unit build.

Our Type 26 platform design has opened up opportunities abroad and in February 2019, the Canadian government together with Irving Shipbuilding selected Lockheed Martin Canada, using our Type 26 platform design, as subcontractor for the Canadian Surface Combatant programme. This is a further endorsement of the Global Combat Ship as one of the world's most advanced anti-submarine warships.

Submarines

The first three Astute Class submarines are in operational service with the Royal Navy. Progress continues on the manufacture of the remaining four boats. A full contract award for the seventh boat, Agincourt, was secured in March.

Functional and spatial design and production on the first of class continues to advance on the Dreadnought Class submarine programme, the replacement for the Vanguard Class submarines. Contract funding of £1.3bn was received through 2018.

The major programme of building works at the Barrow site continues, with contracts in place totalling more than £0.5bn.

The Dreadnought Alliance Agreement detailing the organisational, governance and commercial arrangements between the three parties, the Submarine Delivery Agency, BAE Systems and Rolls-Royce was agreed, allowing for the formal stand-up of the Alliance from April 2018.



Maritime Services

BAE Systems continues to manage and maintain HM Naval Base, Portsmouth, and supports more than half of the Royal Navy's surface fleet through the Maritime Support Delivery Framework contract. The Ministry of Defence extended this contract to March 2020 in the early part of the year.

During the second half of the year, we have mobilised the Type 45 Power Improvement Programme in collaboration with Cammell Laird and BMT, having been selected as prime contractor in the first half of 2018.

Progress continues on the £270m Spearfish torpedo programme, with the demonstration phase forecast to complete in 2020.

Maritime Services has delivered a transformation programme through 2018 to streamline its processes and ensure it is able to deliver value for money as we continue to provide the Royal Navy with the capability it needs to protect the nation's interests.

Land UK

The business continues to provide UK and international customers with a wide range of light and heavy munitions, and support to previously supplied armoured vehicles and bridging systems.

During the year, 115 40mm cased-telescopic cannons were delivered to the Ministry of Defence by CTA International, a joint venture between BAE Systems and Nexter, bringing cumulative deliveries to 275 of 515. This is the first entirely new medium-calibre cannon and ammunition system qualified by the British Army since the late 1960s. Also during the period an order for £72m was received to deliver 110 Case Telescoped Armament Systems to the French Army under their 6x6 combat armoured reconnaissance vehicle programme.

The business is one of two contenders delivering the design stages of the Challenger 2 Life Extension Programme and the British Army's bridging system.

In January 2019 the business entered into an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business. Rheinmetall will purchase a 55% stake in the existing BAE Systems UK-based combat vehicles business for £28.6m with BAE Systems retaining 45%. The transaction is subject to regulatory approvals which are anticipated to be completed in the first half of 2019. The transaction does not include Land UK's munitions business or its holding in the CTAI joint venture with Nexter.

Looking forward

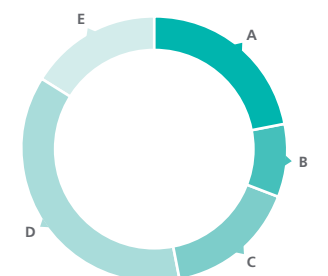
Forward-looking information for the Maritime reporting segment is provided later in this report.

64 Segmental looking forward

Segmental looking forward

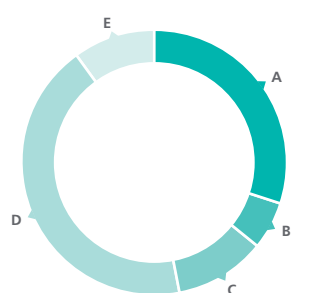
Effective 1 January 2018, BAE Systems has five principal reporting segments, Electronic Systems, Cyber & Intelligence, Platforms & Services (US), Air and Maritime, which align with the strategic direction of the Group.

2018 sales¹



A	Electronic Systems	22%
B	Cyber & Intelligence	9%
C	Platforms & Services (US)	16%
D	Air	37%
E	Maritime	16%

2018 underlying EBITA²



A	Electronic Systems	30%
B	Cyber & Intelligence	6%
C	Platforms & Services (US)	11%
D	Air	43%
E	Maritime	10%

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, precision guidance and seeker solutions, next-generation military communications systems and data links, persistent surveillance capabilities, and hybrid electric drive systems.

Electronic Systems is well positioned to address current and evolving priority programmes from its strong franchise positions in electronic warfare, precision guidance and seeker solutions. Electronic Systems has a long-standing programme of research and development, and its focus remains on maintaining a diverse portfolio of defence and commercial products and capabilities for US and international customers.

The business expects to benefit from its ability to apply innovative technology solutions that meet defence customers' changing requirements. As a result, the business is well positioned for the medium term with strong significant roles on F-35 Lightning II and classified programmes, as well as with specific products such as APKWS®. Over the longer term, the business is poised to leverage its technology strength in emerging areas of demand such as space resilience and autonomous vehicles.

In the commercial aviation market, Electronic Systems' technology innovations are enabling the business to maintain its long-standing customer positions and to compete for, and win, new business.

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.

Intelligence & Security

The outlook for the US government services sector is stable, although market conditions remain highly competitive and continue to evolve. The US business remains well positioned and will continue to leverage its established market positions and reputation for reliable and adaptable performance to meet customer demands for innovative, cost-effective and cyber-hardened solutions to pursue recompeted contracts and new business across its portfolio of sustainment, integration and modernisation solutions for military, intelligence and nuclear triad customers.

Applied Intelligence

Strong market demand and continued investment in people and products position the business for revenue growth in the medium term. Profitability is expected to continue to benefit from focus on operational efficiency and cost control.

1. Revenue plus the Group's share of revenue of equity accounted investments.

2. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items.

+06 Alternative performance measure definitions

+19 Our markets

Platforms & Services (US), with operations in the US, UK and Sweden, manufactures combat vehicles, weapons and munitions, and delivers services and sustainment activities, including ship repair, and the management and operation of government-owned munitions facilities.

The combat vehicles business is underpinned by a growing order backlog and incumbencies on key franchise programmes. These include the US Army's Armored Multi-Purpose Vehicle, M109A7 self-propelled howitzer, Bradley upgrade programmes, the Amphibious Combat Vehicle; and the CV90 and BvS10 export programmes from our BAE Systems Hägglunds business.

FNSS continues to execute on its order book of both Turkish and international orders.

These long-term contracts and franchise positions make the combat vehicles business well placed for growth in the medium term and the team is closely following the US Army's acquisition plans for its next generation of combat vehicles.

In the maritime domain, the sector has a strong position on naval gun programmes and US Navy ship repair activities where the business has invested in facilities in key homeports. This capitalised infrastructure represents a high barrier to entry, and the business remains well aligned to the US Navy's operational strategy.

The Group remains a leading provider of gun systems and precision strike capabilities and, in the complex ordnance manufacturing business, continues to manage and operate the US Army's Radford and Holston munitions facilities under previously awarded contracts.

Air comprises the Group's UK-based air activities for European and International markets and US Programmes and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the European MBDA joint venture.

Future UK sales are underpinned by existing contracts for both Typhoon production and support. Production of rear fuselage assemblies for F-35 Lightning II will increase over the next two years to reach its expected peak rate for the next decade. The business plays a significant role in the F-35 sustainment programme in support of Lockheed Martin.

Defence and security remain priorities for the UK government, reaffirmed in the Modernising Defence Programme and the recently announced UK Combat Air Strategy, which provides the base to enable long-term planning and investment in a key strategic part of the business.

Discussions continue with current and prospective customers in relation to potential further contract awards for Typhoon and Hawk.

The UK Typhoon support operation is underpinned by a long-term partnering arrangement with the Ministry of Defence.

In Saudi Arabia, the In-Kingdom Industrial Participation programme continues to make good progress consistent with our long-term strategy, as well as the Saudi Arabian government's National Transformation Plan and Vision 2030. In order to provide ongoing capability to international customers, the company is reliant on the continued approval of export licences by a number of governments. Any significant change in UK or foreign government policy in this regard may have an adverse effect on the Group's provision of capability to the Kingdom of Saudi Arabia and the Group is liaising closely with the UK government in working to reduce the impact of any such occurrence.

The Australian business has long-term sustainment and upgrade activities in maritime, air, wide-area surveillance, missile defence and electronic systems. It will expand into ship design and production on the Hunter Class frigate programme from 2019.

MBDA has a strong order book which is driving increasing production and sales. Development programmes continue to improve the long-term capabilities of the business.

Maritime comprises the Group's UK-based maritime and land activities.

Maritime

In Maritime, there remains pressure on the Royal Navy's near-term budgets and a highly-competitive environment in ship support and upgrade. Overall the outlook is stable based on the long-term contracted positions.

Within Submarines, the business is executing the Astute Class programme, with four boats still in build. On the Dreadnought programme manufacturing activities continue on the first of class boat. Investment continues in the Barrow facilities in order to provide the capabilities to deliver these long-term programmes through the next decade and beyond.

In shipbuilding, sales are underpinned by the contracts to manufacture the Queen Elizabeth Class aircraft carriers, Type 26 frigates and River Class Offshore Patrol Vessels. The through-life support of surface ship platforms provides a sustainable business in technical services and mid-life upgrades.

Land UK

The Land UK business continues to deliver support to armoured vehicle and bridging systems in UK and international markets, munitions under the 15-year Munitions Acquisition Supply Solution partnering agreement secured in 2008 and 40mm cased-telescopic cannons for the UK and French armies.

In January 2019 BAE Systems entered into an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business. Rheinmetall will purchase a 55% stake in the existing BAE Systems UK-based combat vehicles business for £28.6m, with BAE Systems retaining 45%. The new business is well positioned to address the upcoming Challenger II upgrade programme.

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 the Group 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 Risk Management Policy is set out in the Operational Framework, the Group's detailed governance framework.

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 resources, 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 processes 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 2018 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 and Group functions 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 and Group functions. 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 and emerging risks

The Board has carried out a robust assessment of the emerging and principal risks facing the Group. Emerging and principal risks have been identified, and are managed or mitigated, through the application of the policies and processes outlined above.

Principal risks include those that would threaten the Group's business model, future performance, solvency, liquidity or reputation. Risks have been identified as principal based on the likelihood of occurrence, the potential impact on the Group and the timescale over which they might occur. The principal risks, together with details of how they are being mitigated and managed, are detailed on pages 68 to 71.

Risk management framework



Our principal risks

Risks are identified 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.

Description	Impact	Mitigation
1. Defence spending The Group is dependent on defence spending.		
In 2018, 91% of the Group's sales were defence-related. Defence spending by governments can fluctuate depending on change of government policy, other 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 UK.	Lower defence spending by the Group's major customers could have a material adverse effect on the Group's future results and financial condition.	The business is geographically spread across US, UK and international defence markets: – in the US, the fiscal year 2019 Defense Appropriations bill was enacted in September 2018 providing near-term clarity and support for the industry. The enacted bill maintains support for our medium-term planning assumptions and positive momentum for military readiness and modernisation programmes; – in the UK, the Modernising Defence Programme has outlined a clear direction of travel for the Ministry of Defence. This statement re-emphasises the UK's commitment to strong defence and security; – in Saudi Arabia, regional tensions continue to dictate that defence remains a high priority; and – in Australia, regional instability and the pace of military modernisation in the Asia-Pacific region continue to drive the government's commitment to defence spending, with major recapitalisation programmes under way. The government has indicated its intent to grow defence spending by committing to spend 2% of GDP by 2020/21. The diverse product and services portfolio is marketed across a range of defence markets. BAE Systems benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia. BAE Systems has a growing portfolio of commercial businesses, including commercial avionics and the commercial areas of the Applied Intelligence business.
2. Government customers The Group's largest customers are governments.		
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 US, UK 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. Governments also from time to time review their terms of trade and underlying policies and seek to impose such new terms and policies when entering into new contracts. 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.	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.	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.

Description

Impact

Mitigation

3. International markets

The Group operates in international markets.

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: social and political changes impacting the business environment; economic downturns, political instability and civil disturbances; the imposition of restraints on the movement of capital; the introduction of burdensome taxes or tariffs; change of export control and other government policy and regulations in the UK, US and all other relevant jurisdictions; and the inability to obtain or maintain the necessary export licences.

In July 2017, the High Court of England and Wales ruled that the UK government has been acting lawfully in granting defence export licences to the Kingdom of Saudi Arabia. The Court of Appeal has given permission for the decision of the High Court to be appealed and the hearing and determination of the appeal is awaited.

The Group is exposed to volatility arising from movements in currency exchange rates, particularly in respect of the US dollar, euro, Saudi riyal and Australian dollar. There has been volatility in currency exchange rates in the period since the EU referendum in the UK.

The terms of the UK's exit from the EU on 29 March 2019 are currently uncertain, rendering it difficult for the Group to prepare for potential changes in the regulatory environment. In particular, a no-deal Brexit could have an impact on programmes which depend on the movement of goods between the UK and the EU.

There is also a risk that, as a result of the UK leaving the EU, the Group's ability to take part in collaborative industrial programmes in Europe could encounter new EU barriers.

The occurrence of any such events could have a material adverse effect on the Group's future results and financial condition. The risk of the Group's inability to obtain and maintain the necessary export licences for our business in the Kingdom of Saudi Arabia could affect the Group's provision of capability to the country.

BAE Systems benefits from a large order backlog with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia and there is relatively limited UK-EU trading. In respect of people, the majority of persons employed in the UK are UK nationals, with only small movements of EU nationals into and out of the Group's UK businesses. Accordingly, the resulting Brexit near-term impacts across the business are likely to be limited.

The Group has a balanced portfolio of businesses across a number of markets internationally. The Group benefits from a large order backlog, with established positions on long-term programmes in the US, UK, Saudi Arabia and Australia.

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.

BAE Systems has a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements and identifying restrictions that could adversely impact the Group's activities, including export control requirements.

The Group's policy is to hedge all material firm transactional currency exchange rate exposures.

If there is no deal before the UK leaves the EU, it will require the Group to put in place a set of actions and mitigations to prepare for the change that might take place in relation to a range of business activities. These include customs procedures, export control, and the use of speciality chemicals whose use is currently authorised by an EU agency.

BAE Systems will support the UK government in achieving its aim to ensure that the UK maintains its key role in European security and defence post-Brexit, and to strengthen bilateral relationships with key partners in Europe. This will be important for ongoing collaboration in the development of defence capabilities.

4. Competition in international markets

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

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 US and UK.

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

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.

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.

Our principal risks continued

Description	Impact	Mitigation
5. Laws and regulations The Group is subject to risk from a failure to comply with laws and regulations.		
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.	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.	BAE Systems has a well-established legal and regulatory compliance structure aimed at ensuring adherence to regulatory requirements and identifying 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. BAE Systems continues to reinforce its ethics programme globally, driving the right behaviours by supporting employees in making ethical decisions and embedding responsible business practices.
6. Contract risk and execution The Group has many contracts, including a small number of large contracts and fixed-price contracts.		
In 2018, 44% of the Group's sales were generated by its 15 largest programmes. At 31 December 2018, the Group had eight 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.	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.	Contract-related risks and uncertainties are managed under the Group's mandated Lifecycle Management process. A leadership development programme for project directors continues to be deployed across the Group, covering the leadership competencies required to manage complex projects containing significant levels of risk and uncertainty. 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 awards and cash profiles The Group is dependent on the award timing and cash profile of its contracts.		
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.	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.	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.

Description	Impact	Mitigation
8. Pension funding The Group has an aggregate funding deficit in its defined benefit pension schemes.		
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 funding deficits may be adversely affected by changes in a number of factors, including investment returns and members' anticipated longevity.	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 the UK, new employees have been offered membership of defined contribution rather than defined benefit schemes since April 2012 and, in the US, employees have not accrued salary-related benefits in defined benefit schemes since January 2013. In November 2017, the UK triennial funding valuations and, where necessary, deficit recovery plans were agreed with the trustees and certified by the scheme actuaries after consultation with the Pensions Regulator. The funding deficit across the UK schemes at 31 March 2017 was £2.1bn. Based on these funding valuations, deficit recovery payments to the UK schemes were £211m in 2018. The deficits in each of the schemes are expected to be cleared between 2021 and 2026.
9. Information technology security The Group could be negatively impacted by information technology security threats.		
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.		
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. The Group's business plan is targeting an increasing level of business in international export markets outside the US and UK. 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 the Group's 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.

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 20 February 2019.

David Parkes

Company Secretary

Chairman's governance letter



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Dear Shareholders,

It is clear from conversations with all our stakeholders that board governance, corporate behaviour, stakeholder engagement and environmental sustainability are all becoming increasingly important when considering the activities of any company.

I would like to address each of these important areas in this review.

Board governance

Details of our governance processes and procedures are given on pages 76 and 77. In summary, however, we have a balanced Board with a good mix of gender, skills and experience with effective committees to oversee our financial, corporate responsibility, executive remuneration and board member nomination practices.

A comprehensive Board evaluation is conducted each year with an external advisor employed every other year to facilitate the process. Following the evaluation, I hold one-to-one meetings with individual directors to provide feedback and our Senior Independent Director leads a Board appraisal of my performance. We have found the evaluation process to be helpful in ensuring that an open dialogue delivers good practice and establishes a culture of continuous improvement.

Each year we use the evaluation to agree a number of objectives for the Board to progress over the year ahead. Amongst other things, in 2018 we agreed that we should continue to develop what we do to engage directly with stakeholders, and thereby look to learn more about the Company's performance and the quality of key relationships from their perspective. We also agreed to ensure that we made time to have a more open-ended dialogue on matters such as corporate strategy, culture and performance. Progress was made against these and the other objectives the Board agreed last year.

Stakeholder engagement

We seek to maintain an open dialogue with all stakeholders including shareholders, key suppliers, customers and our employees.

Shareholders

Our day-to-day shareholder contact is largely conducted by our investor relations team, and is supplemented by regular meetings with our Chief Executive, Group Finance Director, and President and Chief Executive Officer of our US business.

I visit a number of major shareholders each year and the Chair of the Remuneration Committee also engages with shareholders to discuss remuneration policies and practice.

Last year, we arranged a separate governance event with major shareholders and investors. Attended by myself, the Chief Executive and non-executive directors, the meeting allowed us to discuss openly our governance arrangements, corporate culture and committee work. The feedback we received was positive and we have decided to continue this practice at regular intervals or when there is a major change in Board membership.

Employees

The Company has well-established links with the principal trades unions representing members of our workforce in the UK which, at six-monthly intervals, bring together union officials with the Chief Executive for an open discussion on the business and matters concerning employees.

In 2018, the Board decided that it would be helpful if the Chief Executive was accompanied by the Chair of the Corporate Responsibility Committee, Ian Tyler, in order to provide wider Board engagement with the unions and our workforce.

This has been welcomed by all parties and, in addition, Ian Tyler will, from time to time, accompany the Chief Executive on his site visits in the normal course of business.

In addition, as Chairman, I continue to visit sites across the world and encourage open 'town hall' sessions with the employees as a matter of course. Similar events are conducted when all Board members attend operational sites as part of the Board's annual programme, and in 2018 we held such meetings in Rochester, UK and San Diego, US.

Employee engagement is also developed through surveys, podcasts and informal breakfast and dinner meetings with members of the management team and directors.

A new provision in the recently revised UK Corporate Governance Code requires companies to have an effective means of engaging with their workforce. The Board has agreed that our Corporate Responsibility Committee – which has a membership comprising only independent non-executive directors – will be responsible for discharging this role, and in doing so will build on the range of employee engagement opportunities we have been undertaking to date. The Committee took on this responsibility from the start of 2019, and therefore we will be well placed to comply with this new requirement and report further on it in next year's Annual Report.

Customers

The nature of our business and the culture of the Company encourages the development of deep, transparent and constructive relationships with our customers. It recognises that, whilst on occasion we may have competing commercial objectives, we are united in our mutual commitment to serve and protect those that serve and protect us.

Customer contact involving relevant management personnel, the Chief Executive and also myself, is with governments, officials and military personnel across the world on a regular basis. During the course of the year, we invited the Chief of the Royal Air Force and the Permanent Under Secretary of the Foreign and Commonwealth Office to meet the Board for an open discussion on the value of our relationship and ways to improve our interaction.

We will continue this practice in the years to come.

Suppliers

The appointment of a senior supply chain management team is starting to deliver a much closer working relationship with our major suppliers. This has been achieved through supplier conferences, strategic partnerships and clearer communication on the ambition and expectation we have in building long-term supplier partnerships.

We have found that this increase in professionalism has delivered a mutual benefit reflected in improved commercial terms and higher commitment to quality. The Board will continue to focus on supplier management and we will report further on this in next year's Annual Report.

Community investment and the environment

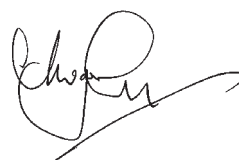
The Board recognises the importance of leading a company that not only generates value for shareholders but also contributes to wider society. As a major employer that develops and trains a highly-skilled workforce, principally in manufacture and engineering roles, we make an important economic contribution to the communities in which we operate. In addition, through our Global Community Investment Strategy we build and nurture mutually beneficial relationships between our business, our people and local stakeholders.

I have been fortunate to see at first-hand how this is being put into action, with initiatives focused on our support for the armed forces, education and skills, and the support we provide for the communities in which we operate. Well-managed companies are an essential part of society but in order to succeed business needs strong, vibrant and prosperous communities.

Recognition of our wider impacts is also an important part of our environmental commitments. As a major manufacturing company, we recognise that environmental and climate risks could impact us directly. We are committed to reducing the environmental impact of our operations and products, and minimising our environmental footprint. This is important to our role in wider society and in 2019 we will develop our environmental policy further and progress our alignment to the UN Sustainable Development Goals. The Board and the Corporate Responsibility Committee will provide oversight of this and monitor implementation.

Conclusion

I am confident that both Board and management believe in the values and benefits of frequent and open dialogue with stakeholders. We are consistently reviewing how we communicate and engage, including how we use technology to broaden our reach and assess the feedback we obtain, to ensure that our messages are well received, appropriately directed and our responses helpful and valued. As a Board we are clear that it is not simply how much money the Company makes but how it makes money that is important to all our stakeholders.



Sir Roger Carr Chairman

Directors' duties

This is an overview of how the directors have performed their duty to promote the success of the Company.

The directors of BAE Systems – and those of all UK companies – must act in accordance with a set of general duties. These duties are detailed in the UK's Companies Act and include a duty to promote the success of the Company, which is summarised below.

As part of their induction, the directors are briefed on their duties and they can access professional advice on these – either through the Company or, if they judge it necessary, from an independent provider.

Typically, in large and complex companies such as BAE Systems, the directors fulfil their duties partly through a governance framework that delegates day-to-day decision-making to employees of the Company.

The Board recognises that such delegation needs to be much more than simple financial authorities and, in this section of the report, we have summarised our governance structure, which covers: the values and behaviours expected of our employees; the standards they must adhere to; how we engage with stakeholders; and how the Board looks to ensure that we have a robust system of control and assurance processes.

For more detail on our governance structure, see pages 76 and 77.

Section 172 of the UK's Companies Act

In summary, as required by Section 172 of the UK's Companies Act, a director of a company must act in the way he considers, in good faith, would most likely promote the success of the company for the benefit of its shareholders. In doing this, the director must have regard, amongst other matters, to the:

- likely consequences of any decisions in the long term;
- interests of the company's employees;
- need to foster the company's business relationships with suppliers, customers and others;
- impact of the company's operations on the community and environment;
- company's reputation for high standards of business conduct; and
- need to act fairly as between members of the company.

Shareholders | Employees | Customers Suppliers | Community and Environment

A board should communicate effectively with its shareholders and understand their views, and also act fairly as between different members. Employees are central to the long-term success of a company, as such, a board should consider their interests, and, to assist in doing so, have means of engaging with and understanding their views. Fostering business relationships with key stakeholders, such as customers and suppliers, is also important to a company's success. A board should have visibility of these relationships so that it is able to take stakeholder considerations into account when making decisions. In their decision-making, directors need to have regard to the impact of a company's operations on the community and environment.

Overview of how the Board performed its duties

Shareholders

Members of the Board, including the chairs of the principal board committees, held a governance event with major shareholders in 2018. This allowed directors to liaise directly with shareholders on the Company's governance arrangements, including the important work undertaken by the committees. The feedback received was positive and the Board intends to continue such events at regular intervals.

Employees

The Company has a well-developed structure through which it engages regularly with trade union officials to discuss and understand matters concerning UK employees. During the year, one of the non-executive directors, Ian Tyler, joined the Chief Executive when engaging with employee representatives through this forum.

Also, in terms of employee engagement, a number of Board meetings were held on operational sites throughout the year which provided an opportunity for all directors to engage directly with employees on a variety of topics. This included 'town hall' meetings with groups of employees at our Rochester, UK and San Diego, US sites. It is proposed that directors will attend further such meetings at Company sites during 2019.

Customers

The Chief Executive and the President and Chief Executive Officer of our US business are in regular contact with our principal customers, and at all scheduled Board meetings they brief the Board on our performance in delivering on our commitments to customers and the quality of these critical relationships. The Chairman also maintains close links with many of our customers and regularly briefs the Board on the feedback he receives. In addition, in order to help directors to develop their understanding of the Company's performance and relationship with key customers at first-hand, a number of informal meetings were held in 2018 with senior customer representatives. Such meetings are an integral part of the Board's annual programme and similar events will take place during 2019.

Suppliers

The Board met with the leadership of the Company's Procurement function to understand more about how they are developing deeper relationships with companies in our supply chains and developing strategic relationships with key suppliers. The Board will continue to focus on supplier management in 2019.

Community and environment

The Board recognises the importance of leading a company that not only generates value for shareholders but also contributes to wider society. Through the Operational Framework the Board has mandated that our businesses implement the requirements of our Community Investment Policy, which looks to ensure that we build and nurture mutually beneficial relationships between our business, our people and local stakeholders.

As a major manufacturing company, we recognise that environmental and climate risks could impact us directly, and we are committed to reducing the environmental impact of our operations and products, and minimise our environmental footprint. Through the Operational Framework the Board has mandated that our businesses implement the requirements of our Environmental Policy, which details our commitment to high standards of environmental management.

Compliance with the above policies is monitored through our Operational Assurance Statement process, the output from which is reviewed regularly by the Audit and Corporate Responsibility committees. Also, community and environmental matters form part of the Board's annual review of corporate responsibility matters.

+18 Group strategic framework

+24 Our people

+72 Chairman's governance letter

+76 Board governance

+87 Corporate Responsibility Committee report

Decision-making | Governance and performance oversight | Risk

Boards of large companies invariably delegate day-to-day management and decision-making to executive management. Directors should maintain oversight of a company's performance and ensure that management is acting in accordance with the strategy and plans agreed by a board, and its delegated authorities. The culture, values and standards that underpin this delegation should help ensure that when decisions are made their wider impact has been considered. A board should also reserve certain matters for its own consideration so that it can exercise judgement directly when making major decisions, and in doing so promote the success of the company whilst having regard to all necessary matters.

A board needs assurance that a company's financial reporting, risk management, governance and internal control processes, including policies mandating procedural requirements and standards, are operating effectively.

Overview of how the Board discharged its duties

Each year, the Board undertakes an in-depth review of the Company's strategy, including the business plan for the following five years. Once approved by the Board, the plan and strategy form the basis for financial budgets, resource plans and investment decisions, and also the future strategic direction of the Company. In making decisions concerning the business plan and future strategy, the Board has regard to a variety of matters including the interests of various stakeholders, the consequences of its decisions in the long term and its long-term reputation.

In 2018, the Board's review of strategy included presentations from the Group Human Resources Director and the leaders of our Procurement function. The Chief Executive is responsible for delivering the plans and strategy agreed by the Board, with authority delegated to executive directors but subject to all decisions being made on the basis of the values and standards mandated in the Company's Operational Framework and underpinned by the culture set by the Board, Chief Executive and senior management.

The Board has approved the Group's Risk Management Policy, which aims to ensure that risks are managed effectively across the Group. It also has overall responsibility for determining the nature and extent of the risk the Company is willing to take. During the year, the Audit Committee reviewed output from the Company's risk management processes. Also in 2018, the Corporate Responsibility Committee reviewed the output from the Company's processes for managing significant non-financial risks, including those arising in respect of business conduct, health and safety, and the environment. Both committees reported their findings to the Board following such reviews. Risk is also an important consideration for Board members when reviewing major bids and contracts. Last year the Board undertook such reviews in respect of the Mobile Protected Firepower programme, Qatar Typhoon sales financing, APKWS® production, Astute Boat 7 and the Hunter Class Frigate programme (see below).

The Board has reserved certain matters for its own decision, including the approval of major bids and contracts. For example, in 2018 the Company signed a contract with the Commonwealth of Australia for its Hunter Class Frigate programme. Following extensive reviews by the Chief Executive and the business team, the initial bid and the subsequent contract were referred to the Board for its review and approval. In reaching its decisions on this, the Board had regard to a number of matters, including the business case and financial returns, technical and programme management matters, risk management, workforce matters and the long-term reputation of the Company in dealing with various aspects of a complex international programme.

The Board has adopted a revised Board Charter, which incorporates governance principles that are aligned with the requirements of the revised UK Corporate Governance Code. Also, revised terms of reference have been adopted by the Board's principal committees to recognise the Code changes.

+66 How we manage risk **+76** Operational framework **+80** Board information

Culture, values and standards

Culture, values and standards underpin how a company creates and sustains value over the longer term and are key elements of how it maintains a reputation for high standards of business conduct. They also guide and assist in decision making and thereby help promote a company's success, recognising, amongst other things, the likely consequences of any decision in the long term and wider stakeholder considerations. The standards set by a board mandate certain requirements and behaviours with regards to the activities of its directors, employees and others associated with it.

Overview of how the Board discharged its duties

The Board is supporting the Chief Executive in embedding a culture that will help deliver long-term success. To assist with this work, during the year the Company undertook an employee engagement survey. The results of this have been reviewed by the directors, together with the subsequent actions the Chief Executive will be taking to reinforce the Company's values and ensure that we have the right culture to meet the strategic needs of the business. Further work on this will be undertaken during 2019.

The Board sets the values and standards required of all employees through its Operational Framework, which contains our Code of Conduct. In 2018, this document was reviewed and amendments agreed by the Board.

In overseeing the effectiveness of the Company's processes for dealing with employees whose behaviour falls short of required standards, the Corporate Responsibility Committee has continued to monitor the nature of issues reported through the Company's Ethics Helpline. Also during the year, the Board reviewed the processes in place for the investigation of complaints concerning inappropriate behaviour by employees. The integrity of these processes is an important part of our governance arrangements and the Board will review these processes again in 2019 to ensure they remain effective.

+76 Operational framework **+77** Operational Assurance Statement **+87** Corporate Responsibility Committee report

Board governance

This is the structure through which we manage the Company. It has evolved over time, and continues to evolve to meet the needs of the business and our stakeholder responsibilities.

Shareholders

The Company has approximately 100,000 individual, corporate and employee shareholders.

Annual General Meeting

Shareholders vote on key governance matters, including the re-election of directors, their remuneration, the payment of dividends and the appointment of the auditor.

Shareholder relations

The Chief Executive and Group Finance Director meet the Company's principal shareholders on a regular basis. Separately, the Chairman maintains regular contact with the Company's principal shareholders on governance matters and ensures that all directors are aware of their views.

Board

The Board consists of executive and independent non-executive directors, plus a non-executive chairman who was independent in accordance with the UK Corporate Governance Code on his appointment.

The non-executive directors constructively challenge and help develop proposals on strategy. They also scrutinise the performance of management in meeting agreed goals and objectives, and satisfy themselves as to the integrity of financial information, and that systems of risk management are robust and defensible. In addition, they set the remuneration of the executive directors and oversee Board succession planning.

Chairman

Responsible for leading the Board and ensuring that it discharges its duties efficiently.

Chief Executive

Responsible for the implementation and delivery of the strategy agreed by the Board.

Senior Independent Director

Acts as a sounding board for the Chairman and acts as an intermediary for the other directors as necessary.

Company Secretary

Responsible to the Board for ensuring that Board procedures are complied with. Through the Chairman, he is responsible for ensuring that directors are supplied with information in a timely manner.

Oversight of performance and compliance with Operational Governance

Operational governance

The Operational Framework sets out how we do business across BAE Systems, and encapsulates our values, policies and processes, together with clear levels of delegated responsibility aimed at ensuring that all of our employees and businesses act in a clear, accountable and consistent manner. It is reviewed and approved annually by the Board.

Board committees

The membership of the principal board committees (see below) solely comprises non-executive directors. They provide leadership, scrutiny and oversight over key governance areas.

+83

Audit Committee

+87

Corporate Responsibility Committee

+90

Nominations Committee

+92

Remuneration Committee



How we work

The Operational Framework sets out the principles of good governance which, together with our culture, guide our work and behaviour in support of the strategy set in our Group strategic framework (see page 18). Here we set out the values that we ask all our employees to demonstrate in their day-to-day work, wherever they are in the world.

Governance

The UK Corporate Governance Code's (the Code) principles are embedded in the Operational Framework, and its policies and processes underpin all the disclosures made by the Board pursuant to the Code's provisions.

How we conduct our business is fundamental to the success of BAE Systems. The Operational Framework sets out our approach and the standards to which we adhere. It includes the following:

Code of Conduct Lays out the standards that are expected of each of us, to support us in doing the right thing. All employees receive annual training designed to stimulate conversations about ethical decision-making.	Responsible Trading Principles We do not compromise on the way we do business and here we mandate a principles-based approach to our business activity.	Internal controls Provide assurance regarding: – the reliability and integrity of information; – compliance with policies, processes, laws, regulations and contracts; – the safeguarding of assets and protection against fraud; and – the economical and efficient use of resources.	Risk framework This is how we identify, analyse, evaluate and mitigate risk (see page 66).	Workplace and operational environment This covers how we expect our people to be managed and the obligations placed on us all concerning avoiding conflicts of interest, anti-bribery, and managing the security of our people, information and other assets.	Delegated authorities As part of a robust system of internal controls, the Board has delegated certain authorities to executive management. Delegation is subject to financial limits and other restrictions, above which matters must be referred to the Board.
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Operational Assurance Statement (OAS)

This key governance process requires that a return is completed every six months by each operational and functional business head, reporting their formal view against such matters as compliance with law and regulation, ethical business conduct, financial controls, risk management, compliance with business planning processes, health and safety, conflicts of interest, delegated authorities, appointment of advisers and product safety. There is a separate OAS process for our joint ventures. Our Internal Audit function owns the OAS process. It is managed independently from management functions. The Internal Audit Director reports functionally to the Audit Committee and, for day-to-day operations, to the Chief Executive.

Core business processes

These core business processes are mandated by the Operational Framework and designed to ensure consistent planning, reporting and review of business performance across all businesses:

IBP

(Integrated Business Planning)

Approved by the Board annually, creates a consistent approach to strategic planning, aligning resources with the delivery of forecast financial performance and strategic objectives.

LCM

(Lifecycle Management Policy)

How we plan and manage the execution of all projects above a certain minimum level, providing decision gate reviews at key stages from initial opportunity to final closure.

M&A

(Mergers & Acquisitions Policy)

A structured approach to mergers, acquisitions and disposals.

Board of directors



Sir Roger Carr
Chairman

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

Skills, competence and experience

Having joined the Board in 2013, Sir Roger was appointed Chairman in 2014. He is an experienced company chairman with a wealth of knowledge gained across a number of business sectors. With over two decades of boardroom experience, Sir Roger has a deep understanding of corporate governance and what is required to lead an effective board.

Sir Roger is a Senior Advisor to KKR and Chairman of the English National Ballet. In 2018, he was appointed as co-chair of the Industrial Infrastructure and Manufacturing Council, an advisory council to the Prime Minister.

He has previously held a number of senior appointments including Chairman of Centrica plc, Vice Chairman of the BBC Trust, Deputy Chairman and Senior Independent Director of the Court of the Bank of England, President of the Confederation of British Industry, Chairman of Cadbury plc, Chairman of Chubb plc, Chairman of Mitchells & Butlers plc, Chairman of Thames Water plc and Chief Executive of Williams plc. Throughout his career he has served on a number of external committees including the Prime Minister's Business Advisory Group, the Manufacturing Council of the CBI, The Higgs Committee on Corporate Governance and Business for New Europe. He is a Fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce, a Companion of the Institute of Management, and an Honorary Fellow of the Institute of Chartered Secretaries and Administrators. He is also a Visiting Fellow of Saïd Business School, University of Oxford and holds an Honorary Doctorate in Business from Nottingham Trent University.

He was knighted for Services to Business in the Queen's New Year's Honours list 2011.

Other non-executive appointments
None.

Committee membership
Chairman of the Nominations Committee.



Charles Woodburn
Chief Executive

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

Skills, competence and experience

Charles joined BAE Systems in May 2016 as Chief Operating Officer and became Chief Executive on 1 July 2017. Prior to joining the Company, he spent over 20 years in the oil and gas industry, holding a number of senior management positions in the Far East, Australia, Europe and the US. He joined the Company from the oilfield services business, Expro Group, where he served as Chief Executive Officer. Prior to that, he spent 15 years with Schlumberger Limited.

Non-executive appointments
None.



Peter Lynas
Group Finance Director

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

Skills, competence and experience

Peter, a qualified accountant, was appointed to the Board as Group Finance Director in 2011. His role has since been expanded to include responsibility for UK Shared Services, Procurement and Group Mergers & Acquisitions.

Peter previously served for a number of years as Director, Financial Control, Reporting & Treasury. He joined GEC-Marconi in 1985 having previously worked for other companies in the UK and Europe. After progressing through a number of positions, he was appointed Finance Director of GEC's Marconi Electronic Systems business, which was subsequently acquired by British Aerospace in 1999 to become BAE Systems.

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



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

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

Skills, competence and experience

Appointed to the Board on 1 February 2014 as President and Chief Executive Officer of BAE Systems, Inc., Jerry is an experienced US executive who has worked in the national security, technology and aerospace industry for over 30 years. Prior to joining the Company, 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.

Jerry has been actively involved with several associations and non-profit organisations, including the Aerospace Industries Association, where he is currently a member of its Executive Committee, the Association of the United States Army, the MILCOM Conference Board, and AFCEA International, where he served on the Board of Directors as an Executive Committee member and as chair of the Audit Committee.

Non-executive appointments
None.



Revathi Advaiti
Non-executive director

Appointed to the Board: 2018 **Nationality:** US

Skills, competence and experience

Revathi brings extensive operational experience and a deep understanding of digital technology and international markets to the Board, gained from her leadership of multinational engineering and manufacturing businesses. In February 2019, Revathi assumed the role of Chief Executive Officer and became a member of the board of directors at Flex Ltd, a global manufacturing company. Prior to this appointment, Revathi was president and chief operating officer for the Electrical Sector business at Eaton, a power management company. She joined Eaton in 1995 and led the Electrical Sector in the Americas and Asia-Pacific, with a three-year assignment in Shanghai. Between 2002 and 2008, Revathi worked at Honeywell, where she held leadership roles spanning manufacturing, procurement, supply chain and sourcing, including a role as general manager, Automation and Control Solutions. Revathi returned to Eaton in 2008 as vice president and general manager of the Electrical Components division.

Other non-executive appointments
None.

Committee membership
Corporate Responsibility Committee and Nominations Committee.

- Chairman
- Executive directors
- Non-executive directors



Elizabeth Corley CBE
Non-executive director

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

Skills, competence and experience

Elizabeth brings investor, governance and boardroom experience to the Board. She is currently a Senior Advisor at Allianz Global Investors. She has served as Chief Executive Officer of Allianz Global Investors, initially for Europe then globally, from 2005 to 2016. Prior to that, she worked for Merrill Lynch Investment Managers. Elizabeth is active in representing the investment industry and developing standards within it. She is a member of the CFA Future of Finance Advisory Council and the AQR Institute of Asset Management at the London Business School. Elizabeth is currently chair of the industry Taskforce for the UK government on social impact investing. In 2017, she stepped down from the board of the UK Financial Reporting Council after completing her second three-year term of appointment.

Elizabeth is also an acclaimed writer, a Fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce and a trustee of the British Museum.

Other non-executive appointments

Non-executive director of Pearson plc and Morgan Stanley.

Committee membership

Nominations Committee and Remuneration Committee.



Harriet Green OBE
Non-executive director

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

Skills, competence and experience

Harriet is a transformative business leader with international operational and boardroom experience. She is currently Chief Executive Officer and Chairman of Asia-Pacific at IBM. Harriet has extensive global business leadership experience. She previously served as Chief Executive Officer and executive director of Thomas Cook plc. Prior to that, she was Chief Executive Officer and executive director of Premier Farnell plc. Previously, she was also a non-executive director of Emerson Electric Co. In 2017, Harriet was named as one of the Fast Company's 100 Most Creative People in Business and in 2018 she was again placed by The Financial Times in the top ten of their 'HERoes ranking: Champions of Women in Business' list. In 2016, she won the Women in Technology Institute (WITI) Award and, in 2014, she received the Veuve Clicquot Business Woman Award. Harriet is a member of the Singapore Economic Development Board.

Other non-executive appointments

None.

Committee membership

Corporate Responsibility Committee and Nominations Committee.



Chris Grigg
Non-executive director

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

Skills, competence and experience

As chief executive of a FTSE 100 company, Chris brings management and boardroom experience to the Board. He is currently Chief Executive of The British Land Company PLC, a position he has held since 2009.

Chris has more than 30 years' experience in the banking and real estate industries. Prior to joining British Land, he was Chief Executive of Barclays Commercial Bank. Before that, he was a partner at Goldman Sachs. Chris is currently a member of the executive board of the European Public Real Estate Association and the board of the British Property Federation.

Other non-executive appointments

None.

Committee membership

Corporate Responsibility Committee and Nominations Committee.



Paula Rosput Reynolds
Non-executive director

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

Skills, competence and experience

An experienced company director in both the UK and North America, Paula is currently Chief Executive Officer and President of the business advisory group PreferWest LLC.

Starting her career as an economist, she spent over 20 years in the energy sector, culminating in her appointment as President and Chief Executive Officer of AGL Resources in 2002. She served as President and Chief Executive Officer of Safeco Corporation before becoming Vice Chairman and Chief Restructuring Officer of American International Group, overseeing its divestiture of assets and serving as chief liaison with the Federal Reserve Bank of New York. She received the National Association of Corporate Directors National Lifetime Achievement Award in 2014.

Past roles include non-executive directorships at Coca-Cola Enterprises Inc., Anadarko Petroleum Corporation, Delta Air Lines Inc., Air Products and Chemicals Inc., and Siluria Technologies, Inc.

Other non-executive appointments

Non-executive director of BP p.l.c., CBRE Group, Inc., General Electric Company and TransCanada Corporation.

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, competence and experience

Nick brings to the Board considerable financial expertise and boardroom experience. Nick was Chief Financial Officer of Diageo plc for over ten years until 2010. In this role, he was responsible for supply, procurement, strategy and IT on a global basis. His financial experience was developed during his time as group treasurer and group controller at Diageo, and also in his earlier career at Ford Finance. He is a former Chairman of the engineering technology company Edwards Group Limited and former non-executive director of Moët Hennessy SNC and Scottish Power plc. Nick is currently an adviser to CCMP Capital Advisors, LLC.

Other non-executive appointments

Chairman of Williams Grand Prix Holdings PLC; non-executive director and senior independent director of BT Group plc; and non-executive chairman of Loch Lomond Group.

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, competence and experience

Ian brings considerable financial and long-term international contracting experience to the Board. Having qualified as a chartered accountant, Ian subsequently held a number of senior finance and operational positions within industrial companies before being appointed Finance Director of Balfour Beatty plc in 1996. He was subsequently appointed as Chief Executive in 2005. He is currently Chairman of Bovis Homes Group PLC and Cairn Energy plc.

Ian is a former non-executive director of Mediclinic International plc, Cable & Wireless Communications plc and VT Group plc.

Other non-executive appointments

Chairman of Amey plc, a subsidiary of Ferrovial, S.A., and AWE Management Limited.

Committee membership

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

Board information

Membership

	Committee membership	Nationality	Tenure													
			2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Sir Roger Carr Chairman ¹	N															
Revathi Advaiti Non-executive director	C N															
Elizabeth Corley Non-executive director	N R															
Harriet Green Non-executive director	C N															
Chris Grigg Non-executive director	C N															
Paula Rosput Reynolds Non-executive director	A N R															
Nick Rose Non-executive director and Senior Independent Director	A N R															
Ian Tyler Non-executive director	A C N															

The average length of appointment of non-executive members of the Board (as at 31 December 2018) was 5.6 years.

Date of appointment to the Board of executive members

Charles Woodburn Chief Executive																
Peter Lynas Group Finance Director																
Jerry DeMuro President and Chief Executive Officer of BAE Systems, Inc.																

The average length of appointment of executive members of the Board (as at 31 December 2018) was 5.1 years.

Chairman	Committee chair	
Non-executive director	A Audit Committee	C Corporate Responsibility Committee
Executive director	N Nominations Committee	R Remuneration Committee

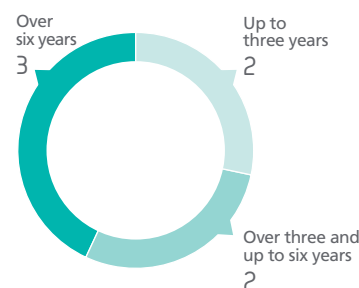
First term
Second term
Third term

Attendance

Individual directors' attendance at meetings of the Board and its committees in 2018

	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Revathi Advaiti	8/8	–	4/4	5/6	–
Sir Roger Carr	8/8	–	–	6/6	–
Elizabeth Corley	8/8	–	–	6/6	6/6
Jerry DeMuro	8/8	–	–	–	–
Harriet Green	6/8	–	2/4	5/6	–
Chris Grigg	8/8	–	4/4	6/6	–
Peter Lynas	8/8	–	–	–	–
Paula Rosput Reynolds	8/8	5/5	–	6/6	6/6
Nick Rose	8/8	5/5	–	6/6	6/6
Ian Tyler	8/8	5/5	4/4	6/6	–
Charles Woodburn	8/8	–	–	–	–

Tenure – independent non-executive directors



Diversity – Board

4 female
7 male

1. Sir Roger Carr joined the Board in October 2013 and was appointed as Chairman in February 2014.

Governance disclosures

UK Corporate Governance Code (the Code) compliance

The Company was compliant with the provisions of the Code throughout 2018 and the Board has applied its principles in its governance structure and operations. The following statements are made in compliance with the Code.

Risk management and internal control statement

The Board is responsible for the Company's risk management and internal control systems. It has delegated responsibility for reviewing in detail the effectiveness of these systems to the Audit Committee, which reports to the Board on its findings so that all directors can take a view on the matter.

An overview of the processes used to identify, evaluate and manage the principal risks can be found on pages 66 and 67. These processes are an integral part of our governance framework, the Operational Framework, details of which can be found on page 76. The Operational Framework mandates the Operational Assurance Statement process, which is owned by the Company's Internal Audit function and is one of the principal processes used by the Board in monitoring the effectiveness of the Company's internal control systems.

The risk management and internal control systems detailed in the Operational Framework were in place throughout the year and the Board, having reviewed their effectiveness, believes they accord with the Financial Reporting Council's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

Viability statement

As required by the provisions of the Code, the Board has undertaken an assessment of the future prospects of the Company, taking into account the Company's current position and principal risks. This assessment considered both the Company's long-term prospects and also its ability to continue in operation and meet its liabilities as they fall due over its five-year business planning period.

Analysis of business prospects

Whilst recognising the geopolitical environment in which the Company operates and with due regard to the principal risks set out on pages 68 to 71, the Board has also considered the long-term prospects of the Company based on our strategy, markets and business plan as outlined on pages 18 to 34 of this report. In its strategic review of the Company, the Board recognised the importance of certain factors that underpin its long-term prospects and viability. In summary, these are:

- a diverse portfolio of businesses based on well-established market positions, providing both complex, high technology products and programmes, and differentiated technical services and support. In 2018, 30% of group sales were product/programme related and 70% services and support;

- a geographically diverse business with a high proportion of sales to governments and other major prime defence contractors. In 2018, 28% of sales were to the US Department of Defense, 21% to the UK Ministry of Defence and 13% to the Kingdom of Saudi Arabia Ministry of Defence and Aviation. Major new business wins in the Middle East, Australia and Canada provide a strong foundation for further market diversity and growth;
- long-term visibility of sales and future sale prospects through a substantial order backlog (2018 £48.4bn) and incumbent positions on major defence programmes; and
- market positions underpinned by a highly skilled workforce, intellectual property assets and proprietary know-how, which are safeguarded and developed for the future by customer- and Company-funded investment. Such investment is focused on a well-developed understanding of future technologies and the threat environment shaping the long-term defence and aerospace market.

Assessment

The Board's assessment of the Company's prospects was informed by the following business processes:

Risk management process – the Company has developed a structured approach to the management of risk (see above) and emerging and principal risks identified are considered as part of the Board's annual review of the Integrated Business Plan.

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 Company and also for each of its businesses over the following five years. The use of a five-year period provides a robust planning tool against which long-term decisions can be made concerning, amongst other things, strategic priorities, funding requirements (including commitments to the Company's pension schemes), returns made to shareholders, capital expenditure and resource planning. Longer-term strategic inputs also form part of the IBP process and, where activity is required to meet such long-term priorities, this is provided for in the plan.

The detailed plan is reviewed each year by the Board as part of its strategy review process. Once approved by the Board, the IBP provides the basis for setting all detailed financial budgets and strategic actions across the businesses, and is subsequently used by the Board to monitor performance.

Governance disclosures continued

Liquidity analysis – the Board regularly reviews an analysis based on the financial output from the IBP, 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, including the following:

- the Company being unable to access debt markets to renew term debt facilities;
- an unfavourable change to the terms of trade the Company enjoys with certain principal customers;
- the Company failing to win certain major export contracts;
- potential change of UK government policy; and
- the loss of a major export market.

The scenarios tested included the impact of multiple adverse factors.

Conclusion

In undertaking its review of the IBP in 2018, the Board considered the prospects of the Company over the five-year period covered by the process. On the basis of this and other matters considered and reviewed by the Board, 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 following five years. 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 68 to 71).

Going concern statement

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.

Directors

All directors undertake a structured induction programme when they first join the Board, thereafter they regularly update and refresh their knowledge of the Company.

In compliance with the Code, all directors are subject to annual election by shareholders. The Chairman has confirmed that, based on the formal performance evaluations undertaken in 2018, all remain committed to the role and the individual performance of all directors continues to be effective. Also, in compliance with the Code, the Company ensures that 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.

Elizabeth Corley, a non-executive director of the Company, is a non-executive director of Morgan Stanley, a US listed company. One of its UK subsidiary companies provides corporate broking services to the Company and, consequently, an assessment has been undertaken to determine whether this relationship has a bearing on her independence for the purposes of provision B.1.1 of the Code. After review, it was determined that this was not a material business relationship given the relatively low value of the contractual arrangements and the nature of the relationship, i.e. broking services are provided by a UK subsidiary of Morgan Stanley and her appointment is to the board of the US parent company and non-executive in nature.

Should there be any change to either Elizabeth Corley’s role with Morgan Stanley or a material change in the services its UK subsidiary provides to the Company, this decision will be reconsidered.

In addition to being a non-executive director of the Company, Ian Tyler is chairman of two listed FTSE 250 companies, Bovis Homes Group and Cairn Energy, and also two non-listed companies, AWE Management, a private company owned by three joint venture partners, and Amey, a subsidiary of Ferrovial, S.A., a Spanish listed company. The Chairman has reviewed Ian Tyler’s other commitments and is satisfied that they do not impinge on his ability to discharge his responsibilities to BAE Systems effectively. He will keep this matter under review.

In addition to being a non-executive director of the Company, Paula Rosput Reynolds is currently a director of four other listed companies. However, it has been announced that she will shortly be standing down from the board of CBRE Group, Inc.

As detailed in the Nominations Committee report (see pages 90 and 91), the Board believes that, despite having served as a non-executive director for more than nine years with effect from 8 February 2019, Nick Rose remains independent for the purposes of the Code.

The Company considers that all of the non-executive directors identified on pages 78 and 79 of this report are independent in accordance with Code provisions.

Audit Committee report

Nick Rose

Chairman of the
Audit Committee



Members

Nick Rose (Chairman)

Paula Rosput Reynolds

Ian Tyler

Dear Shareholders,

I reported last year on progress on our audit re-tender and on our audit transition plans. I am pleased to report that our audit re-tender process, for which preparatory work had commenced in 2016, concluded at the Annual General Meeting on 10 May 2018 when shareholders approved the appointment of Deloitte LLP as the Company's auditor, succeeding KPMG LLP in that role.

Whilst the audit re-tender process and subsequent transition spanned quite a lengthy period, we were keen to ensure that the incoming auditor had a good understanding of our business that would enable it to identify areas of audit risk efficiently, formulate a risk-focused approach to audit scope, and to embark on the 2018 audit as well-prepared as possible. That there has been a smooth transition has been testament to the ground work laid in execution of the transition plan which included Deloitte shadowing the 2017 year-end audit conducted by the outgoing auditor, KPMG. We are also pleased that Deloitte have commented favourably on the constructive engagement with management, both centrally and across the Group, during the transition period.

The section on the Audit Committee's year on page 86 provides an overview of the work that we have undertaken in the last 12 months and I will comment here on several aspects of that activity.

In June we agreed the scope and level of materiality of the 2018 audit plan of work and discussed with Deloitte the areas that they had identified as key risks and other particular areas of focus, and the specific audit procedures that they would perform to undertake the related audit work. Whilst audit continuity is important, as a Committee we equally recognise the benefits that fresh perspective, challenge and insight can bring.

At the beginning of the year the Group adopted accounting standard IFRS 15 Revenue from Contracts with Customers, in the financial statements. A significant amount of work had been undertaken throughout the Group to enable the new standard to be implemented and further information on IFRS 15 is provided in note 37 to the Group accounts on pages 205 to 209.

We also reviewed the implementation and disclosures relating to the adoption of IFRS 9 Financial Instruments by the Group on 1 January 2018 which did not result in any adjustments in previous periods. Further information is set out in note 37 to the Group accounts on pages 205 to 209.

A further accounting change coming into force in 2019 is the adoption of IFRS 16 Leases. We reviewed the implementation plan and disclosures relating to IFRS 16 which will be adopted by the Group with effect from 1 January 2019. The expected impact of IFRS 16 is set out in note 38 to the Group accounts on pages 210 and 211.

Using our Internal Audit function to optimal effect within the overall context of the risk environment remains a key priority for us. I reported last year that an external assessment of the function originally scheduled to be undertaken in 2017 had been deferred until 2018 following organisational changes taking effect from 1 January 2018. That assessment has since been completed and is reported on below.

Audit Quality Review (AQR)

The Financial Reporting Council's AQR team monitors the quality of audit work of certain UK audit firms through inspections of a sample of audits and related procedures at individual audit firms. Deloitte have taken us through their latest AQR report (of which the period under review preceded their appointment as the Company's auditor) and outlined actions being taken to address the issues raised.

Audit independence

We reviewed in detail the confirmation and information received from KPMG on the arrangements that they had in place to safeguard auditor independence and objectivity, including specific safeguards in place where they were providing permissible non-audit services to the Group.

As part of the auditor transition arrangements, and subsequent to their appointment, we have reviewed on a regular basis similar confirmations and information from Deloitte to ensure their independence.

Non-audit services policy

The Committee has a formal policy governing the engagement of the auditor to provide non-audit services which we review on an annual basis. The policy prohibits certain activities from being undertaken by the auditor and also places restrictions on the employment of former employees of the auditor.

We recognise that the auditor is best placed to undertake certain work of a non-audit nature, and thus 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.

Following the selection of Deloitte as the Company's proposed auditor in 2017, the Committee reviewed the non-audit services being provided by Deloitte at that time and the steps being taken by Deloitte to ensure audit independence by 1 October 2017 when shadowing began. Certain services, even though they fell within the Permitted Non-Audit Services category, were wound up or discontinued. A number of non-audit services being provided by Deloitte which were expected to continue beyond 1 January 2018 were carefully considered and individually approved by the Committee. Particular consideration was given to consultancy work undertaken in relation to the Group's Submarines business which had been disclosed in the pre-audit qualification exercise. Actions were taken to ensure that independence was successfully managed throughout the regulatory 'cooling in' period which commenced on 1 January 2017, as well as from 1 October 2017 onwards when shadowing began. The Committee is satisfied that independence was maintained throughout this period.

Details of fees payable to the auditor are set out on page 154. In 2018, non-audit fees for Deloitte represented 30% of the audit fee. The principal non-audit services provided by Deloitte related to its review of the half-yearly financial report and completion in 2018 of consultancy work that was already under way prior to Deloitte's appointment as our auditor.

Audit Committee report

continued

Financial statements

The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2018 financial statements, in addition to the going concern and viability statement reviews referred to opposite, were:

Recognition of revenue, profit and provisioning

From 1 January 2018 the Group adopted IFRS 15 Revenue from Contracts with Customers.

The Committee reviewed the Group's implementation and processes for the adoption of IFRS 15. In addition, the Committee reviewed key estimates and judgements applied in determining the financial status of the more significant programmes including UK aircraft carrier programme, Astute, OPVs, Radford, Saudi British Defence Co-operation Programme and Saudi Typhoon.

Pensions

Accounting for pensions and other post-retirement benefits involves making estimates when measuring the Group's retirement benefit obligations. These estimates require assumptions to be made about uncertain events such as discount rates and longevity.

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 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 (see note 22 to the Group accounts on pages 178 to 188).

The Committee also reviewed the disclosures set out in note 37 to the Group accounts on pages 205 and 206 in relation to the correction of a prior year error in the value of pension scheme assets regarding the treatment of experience collateral in the accounting valuation of a longevity swap.

Goodwill

Impairment testing of goodwill on the balance sheet is underpinned by the value of the future prospects of the related business which have to be estimated.

We considered the level of goodwill held on the Group's balance sheet and whether, given the future prospects of the acquired 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 161. No goodwill impairments were identified as a result of this review.

Taxation

Computation of the Group's tax expense and liability, the provisioning for potential tax liabilities and the level of deferred tax asset recognition are underpinned by management judgement and estimation of the amounts that could be payable.

Whilst tax policy is ultimately a matter for the Board's determination, we reviewed the Group's tax strategy as set out on page 41. Twice during the year, we reviewed the Group's tax charge, tax provisions and the basis of recoverability of the deferred tax asset relating to the Group's pension deficit.

Going concern and viability statements

The Committee also agreed the parameters of, and reviewed the supporting report for, the going concern statement (see page 82) and the statement on the Board's assessment of the prospects of the Company (the viability statement on page 81) over the five-year period used in the Integrated Business Plan. The Committee considered the period covered by the viability statement and continues to be of the view that a five-year period remains the most appropriate timespan in this regard.

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 the effectiveness 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, controls reports, and reports from both internal and external auditors.

A key focus for the Committee is the controls environment surrounding the Company's Lifecycle Management (LCM) process, the bedrock of our programme execution and management. 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 which, you will see from above, tend to be areas where we are required to exercise judgement. We have discussed the outputs of financial, IT 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.

We have reviewed the ongoing effectiveness of the Company's risk management processes as part of our wider review of internal controls. The Group's principal risks are set out on pages 68 to 71.

For a number of years it has been part of the Committee's remit to oversee the effectiveness of the whistle-blowing facility with particular reference to matters of financial concern. Under the new UK Corporate Governance Code effective from 1 January 2019, responsibility for oversight of an anonymous whistle-blowing facility rests with the Board, and we have therefore taken the opportunity, with the agreement of the Board, to re-align the Committee's Terms of Reference to reflect the new Code provision.

How we ensure that the Group's financial statements, taken as a whole, are fair, balanced and understandable and provide information necessary for shareholders to assess the Company's position and performance, business model and strategy

The process is:

- 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 Executive Committee.

Internal audit

Internal Audit plays an integral role in the Company's governance structure and provides regular reports to the Committee. These include an overview of the work undertaken in the period under review, individual reports on audits conducted and progress against the agreed internal audit plan, as well as the outputs of the twice-yearly OAS process and the tracking of remedial action in the case of any control failures. Specific attention has been paid during the year to the organisational changes effective from 1 January 2018.

The annual Internal Audit programme is agreed jointly by the Audit and Corporate Responsibility committees to ensure that the overarching programme covers not only financial risk, but also the assessment of the effectiveness of key areas of ethical and reputational risk. The assurance programme comprises a broad range of audits covering areas such as mandated governance, OAS outputs, risk register findings, change programmes, structural and business changes, and areas relating to responsible behaviour and non-financial risk. Internal Audit may also from time-to-time undertake other work within the context of the risk environment.

During the year under review, and separate from the normal regular sessions we hold with the Internal Audit Director without management present, we held a separate session with him, his heads of internal audit and the external auditor, after we had had the benefit of Deloitte's output on their controls testing. At this session we continued our discussions around (i) the mandated control environment, e.g. finance and export compliance controls; and (ii) other risk-based assurance priorities, e.g. general IT, quality, project management and engineering controls.

An External Quality Assessment (EQA) of the Internal Audit function was undertaken in 2018 by Ernst & Young LLP (EY). The objective of the EQA was to independently assess the quality and effectiveness of Internal Audit, in line with the International Standards for the Professional Practice of Internal Auditing.

During the assessment, EY interviewed a sample of Internal Audit's stakeholders across the business and reviewed working papers and outputs related to a sample of internal audits that had been conducted in 2017. Based on their work, EY concluded that within BAE Systems the Internal Audit function is respected and trusted, is clear on its role and remit in the organisation, has access to the majority of skills and capabilities that it needs to deliver its current programme of audits, and has many strong operational processes in place which enable it to deliver on its mandate.

Recommendations were made by EY to supplement the continuous improvement activities already under way, which will be addressed by the function through a number of workstreams over the next two years. The areas of improvement include the use of technology and tools specifically in connection with data analytics, embedding cultural assessments into audit activities, and working with the business to improve integrated assurance across the three lines of defence (see below).

We have had the opportunity to hear direct from the VP, Internal Audit, on internal audit work undertaken within the US businesses as well as from the Head of Audit – Risk, in respect of optimising impactful internal audit reporting and risk-based approaches to developing and executing the annual internal audit plan.

Nick Rose
Chairman of the Audit Committee

How the effectiveness of the external audit process and audit transition was assessed

Who we surveyed:

- Executive directors
- Operating group/sector and line of business management
- Internal Audit Director
- Other senior executives, including key finance roles

Areas we covered:

- Transition process
- Understanding of the Group's risks
- Audit plan
- Robustness of audit processes
- Objectivity
- Quality of communications
- Ability to provide a seamless service across differing jurisdictions

as well as interaction with the Committee members.

The output of the review was positive with a strong transition and the incoming auditor demonstrating a good understanding of key business risks, and providing robust and constructive challenge. It was recognised that a key requirement going forward would be to retain continuity of the audit team in order to develop the knowledge base and level of experience.

On the basis of the review following the 2018 year-end audit, the Committee has proposed to the Board that it recommend that shareholders support the re-appointment of Deloitte LLP at the 2019 AGM.

Three lines of defence model

Endorsed by the Chartered Institute of Internal Auditors, the three lines of defence model comprises:

First line of defence

Operational management has ownership, responsibility and accountability for assessing, controlling and mitigating risks.

Second line of defence

Activities covered by certain components of internal governance (e.g. compliance, quality, project management, engineering etc).

Third line of defence

Internal audit function and other independent assurance.

Competition and Markets Authority Audit Order

The Committee has complied with the provisions of the Competition and Markets Authority Audit Order in respect of committee responsibilities and audit re-tendering disclosures.

Audit Committee report continued

The Audit Committee's year

February

Committee

London, UK

- Considered the accounting, financial control and audit issues reported by the auditor that flowed from the audit work.
- Reviewed the financial statements and specific disclosures, including viability and going concern, for recommendation to the Board.
- Reviewed the effectiveness of the external audit process.
- Received a report from the Group Taxation Director.
- Considered output from the six-monthly OAS review.
- Reviewed the procedures and outputs for the identification, assessment and reporting of risk.
- Reviewed the effectiveness of the Company's helpline procedures in respect of the reporting of accounting or financial improprieties.
- Regular quarterly items¹.

Joint session with the Corporate Responsibility Committee:

- Agreed final iteration of the annual Internal Audit programme.

May

Committee

Farnborough, UK

- Agreed the AGM Trading Statement.
- Received a report on the Group's insurance arrangements.
- Agreed the audit engagement letter².

June

Committee

Baltimore, US

- Agreed audit strategy and scope.
- Reviewed external auditor independence issues.
- Agreed audit fee.
- Considered output of the Internal Audit Director's report.
- Received a presentation from VP, Audit for the US businesses.
- Regular quarterly items¹.

July

Committee

London, UK

- Considered the accounting, financial control and audit issues reported by the auditor that flowed from the half-year review work.
- Reviewed the financial statements and specific disclosures, including going concern, for recommendation to the Board.
- Received a report from the Group Taxation Director.
- Considered output from the six-monthly OAS review.
- Reviewed the procedures and outputs for the identification, assessment and reporting of risk.
- Considered output from the external quality assessment of the Internal Audit function.
- Regular quarterly items¹.

December

Committee

London, UK

- Considered the external auditor's controls report.
- Considered output of the Internal Audit Director's report.
- Received a presentation from Head of Audit – Risk.
- Reviewed Internal Audit Charter.
- Received a report on export control compliance.
- Reviewed the Non-Audit Services Policy.
- Discussed the first iteration of the annual Internal Audit programme.
- Set the parameters for work supporting the viability and going concern statements.
- Received briefing on IFRS 16 Leases.
- Review of the Committee's Terms of Reference.
- Regular quarterly items¹.

Meeting

London, UK

- Informal meeting with the Internal Audit Director and external auditor to discuss the balance between mandated audits and other risk-based assurance processes.

Committee composition and evaluation

The breadth of experience of the Audit Committee members is set out on page 79. The performance evaluation of the Committee is undertaken as part of the wider Board evaluation and the Board believes the Committee to have the appropriate composition, skills and experience to discharge its responsibilities.

1. The Committee reviews the nature and level of non-audit services (including independence safeguards from the incumbent auditor where it provides such services), and holds a separate session with the Internal Audit Director and external auditor without management present. The Audit Committee Chairman also meets separately with internal and external audit on an ad hoc basis.
2. Subject to Deloitte LLP being appointed as auditor at the 2018 AGM.

Audit Committee timeline

February

Committee

May

Committee

June

Committee

July

Committee

December

Committee

Meeting

Corporate Responsibility Committee report

Ian Tyler

Chairman of the Corporate
Responsibility Committee



Members

Ian Tyler (Chairman)

Revathi Advaiti

Harriet Green

Chris Grigg

Dear Shareholders,

I am pleased to provide you with an update on the activities undertaken by the Corporate Responsibility Committee during the year. The Committee continues to develop its agenda to address the key developments in corporate responsibility and responsible business conduct. The scope of the work has necessarily broadened over recent years and our agenda focuses on both our core areas of safety, ethics and responsible business conduct and now more fully covers the broader definition of corporate responsibility, and as such includes diversity and inclusion, stakeholder and employee engagement and supplier conduct as regular agenda items.

Safety

As I have done in previous reports, I begin with a discussion of our health and safety agenda, which remains a priority. The year saw an improvement in the overall number of recordable injuries, which was welcomed by the Committee. However, this was offset by some significant major events. In June last year, Committee members were alerted to a serious incident at the US Army munitions plant in Radford, Virginia, a facility operated by our US business. An accident in the plant's nitrocellulose drying facility resulted in the tragic death of a Company employee, Andrew Goad, and injuries to two other employees. Shortly afterwards, the Committee met with local management and the leaders of our US business to understand more about the incident and the actions being taken by the Company. We have continued to receive reports on the incident, and with all the investigations having been completed recently, the Committee will now be looking more broadly at whether there are lessons to be learnt and shared, both at Radford and more widely across the Group.

In light of our ongoing focus on safety, the Committee has continued to undertake a deep dive into the safety metrics and practices at each of our businesses on a rotation throughout the year. This allows for a comprehensive review of each area and for the Committee to develop an understanding of how the local management teams are taking measures to improve safety performance and for us to assess the strength of the safety culture across the business. While good progress has been made on all aspects, the serious nature of the Radford incident has been reflected in the assessment of safety performance both for the business concerned but also for senior management in the US and at Group level.

Diversity and inclusion

The way in which the Committee has overseen the Company's diversity and inclusion agenda was further developed during 2018. In 2017, I reported to you that we had carried out a deep dive into different areas of the business, meeting with line leaders to understand the particular challenges and successes they had experienced. At our meeting in February we carried out the last of these detailed reviews, focusing on Applied Intelligence.

In 2018, the focus of the Committee was on gaining an understanding of the aspirations and direction of the Company as a whole and the way in which progress could be measured and targeted. The Committee asked the Chief Executive and his management team to provide a clear view and detailed analysis of the direction and activity to be undertaken to ensure an inclusive, engaged and diverse workforce to drive success.

In September, the Committee received a report on diversity and inclusion from Karin Hoeing, Group Human Resources Director, setting out the outcome of an internal review of data, key trends, benchmarking, successes and challenges. This was a thorough assessment of the Company's current position and we will use this to inform how we measure progress as we continue on our diversity and inclusion journey. Accordingly a specific objective on diversity and inclusion has been set as part of the executive annual incentive plan in 2019.

Responsible business conduct

The Company's responsible business policies, set out in the Operational Framework, are the fundamental controls that govern how we do business. Adherence to these policies is mandated across the Group and the Committee regularly reviews the robustness of the control environment in this area. We recognise that implementation of these policies in some markets can be more challenging than in others due to differences in regulatory regimes and different commercial arrangements. The Committee is therefore interested in understanding how we practically do business in different markets, how responsible trading risks are managed and the decision-making process behind our presence in certain markets. The Committee looks for robust adherence to the policies and also how any additional controls and compliance measures may be used to reduce both operational and reputational risk.

For example, the Company has put in place an enhanced compliance governance framework to support the delivery of the Typhoon contract in Qatar.

Corporate Responsibility Committee report

continued

Our annual schedule includes a detailed review of the Adviser Policy and the adviser appointments. This policy and the accompanying procedures are designed to ensure that any risks posed by working with advisers are managed so that the Company abides by its ethical principles and complies with anti-bribery and corruption laws and regulations that govern the Company's activities around the world. The Committee receives reports on the advisers appointed by the Company, the work that they do and the commercial arrangements governing their appointments.

Consideration of responsible business conduct formed part of the agenda during our site visit to India in August 2018. The Committee also reviewed other markets at its meetings during the year.

Responsible procurement

We have seen a significant change in the Procurement function over the last two years with new leadership taking the helm. A key milestone was reached in early 2017 when the global Supplier Principles were launched. These principles have now been in place for two years and at our review in December with the Chief Procurement Officer, the Committee considered the actions that have been taken to embed these principles in the culture of our own Company and, importantly, in our supply chain. It was pleasing to see that the focus in 2018 has been on strengthening internal education and that we have actively assessed how well our suppliers understand and are embracing our principles. We will review the position again in 2019 as part of our ongoing focus on reducing the threat of unethical behaviour in our supply chain and the associated reputational risk.

Workforce engagement

The 2018 UK Corporate Governance Code has given additional focus to the way in which boards consider the impact of the decisions they make with regard to the various stakeholders. During the second half of the year, the Board considered how it would discharge the requirement to seek to understand the views of the workforce, noting the suggested mechanisms in the revised Code. After consideration of the options, the Board agreed that the Corporate Responsibility Committee would be appointed to fulfil this requirement. The Committee already provides a conduit for employee engagement through trade union interaction, site visits and the review of employee survey and ethics helpline calls. Initial discussions were held on how to extend this engagement, noting that this is an emerging area of governance and we expect to review this approach at the end of 2019. We will report to you in the 2019 Annual Report in more detail.

In December, the Committee reviewed the initial results of a short and confidential survey that was open to all employees. The survey asked for employees' views on characteristics and behaviours that will be key to the future success of the Company. We discussed with the Group Human Resources Director how the results of the survey would be analysed and used by the senior management team to understand the current strengths, and also the areas we need to focus on as we evolve the organisational culture of the Company.

Next year

Our agenda for next year, as in previous years, will be structured around our key areas of focus: safety, ethics, diversity and inclusion, and responsible business conduct. In addition, we will look more closely at workforce engagement in the first year of implementation of the new UK Corporate Governance Code. We will also continue to develop our understanding of the sustainability agenda for the Company as wider market practice around targets and reporting continues to develop.

Ian Tyler

Chairman of the Corporate Responsibility Committee

Focus on governance

Delhi, India

In August, the Committee visited our office in Delhi to gain a deeper understanding of the following areas:

- responsible trading and particularly corruption risks, either directly or through our partners;
- workplace safety and employee welfare; and
- diversity and inclusion.

The Committee spent time with the BAE Systems employees based in Delhi and discussed how the team is delivering on our corporate responsibility agenda. We looked at how the Company engages with local procurement processes, considering the governance in place to ensure that we meet the customer's and our own compliance requirements. The Committee visited the new M777 ultra-lightweight howitzer manufacturing facility that has been built and will be operated by Mahindra Defence Systems. This was a good opportunity for the members of the Committee to understand the safety culture of the team and how best practice will be brought into the new manufacturing line.

The visit emphasised the risk in operating in export markets and the need for the Company to continue to be vigilant in ensuring that we robustly apply our responsible trading policies. The Committee will continue to monitor how we operate in overseas markets, such as India, to ensure that we have the governance oversight and controls in place to allow us to meet high standards of ethical conduct.

Barrow, UK

During the year the Chair of the Corporate Responsibility Committee visited the shipyard at Barrow, accompanied by the Managing Director, Operational Governance. The aim of the visit was to meet with members of the team to understand the processes in place for adherence to the Company's nuclear licensing requirements. As part of the visit the Chair met with the senior management team responsible and reviewed the robustness of these processes. During the visit he met with employees from the different functions and talked with them about their roles and experience of working at the Company, with an aim to understand more about the culture of the Company at different sites.

The Corporate Responsibility Committee's year

February

Committee

London, UK

- A review of the Product Trading principles of the Company. This included a consideration of how the Company does business in markets which may experience political and/or economic instability and the ways in which any risks are either mitigated or managed.
- As part of a review across the business of the strategy for diversity and inclusion, a presentation was made by the Applied Intelligence business on the progress made to date to attract and retain a diverse workforce and advance an inclusive workplace.
- Review of performance against the 2017 safety performance objectives. A recommendation on the performance rating was made to the Remuneration Committee.

June

Committee

Baltimore, US

- A review of the anti-bribery and anti-corruption policies, including a consideration of the application of the adviser policy to joint venture partners. This covered the proposed arrangements for the sale of Typhoon to Qatar.
- A report was made to the Committee on an incident that had occurred at the US Army munitions plant in Radford, US, which had resulted in the death of one employee and injuries to two others. The Committee reviewed the immediate actions that had been taken at that point, including how the Company was supporting both the families of those affected and our employees.
- The annual review of the safety performance of BAE Systems, Inc., considering the recordable injury rate statistics, the work undertaken to improve safety, behavioural change and the ways in which risk could be reduced through engineering initiatives.

September

Committee

San Diego, US

- A further detailed update was received on the incident at the US Army munitions plant in Radford, US.
- Received a report on diversity and inclusion from the Group Human Resources Director.
- Review of the current environmental position of the Company and outline plans for a programme of work to consider whether changes are made to the way in which the Company monitors its impact on the environment.

December

Committee

London, UK

- Consideration of the Company's approach to responsible procurement. An update was received from the Chief Procurement Officer on the way in which the Global Procurement Policy and the Supplier Principles are being embedded.
- Undertook the annual review of the Gifts and Hospitality, Facilitation Payments and Advisers policies. Received a report on the number and type of advisers currently appointed.
- Agreed the approach to be taken with regard to workforce engagement in 2019 as part of the new UK Corporate Governance Code.
- Received a top level summary of the results of the enterprise-wide employee opinion survey.
- Consideration of the structure and focus of the corporate responsibility objectives for 2019.
- Review of the corporate responsibility audit review programme for 2019.

Schedule for 2019

Committee

February

- Review of performance metrics for 2018.
- Trading policy review.
- Review and approval of Modern Slavery statement.
- Workplace engagement update.

June

- Workplace safety deep dive.
- Workplace engagement update.
- Diversity and inclusion update.

September

- Workplace safety deep dive.
- Sustainability and environment review.

December

- Consideration of forward-looking objectives.
- Responsible procurement update.
- Workplace safety deep dive.
- Anti-bribery and anti-corruption policy review.

Corporate Responsibility Committee timeline

February

Committee

June

Committee

August

Site visit
India

September

Committee

December

Committee

Nominations Committee report

Sir Roger Carr
Chairman of the
Nominations Committee



Members

Sir Roger Carr (Chairman)

Revathi Advaiti

Elizabeth Corley

Harriet Green

Chris Grigg

Paula Rosput Reynolds

Nick Rose

Ian Tyler

Dear Shareholders,

The Nominations Committee was active throughout 2018 dealing with both executive and non-executive succession planning.

With Charles Woodburn now well established as Chief Executive, the Committee has been working with him in researching the strength and depth of the executive pipeline below the Board and what we are doing to develop this further. With regard to non-executive director membership, last year we welcomed Revathi Advaiti who, with her global industrial sector business experience, has been a valuable addition to the Board. The need to refresh the Board but at the same time maintain a knowledgeable and experienced team of non-executive directors is essential, and this is something that the Committee has continued to address in our succession management discussions. Further details of this and the other principal responsibilities of the Committee are detailed below.

Executive succession

With effect from the beginning of 2018, our Chief Executive implemented his plans for a new organisational structure for the Company. This was an important matter for the Board, and in the months prior to it the Committee engaged with Charles in understanding his plans, ambitions and resource requirements. We were particularly interested in how he intended to use this opportunity to refresh the management team and create opportunities for high-potential individuals within the executive pipeline. One of the Board's principal objectives agreed with the Chief Executive is to ensure that the Company is making best use of the many highly talented individuals we employ and that we use such individuals to create a culture that supports a diverse and inclusive working environment. This is vital to the long-term health of the Company and is fundamental to the effective management of executive succession at all levels, and blends seasoned experience with fresh thinking.

During the year, the Committee spent time with the Chief Executive and our Group Human Resources Director hearing about the work they have under way to ensure that we have effective executive succession planning processes in place. This included the presentation of data analysing all executive grade positions across the Group and the succession candidates for these roles. This analysis has been one of the key inputs to the work currently under way to actively manage our succession planning performance across all executive grades. The oversight of this work will remain a priority for the Committee in 2019.

Board composition

One of the Company's strategic objectives is to develop a diverse workforce to drive success at all levels. Against this background, I am pleased to report that we have continued to make progress in refreshing and strengthening the Board, and in doing so we have become increasingly more diverse in terms of gender, ethnicity and nationality. Our policy on Board gender diversity is aligned to the target set by the Hampton-Alexander Review, i.e. 33% representation of women on FTSE 350 boards by the end of 2020. We are performing well against this target, with women representing 36% of Board membership at present.

In terms of other aspects of board diversity, our policy is to continue, over time, to create a Board that not only brings together individuals with the right skills, knowledge and experience, but one that also has a diversity that reflects the multi-national nature of the business world in general. We will continue to engage with search consultants to identify candidates in a manner that is consistent with achieving these objectives.

Non-executive succession

The need to refresh the Board is central to the remit of the Nominations Committee. On page 80, you will see the analysis of the length of time that individual non-executive directors have served. This shows that we have a reasonable spread of terms, ranging from Revathi Advaiti, who joined the Board just over a year ago, to Nick Rose who has just completed his ninth year on the Board.

In 2018, the Committee recognised the need to recruit up to two new non-executive directors, including a suitable candidate to join the Board and succeed Nick Rose as Chair of the Audit Committee. However, recognising that we have a new auditor this year and the level of geopolitical uncertainty facing the Company at present, the Board considered it was in the Company's and shareholders' best interests that we extend Nick Rose's tenure as Senior Independent Director and Chair of the Audit Committee beyond the nine-year period to 31 December 2019.

I recognise that the provisions of the UK Corporate Governance Code state that a term of office in excess of nine years is one of the factors that is likely to impair, or could appear to impair, a non-executive director's independence. However, if a board believes that such an individual remains independent, the Code requires it to clearly explain why it takes that view. Having worked with him for some years, his fellow Board members and I certainly take the view that Nick Rose remains independent. He has been an excellent non-executive member of the Board, and our annual board evaluations evidence the quality of his contribution and the effective manner in which he

discharges his responsibilities in chairing the Audit Committee and acting as our Senior Independent Director. I have also engaged with a number of our principal shareholders on this matter and they were very helpful in giving me the opportunity to explain the above, and were supportive of the decision.

The recruitment consultants, Spencer Stuart, and other sources were used to identify possible candidates for the non-executive director succession requirements identified by the Committee in 2018. As reported in my opening letter, this has resulted in the recent appointments of Nicole Piasecki and Stephen Pearce as non-executive directors, effective from 1 June 2019. Stephen will succeed Nick Rose as Chairman of the Audit Committee with effect from the beginning of next year.

I am pleased to report that Elizabeth Corley, who joined us three years ago, has agreed to serve for a further three years. I am also appreciative that Ian Tyler and Chris Grigg have each agreed to serve for an additional three-year period when their current six-year terms come to an end later this year.

As evidenced by our annual performance evaluation, all three continue to be highly engaged and valuable non-executive members of the Board and its committees.

Harriet Green will step down from the Board in November this year having been a valuable contributor for nine years. Her engagement, knowledge and experience will be much missed.

Finally, the Board's most recent annual performance evaluation is detailed opposite. With regard to the Nominations Committee and its remit and duties, the evaluation specifically asked directors about the effectiveness of succession planning, in terms of both executive and non-executive directors, and also senior management. Overall, it was believed that good progress had been made on this issue in 2018 but it was agreed that the Board would continue to work with the Chief Executive in ensuring that our executive succession planning processes fully support our strategic objectives and make best use of the talented people we employ.

Sir Roger Carr

Chairman of the Nominations Committee

Board evaluation

Period of evaluation

December/January with feedback and review taking place at a Board meeting held on 20 February 2019.

Evaluation process

Internally evaluated using a questionnaire developed by the Company using best practice guidance, including the FRC's Guidance on Board Effectiveness. Questions covered the performance of the Board, its committees and individual directors. In addition, feedback was requested on the Board's performance against the objectives agreed following the previous year's evaluation, and directors were also asked to identify their priorities for the Board in 2019.

Facilitator

The Company Secretary, with guidance from the Chairman.

Feedback

The Company Secretary produced a report for the Board analysing the responses to the questionnaire, including any additional comments made by directors. Also, where the same questions had been used for previous surveys, the trend in performance relative to past years was provided. The report formed the basis of a discussion at a Board meeting, following which it agreed a number of objectives for 2019. Reports were also produced analysing the responses to questions concerning the performance of the Board's committees, which have been provided to committee chairs and will be considered by the individual committees.

Feedback from the survey concerning individual directors has been provided to the Chairman and he will use this as part of an annual review process with each board member. Feedback on the Chairman's performance has been provided directly to the Senior Independent Director who, following discussion with his fellow non-executive directors, will discuss this with him.

Resulting actions

The Board has agreed the following actions in response to the evaluation:

- facilitate the use by executives of the competences, knowledge and skills offered by individual non-executive directors;
- further develop the Board's strategy review process;
- provide further opportunities for Board members to engage directly with stakeholders;
- complete non-executive director succession planning actions;
- drive best practice executive succession planning across the Company; and
- provide further opportunities for directors to undertake deep-dive reviews into major programmes.

Nominations Committee timeline

March

Committee

May

Committee

July

Committee

September

Committee

November

Committee

December

Committee

Remuneration Committee report

Paula Rosput Reynolds
Chairman of the
Remuneration Committee



Members

Paula Rosput Reynolds
(Chairman)

Elizabeth Corley

Nick Rose

Dear Shareholders,

2018 was a year of intense activity on the part of the Remuneration Committee. Although we do not plan to renew our Policy until the spring of 2020, the volume of initiatives and regulations being introduced has stimulated much discussion as to how best to engender a healthy environment of incentives while addressing broader societal concerns. More immediately though, the Committee has been deeply engaged with the Chief Executive on implementing a robust performance management approach and using our reward structure to create stronger alignment with the execution of our strategy.

As you will be aware, the Group operates within a challenging and rapidly changing political, economic, defence and security environment around the world. You will read, within the contents of this report, how the Committee has supported ambitious operating goals and sustained financial performance. In other words, whilst the environment is difficult, it is our expectation that management will not relent in its efforts to deliver underlying business performance. Our Chief Executive is making changes in the organisation and redefining expectations. Whilst change does not happen overnight, the Committee is using its tools to reinforce these efforts.

In addition to our focus on the internal workings of BAE Systems, the Committee has followed closely the emergence of the new UK Corporate Governance Code (the Code) requirements. Prior to the issuance of the requirements, we had already begun an analysis of wider workforce remuneration, pension provision, and constructive ways to engage with our employees around the world. Broadly, the Board believes that employee engagement is part of a modern business culture and hence it is not merely a remuneration exercise.

Where feasible, we are adopting in our 2018 Annual Report many aspects of the Code requirements ahead of the mandated schedule, including:

- a new section setting out more information in relation to our wider workforce;
- building on our previous Chief Executive pay ratio disclosure which has been well received by stakeholders, and reflecting publication of the regulations, we are additionally disclosing the Chief Executive pay ratio on the new required basis;
- describing how the Committee has addressed the factors of clarity, simplicity, risk, predictability, proportionality and alignment to culture; and
- recognition of the Committee's expanded remit with its Term of Reference having been updated accordingly.

Acknowledging the relevant provisions of the new Code as well as broader expectations of investors, the Committee intends to make necessary changes to our existing Policy on minimum shareholding requirements to ensure an appropriate post-cessation holding policy is in place. This policy will be finalised and implemented as part of our broader executive remuneration policy proposals to be submitted for approval at the Company's Annual General Meeting (AGM) in May 2020. The Committee additionally recognises the requirements and expectations in relation to executive director pension provision and will review this as part of our remuneration policy to be approved at the 2020 AGM.

With respect to our customary remuneration activities, all changes we are making for 2019 are within the current approved Policy; you will see them summarised immediately below and detailed more fully within the contents of this report.

Summary of key decisions for 2018

- Salary of the Chief Executive is increased by 2.5% from 1 January 2019.
- Salary of the Group Finance Director is increased by 2.5% from 1 January 2019.
- Salary of the President and Chief Executive Officer of BAE Systems, Inc. is increased by 2.5% from 1 January 2019.
- Approval of remuneration packages for newly appointed Executive Committee members.
- Long-term incentive awards of Performance Shares granted in spring 2018, subject to the same performance conditions as applied in 2017, and Restricted Shares to US executive director only.
- For 2019, in respect of the annual short-term bonus programme metrics, revised weighting of the financial measures agreed (which account for 75% of the annual incentive opportunity), and the remainder continuing to be subject to personal objectives and safety measures.

Context to the Committee's decisions

The Committee remains responsible for the full spectrum of senior executive employment matters: recruiting, promoting and retaining the best top-level leaders, setting the incentives under which these leaders operate, and monitoring the results they produce and the manner in which they produce them. Our overall remuneration framework has a number of specific goals. It is designed to motivate our key talent to achieve the Company's strategic objectives, to deliver on customer commitments, to lead and inspire employees, and to drive value for our shareholders. It is also designed to be competitive in the various markets in which we operate and compete for talent.

Our short-term programme metrics are tied to Group performance, business segment performance and individual goals, including the leadership behaviours that underpin BAE Systems' Total Performance culture. Working with our Chief Executive, we have considerably expanded the individual goals of our leaders to tie objectives more explicitly to strategy and to enhance accountability. Our long-term incentive programme measures absolute performance of the Group and performance relative to peers.

In addition to developing the overall remuneration framework, the Committee assesses the level of challenge within our annual and long-term incentive plan targets. Annually, in November, the full Board reviews and adopts the Integrated Business Plan. Thereafter, the Committee reviews the specific business targets/metrics for the one and three-year periods and examines the underlying assumptions, including the degree of 'stretch' contained within them. After setting one and three-year targets, the Committee periodically reviews progress towards the attainment of the objectives. After the close of each year, the Committee undertakes a thorough review of annual and three-year performance. Separately, the Committee regularly considers the overall construct of the remuneration package to ensure that potential pay outcomes are appropriate and reasonable against different performance scenarios. As we have enhanced the individual goals, it provides the challenge and opportunity to exercise greater judgement in evaluating the performance, contributions and potential of our executives.

2019 remuneration

To confirm, for 2019 no revisions are proposed to our executive remuneration framework that would constitute a change to the Policy. In line with our commitment to continued transparency, we have contacted our major shareholders on the following modest changes for 2019:

- taking account of the need of our leadership team to continue to steer the Company through a period of significant change and the skills, experience and performance of each executive, the Committee believes it is appropriate to adjust the salaries of the executive directors by 2.5% from 1 January 2019. This increase is in line with the broader workforce; and
- for 2019, the split of financial and non-financial performance measures within the annual incentive remains at 75%/25% respectively. The 25% non-financial element will continue to be based 20% on personal performance objectives that provide clear line of sight to our strategic objectives, with 5% relating to safety, diversity and inclusion targets. Recognising the significant focus on delivering earnings growth in 2019, the following weighting of financial measures, which account for 75% of the total annual incentive, will apply:

	Group underlying EPS/EBITA %	Group debt %	Order intake %	Total %
2019				
Allocation	45	22.5	7.5	75
Weighting	60	30	10	100

In setting 2019 financial targets, the Committee has reduced the relative importance of order intake and cash targets relative to earnings as compared to past years. This change principally recognises the importance that shareholders attach to greater earnings growth. However, it also reflects the fact that 2018 was a record year of order intake and that 2019 is a year for greater emphasis on the execution of the order book rather than building a larger backlog. The Committee remains mindful of the importance of cash to the health of the Group and to our dividend-paying capability, and we believe that our discretion in evaluating the outcome can serve as the appropriate balance to ensuring that overall bonus outturn is reasonable.

Incentive outturn

After the close of 2018, the Committee met and reviewed performance under the short-term annual incentive for all of the executive directors and Executive Committee members. Financial results were achieved at or above target; non-financial achievements varied for the executive directors and Executive Committee members.

As disclosed in our report, the Group achieved a record order intake in 2018 of £28.3bn, reflecting, among other achievements, the aircraft award in Qatar and the maritime award in Australia. However, an anticipated aircraft purchase by the Kingdom of Saudi Arabia, which was included in the 2018 order intake component of the financial goals, was not finalised within the year. In March 2018, a Memorandum of Intent was signed by the UK government with the Kingdom of Saudi Arabia to finalise discussions for the purchase by the Kingdom of 48 Typhoon aircraft, but given the prevailing geopolitical environment, the Committee agreed that it was not reasonable to hold the executives responsible for the delay in achieving that order, or, in the alternative, for booking replacement orders of comparable magnitude. Therefore, the Committee used its discretion with respect to the order intake measure and agreed that the record intake of £28.3bn was on-target.

The Committee used its judgement in evaluating non-financial performance, including the executives' commitment to safety, diversity and inclusion, as well as overall leadership contributions. A discussion of that evaluation and the bonuses earned by the executive directors are reported on pages 107 and 108.

The Performance Shares and Share Options granted in 2016 under our long-term incentives will partially vest in early 2019 as will the Restricted Shares granted to our US executive director. The details of the vesting outcomes and amounts awarded are also described in the following report.

As described above, after the close of 2018, the Committee thoroughly reviewed annual and three-year performance, and relative to the remuneration outcomes, is satisfied that the Policy operated as intended during 2018.

Concluding comments

The backdrop of the Group's business and the changes in leadership approach made for a challenging year at BAE Systems. Nevertheless, the leadership team kept its focus on delivering solid financial results and made material improvements in key areas such as our UK Maritime business, the widening scope of our US Inc. business, and the significant increase in our order book internationally. We believe the rewards conferred in the performance cycle just concluded are commensurate with the progress the Group has made. Further, the goals and incentives we have approved for the upcoming period are, we believe, consistent with achieving an ambitious future plan.

On behalf of the Board

Paula Rospit Reynolds

Chairman of the Remuneration Committee

Remuneration Committee report

continued

The Remuneration Committee's year

January

Committee

London, UK

- Agreed 2018 objectives for executive directors and Executive Committee members.
- Approved remuneration package for new or existing Executive Committee members.
- Reward framework deep dive session on pay and benefits received by the workforce across the Group.

February

Committee

London, UK

- Determined 2017 bonuses against performance for executive directors and Executive Committee members for payment in March 2018.
- Approved 2017 Group All-Employee Free Share Plans payments.
- Determined vesting outcome for 2015 Long-Term Incentive awards.
- Approved 2018 Long-Term Incentive awards and associated performance targets for executive directors and Executive Committee members.
- Approved 25% weighting on non-financial objectives in annual incentive.
- Reviewed feedback from shareholder consultation on 2018 remuneration review.
- Approved 2017 Annual remuneration report.
- Reviewed Remuneration Committee terms of reference.
- Appointed PricewaterhouseCoopers (PwC) as independent adviser to the Committee.

May

Committee

Farnborough, UK

- Reviewed feedback from shareholder consultation on 2018 remuneration review.
- Considered detailed analysis of the factors influencing the structure of long-term incentive design, including an analysis of the application of such arrangements at Executive Committee level and below.
- Approved changes to Company's employee share plans to assist in complying with the requirements of the EU's General Data Protection Regulations.

September

Committee

San Diego, US

- Received an update on the 2018 UK AGM season and recent corporate governance changes.
- Agreed the approach to 2019 and 2020 incentive design and key considerations for the route map towards the renewal of the Company's remuneration policy in 2020.
- Approved remuneration package for new or existing Executive Committee members.
- Received update on performance conditions for Long-Term Incentive awards.
- Received remuneration analysis for individuals on succession plans.

November

Committee

New Milton, UK

- Approved the approach to the development of the 2018 Annual remuneration report including early adoption of the new requirements.
- Reviewed level of executive directors' and Executive Committee members' shareholdings relative to their Minimum Shareholding Requirement.
- Reviewed dilution levels and share usage under Employee Share Plans.
- Approved operation of Group All-Employee Free Share Plans.
- Considered high-level remuneration market practice findings.
- Received presentation on the UK Gender Pay Report for 2018.
- Reviewed Remuneration Committee terms of reference.

December

Committee

London, UK

- Considered the recent updates to institutional investor guidance.
- Reviewed and set salaries and bonus opportunity levels for executive directors and Executive Committee members.
- Agreed the approach, structure and targets for the 2019 annual incentive plan.
- Considered the approach to setting the 2019 strategic objectives applicable to Executive Committee members.
- Approved remuneration package for new or existing Executive Committee members.
- Reviewed and evaluated the proposed 2019 annual and three-year targets.

Remuneration Committee timeline

January

Committee

February

Committee

May

Committee

September

Committee

November

Committee

December

Committee

Annual remuneration report at a glance

for the year ended 31 December 2018

Business performance and incentive outcomes in 2018

		2018 performance	2018 incentive outcome
Group underlying EPS ¹	AIP	41.8p	●
Group net debt ¹	AIP	£(951)m	●
Group order intake ¹	AIP	£29.2bn	●
Average three-year diluted underlying EPS growth	LTI	<3%	●
Three-year TSR	LTI	21.9%	●
Recordable Accident Rate (per 100,000 employees) ²	AIP	471	●
Major injuries recorded	AIP	37	●

● Below threshold
● Between threshold and target
● Between target and stretch

AIP Annual Incentive Plan
LTI Long-Term Incentive

1. Adjusted to be on a like-for-like basis with the targets (see page 107).

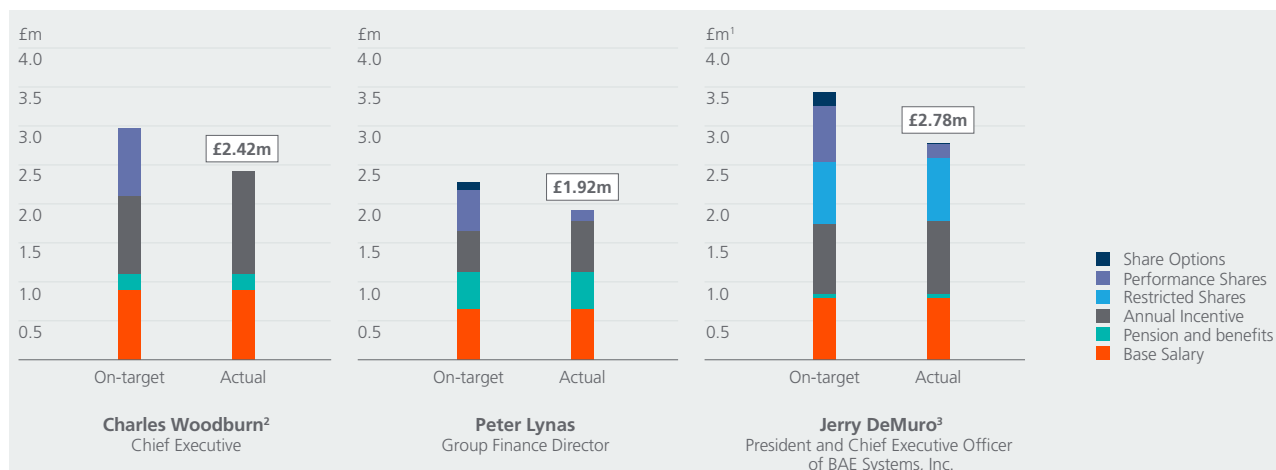
2. Although the Company met its stretch target for reduction in recordable injuries, the amount awarded was reduced by the Corporate Responsibility Committee to reflect the employee fatality and increase in major accidents.

This resulted in the following incentive outcomes:

- 2018 annual bonus payouts for the executive directors ranged from 52.7% to 65.6% of maximum; and
- Performance Shares (EPS) granted to Group Finance Director and President and Chief Executive Officer of BAE Systems Inc. in March 2016 and to the Chief Executive in September 2016 did not meet their performance condition and will lapse. Performance Shares (TSR) and Share Option awards granted at March 2016 to Group Finance Director and President and Chief Executive Officer of BAE Systems Inc. will vest at 18.8%. The performance period in respect of the Performance Shares (TSR) and Share Option awards granted in September 2016 to the Chief Executive has not yet been completed and will be reported on in 2019.

Summary of executive directors' remuneration in 2018

The charts below show the 2018 actual remuneration achieved, as disclosed in the single total figure of remuneration on page 105, compared with the 2018 on-target opportunity. On-target remuneration assumes target vesting of incentives payable in respect of the performance period with year-end 2018, although actual remuneration for each of the executive directors was less than target, reflecting business performance.



1. The figures for Jerry DeMuro have been converted from US dollars to sterling.

2. Charles Woodburn's first LTI is not due to vest until September 2019 (subject to performance conditions being met). However, the EPS performance condition was tested as at 31 December 2018 and failed to meet the necessary threshold requirement and therefore this portion of the award will lapse. The TSR performance period has not yet completed.

3. Long-term incentive figures in the charts above are based on the 2016 Performance Shares, Share Options and Restricted Shares awards. For Jerry DeMuro, the single total figure of remuneration on page 105 includes his 2018 Restricted Shares award as required by regulation.

Remuneration in the wider context

Context to our executive director remuneration in light of wider workforce considerations:

- Consistent remuneration philosophy and strategy applicable to all employees across the Group.
- Wider workforce predominantly have access to competitive retirement plans and participate in all-employee share plans and/or recognition schemes.
- Level of salary adjustment for the executive directors remains consistent with the average increase for employees across the Group.
- Ratio of CEO pay to pay of global workforce of 33:1.
- UK gender pay gap of 9.0%.

Annual remuneration report at a glance

for the year ending 31 December 2019

Executive director remuneration in 2019

For 2019, no revisions are proposed to the executive remuneration framework which would constitute a change to the Policy.

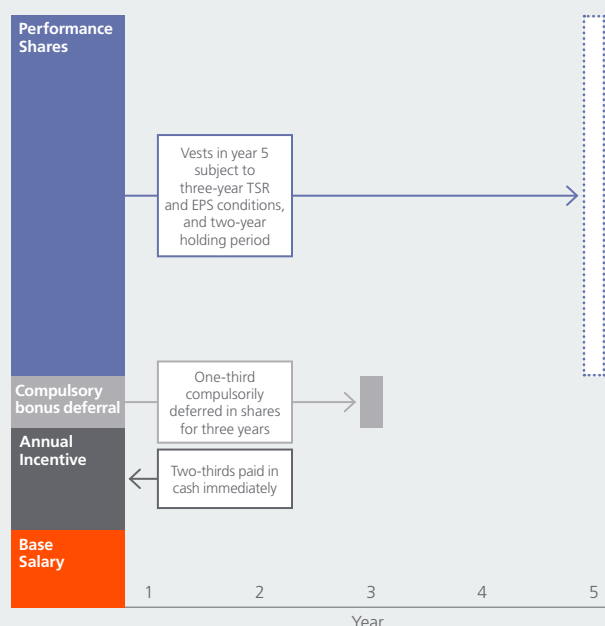
Summary of remuneration framework

The overall remuneration framework applicable in 2019 to each of the three executive directors under the policy approved by shareholders at the 2017 Annual General Meeting¹ is summarised in the following table.

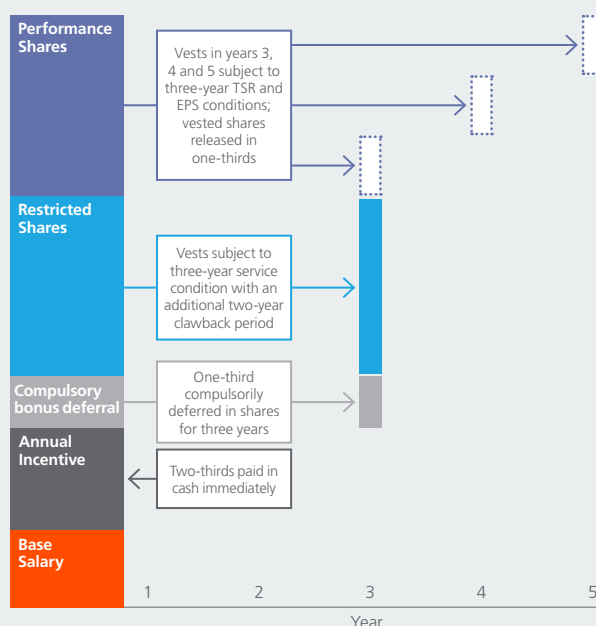
	Purpose and link to strategy		Charles Woodburn CEO	Peter Lynas GFD	Jerry DeMuro CEO Inc.
Base Salary (with effect from 1 January 2019)	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.		£919,500	£657,700	\$1,080,000
Pension and benefits	Provide competitive benefits.		Defined contribution	Defined benefit	Section 401(k) defined contribution
Annual Incentive	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.	On-target/maximum opportunity (% salary)	112.5%/225%	80%/160%	112.5%/225%
		Performance condition	75% financial/25% non-financial		
		Deferral into Deferred Bonus Plan	One-third compulsory deferral		
Performance Shares	Drive and reward delivery of sustained long-term Earnings per Share (EPS) and Total Shareholder Return (TSR) performance aligned to the interests of shareholders.	Grant (% salary)	370%	335%	298%
		Performance condition	50% on relative TSR/ 50% on three-year diluted underlying EPS growth		
Restricted Shares	Provide long-term reward through time-vesting awards principally in the Company's US market.	Grant (% salary)	n/a		150%
Minimum Shareholding Requirement	Provide long-term alignment with shareholder interests.	(% salary)	300%	200%	425%

1. The full Directors' remuneration policy approved by shareholders at the 2017 Annual General Meeting is set out on pages 117 to 129.

Application of 2019 package for UK executive directors



Application of 2019 package for US executive director



Charts are illustrative and are not to scale.

Annual remuneration report

for the year ended 31 December 2018

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2018 and will be proposed for an advisory vote by shareholders at the 2019 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.

Response to new remuneration reporting provisions in the 2018 UK Corporate Governance Code

As set out in the Remuneration Committee report on page 92 we are adopting a number of the new 2018 UK Corporate Governance Code requirements in our remuneration reporting in advance of the mandated time schedule for their inclusion.

These include:

+ 99

Describing how the Committee has addressed the factors of clarity, simplicity, risk, predictability, proportionality and alignment to culture.

+ 100

A new section setting out more information in relation to the wider workforce.

+ 101

Building on our previous Chief Executive pay ratio and additionally disclosing the Chief Executive ratio on the new regulatory basis.

+ 105

Disclosure of how much of individual directors' long-term incentive awards is attributable to share price appreciation.

+ 116

Disclosure of maximum remuneration receivable assuming a 50% share price appreciation in the application of the remuneration policy charts.

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Statement of voting

Shareholder voting on the resolutions to approve the Annual remuneration report put to the 2018 AGM and the Directors' remuneration policy put to the 2017 AGM was as follows:

Annual remuneration report

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,425,636,219	98.40	39,353,964	1.60	2,464,990,183	33,369,345

Directors' remuneration policy

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,286,232,998	95.09	118,030,799	4.91	2,404,263,797	6,035,623

The Company's remuneration policy approved at the 2017 AGM, which took effect on 10 May 2017, is detailed on pages 117 to 129.

Remuneration overview and link to Group pay policy

Our reward philosophy and approach

Our aim across the Group is to provide a reward package that is aligned to shareholders' interests, supports the achievement of the Company's in-year and strategic objectives, is competitive against the appropriate market and is consistent with our focus on performance and our values of Trusted, Innovative and Bold. This means:

- base salaries are set with reference to median of the relevant market competitive level;
- high performance and exceptional contribution are recognised through in-year incentives;
- packages for leadership roles have an increased emphasis on longer-term share-based reward;
- providing employees with competitive and affordable retirement benefits which reward long-term contribution and loyalty; and
- ensuring access to a competitive and cost-effective package of other benefits as part of our total reward offering.

Senior executive reward framework

Element	Structure/operation	Purpose and link to strategy
Base salary	Normally reviewed annually. Market pay approach taking into account individual's skill, knowledge, experience levels and contribution to role.	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.
Pension and benefits	Differentiated by competitive practice in relevant home market.	Provide employment benefits and competitive post-retirement benefits to ensure overall package is market competitive.
Annual incentive	Incentive based on annual financial performance and non-financial metrics paid in cash and shares (see bonus deferral below). 75% weight on financial metrics on following KPIs: – Group underlying earnings per share (45%) – Net debt (22.5%) – Order intake (7.5%) 25% weight non-financial metrics: – Safety (5%) – Key strategic objectives (20%) around six key areas: – Drive operational excellence – Continuously improve competitiveness and efficiency – Advance and further leverage our technology – Pursue and deliver growth – Lead and inspire high-performing teams and individuals – Build trust by operating to the highest standards of business conduct	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. Further detail on KPIs is provided in the Group financial review (pages 35 to 41) and on safety within Our values and responsible behaviour (pages 28 to 30).
Bonus deferral	Compulsory deferral into shares for three years.	Increases alignment with shareholder interests.
Performance shares	Shares vest subject to three-year performance period as follows: – 50% on diluted underlying earnings per share (EPS) – 50% on total shareholder return (TSR) against sectoral comparator group and the companies in the FTSE 100 index – UK executive directors have a further two-year holding period – Others have phased release in years 3, 4 and 5 – For executives below Executive Committee within the US Inc. business, TSR is replaced with Inc. operating cash flow	Drive and reward delivery of sustained company financial performance including long-term EPS and TSR performance aligned to the interests of shareholders.
Restricted shares (US only)	Award of shares that are released after three-year service condition.	Provide long-term reward through time-vesting awards principally in the Company's US market.
Share options (below executive director level)	Award of share options that are exercisable after three-year vesting period.	Drive and reward delivery of sustained improvement in the Company's share price.
Minimum shareholding requirement	Requirement to establish and hold minimum personal shareholding.	Provide long-term alignment with shareholder interests.

Appropriateness of remuneration and link to strategy

The Committee has established the following six core principles which underpin our approach to executive remuneration aligned to BAE Systems' strategic objectives, taking account of shareholder expectations and the new remuneration factors in the 2018 UK Corporate Governance Code, as well as reflecting a stronger performance accountability across the enterprise:

Simplicity – Clarity and simplicity of design; ease of understanding by executives and external stakeholders.

Motivational – Plans are relevant and meaningful with clear line of sight between actions and reward outcomes; metrics and targets which drive superior performance and value for shareholders.

Aligned with shareholder interests – Close alignment of reward outcomes and shareholder experience; long-term share ownership and 'skin in the game' for executives.

Globally competitive – Compensation opportunity aligned to relevant competitive employment market; enabling mobility across different businesses and geographies.

Acceptable to shareholders – Compliance with proxy bodies and corporate governance guidelines; continuing government, investor, media and public scrutiny of executive pay and fairness relative to wider workforce.

Flexibility/adaptability – Transparent and responsible application of discretion to override formulaic outcomes; ability to respond to special/unforeseen circumstances during life of binding policy.

How the Committee has addressed the following factors in the 2018 UK Corporate Governance Code

Factor	How this has been addressed
Clarity Remuneration arrangements should be transparent and promote effective engagement with shareholders and the workforce.	In line with our commitment to full transparency and engagement with our shareholders on the topic of executive remuneration, the Remuneration Committee chairman engages with our major shareholders to set out the changes planned for the following year. In a year of significant change, the chairman will consult with our major shareholders to discuss and seek views on potential changes. The Company consults directly with the broader employee population on their remuneration through a variety of methods including WebEx, explanatory guides hosted on intranet, human resources or business-led briefings.
Simplicity Remuneration structures should avoid complexity and their rationale and operation should be easy to understand.	Clear direction of travel for changes to our reward framework in recent years has been to reduce the complexity of our long-term incentive arrangements as demonstrated by: – 2014: Introduction of new single 'umbrella' LTI plan – simplicity and flexibility of design. – 2018: Simplification of construct by elimination of share options for executive directors.
Risk Remuneration arrangements should ensure reputational and other risks from excessive rewards, and behavioural risks that can arise from target-based incentive plans, are identified and mitigated.	Full range of design features exist within remuneration arrangements to take risks into account as follows: – Malus and clawback mechanisms within AIP and LTIs. – Remuneration Committee application of reasonable discretion to override formulaic outcomes. – Safety objective within AIP – focus on recordable accident rate and major injuries recorded.
Predictability The range of possible values of rewards to individual directors and any other limits or discretions should be identified and explained at the time of approving the policy.	Remuneration Policy approved at 2017 AGM contains the following: – Maximum award levels and vesting outcomes applicable to annual and long-term incentive arrangements. – As set out above in Risk, Committee has the ability to apply malus, clawback and reasonableness discretion where appropriate.
Proportionality The link between individual awards, the delivery of strategy and the long-term performance of the company should be clear. Outcomes should not reward poor performance.	Performance conditions attached to annual and long-term incentive arrangements require a minimum level of performance to be achieved before any payout is made. As set out in senior executive reward framework on page 98, there is a direct link between individual's reward and their contribution to driving strategy and increasing company performance. No payment is made for poor performance. Any individual's performance that is below expectations is dealt as part of our performance management process – any individual leaving due to performance issues would not be entitled to any incentive payments.
Alignment to culture Incentive schemes should drive behaviours consistent with company purpose, values and strategy.	As set out in senior executive reward framework on page 98, there is a direct link between driving BAE Systems' strategy and an individual's reward. As set out above, the Committee has established six core principles which underpin the philosophy and approach to executive remuneration to ensure alignment to BAE Systems' strategic objectives.

Annual remuneration report

continued

Wider employee remuneration

The Committee has responsibility for reviewing remuneration and related policies applicable to the wider workforce, ensuring that this is taken into account when setting the policy for executive remuneration. As part of our commitment to openness and transparency we have introduced this section which sets out more information in relation to our wider workforce and recognises the requirements of the revised UK Corporate Governance Code in this area. Further detail regarding our employees is provided in the Our People section on page 24 including our approach, diversity and inclusion, reward and employee engagement.

For our wider employee population, reward is managed by reference to external competitor benchmarks, differentiated by competitive practice in each home market.

Share plans

All-employee share plans are a long-established and highly valued part of our total reward package, providing opportunity for eligible employees in a number of our markets to acquire shares in the Company and share in its success. The Company rewards eligible employees under these plans with an annual award of free shares, or cash equivalent, based on and subject to our Group financial performance. We also invite eligible employees to participate in and receive free matching shares in our Company Share Incentive Plan (SIP) or international equivalent.

Retirement benefit provision

Our reward framework includes the provision of competitive and affordable retirement benefits which reward long-term contribution and loyalty. This is achieved through providing access to competitive retirement plans aligned to local market practice in our various locations across the globe. In the UK, all defined benefit schemes are closed to new entrants, with benefits for all new employees being provided through a defined contribution scheme.

Informing the Committee on wider workforce

To build the Remuneration Committee's understanding of reward arrangements applicable to the wider workforce, the Committee undertook a deep dive session in 2018 covering the broader executive reward framework as well as a range of other topics including reward principles, job sizing, pay philosophy and pay ranges, annual and long-term incentive design, employee share plans and other employee benefits including pension and retirement schemes.

It is intended that a similar deep dive session will be undertaken on an annual basis in order to provide the Committee with visibility of remuneration practices in the different sectors/markets in which we operate and for the different populations within the wider workforce across the Company globally.

During meetings, the Remuneration Committee is periodically updated on wider employee matters such as the outcome of our UK gender pay analysis.

Whilst the Company does not currently directly consult with employees as part of the process of reviewing executive pay and formulating the Remuneration Policy, the Company does receive insights from the broader employee population on an annual basis using an engagement survey.

Communication with employees

BAE Systems' employees are kept informed of its activities and performance through a series of employee briefings at regular points during the year. These briefings also serve as an informal forum for employees to ask questions about the Company. Corporate announcements and other relevant information are circulated to employees and supplemented with updates on the Company's intranet.

The Chief Executive, Group Finance Director and other sector and business managing directors post blogs to keep employees informed of relevant Company or sector and business matters. Monthly radio podcasts called 'Our Conversation' are delivered for BAE Systems employees around the world. The topics vary and typically include discussions on recent programme or contract activity, company performance updates, and specific deep dive features into a programme, business or market opportunity.

As shareholders through our all-employee share schemes, eligible employees are encouraged to vote and attend our Annual General Meeting (AGM). In addition to providing an update on our business performance, it also provides the opportunity for them in their capacity as shareholders to ask questions to our Chairman and other members of the Board.

Communication with shareholders

In line with our commitment to full transparency and engagement with our shareholders on the topic of executive remuneration, the Remuneration Committee chairman annually writes to our major shareholders to set out the changes planned for the following year. In a year of significant change, such as during our Remuneration Policy renewal, the Remuneration Committee chairman will additionally engage directly with our major shareholders to discuss and seek views on potential changes. The Remuneration Committee chairman values direct engagement with our shareholders and makes herself available for such meetings throughout the year to hear their perspective on remuneration matters.

In early 2018, BAE Systems conducted a Governance Investor event, aimed at encouraging greater transparency and awareness of our governance programmes, with an opportunity to provide closer contact with non-executives, particularly the committee chairs. As part of this, the Remuneration Committee chairman shared an overview of the Remuneration Committee including the key themes and areas for focus for the Committee looking forward.

Pay comparisons

Pay ratio of Chief Executive to global average employee

The Committee is mindful of the relationship between Chief Executive remuneration and remuneration of the wider BAE Systems employee population. Therefore, in line with our commitment to transparency, the table below provides the ratio of remuneration of the Chief Executive to the average employee of the Group for the past five years.

As can be seen, the ratio has typically been around 50:1, with the ratio being higher in 2014 as a result of the partial vesting of Long-Term Incentive awards in that year. The ratio could range from around 20:1 to 100:1 depending on the level of performance against the measures which drive the Annual and Long-Term Incentive Plans.

The ratio of remuneration of the Chief Executive to the average employee of the entire Group over the last five years was as follows:

	2014	2015	2016	2017 ¹	2018
Chief Executive's remuneration (£'000) ²	3,519	2,929	3,463	3,365	2,416
Average employee remuneration (£'000) ³	58	62	67	72	72
Ratio	60:1	47:1	52:1	47:1	33:1

1. Chief Executive's remuneration in 2017 includes a combination of the remuneration of Ian King and Charles Woodburn. As Charles Woodburn's overall remuneration is lower than Ian King's, the calculation for 2017 results in a downward movement in the pay ratio.
2. The Chief Executive's remuneration is calculated on the same basis as the single total figure of remuneration table.
3. Average employee remuneration is based on staff costs calculated on the same basis as note 3 to the Group accounts, excluding social security costs and US healthcare costs. The 2018 figure excludes the Guaranteed Minimum Pension equalisation charge (see note 22 to the Group accounts).

Recognising the global nature of our workforce, we believe the above pay ratio measured against the average employee of the entire Group is the most appropriate for BAE Systems. We will therefore continue to provide the pay ratio on this basis.

Pay ratio of Chief Executive to UK average employee

The UK government has now introduced legislation requiring companies to publish the ratio of their Chief Executive to that of the median, 25th and 75th percentile total remuneration of full-time equivalent employees. We are voluntarily disclosing the pay ratio on the required basis in this year's report as shown in the table below:

Year	Method	25th percentile pay ratio	Median pay ratio	75th percentile pay ratio
2018	Option B	61:1	48:1	38:1

The reporting regulations offer three calculation approaches for determining the pay ratio – Options A, B and C. The table above has been calculated using the approach determined by Option B which is deemed the most appropriate methodology for BAE Systems. Recognising that BAE Systems has more than 30,000 UK employees, operating on different human resources and payroll systems, it is not feasible to adopt Option A. The calculations for the relevant representative employees were performed as at 31 December 2018.

To ensure Option B provides a sufficiently accurate representation of the UK workforce, we have performed sensitivity analysis around the three quartiles. Our approach has been to consider the total pay and benefits for a number of employees centred around each quartile. This allows any anomalies that may arise when calculating the total pay and benefits for the full financial year (such as if an employee left part way through the year) to be adjusted or excluded. By taking an average of the remaining figures, this provides a robust representation of each quartile.

The total full-time equivalent pay and benefits for the relevant employees has been calculated based on the amount paid or receivable in respect of the financial year. The calculations are on the same basis as required for the Chief Executive's remuneration for single total figure purposes. For pension-related benefits, employer pension costs have been estimated using the employer contribution rates applicable to the member's pension scheme. No other estimates or adjustments have been used in the calculation and no remuneration items have been omitted. A minority of employees in this calculation are employed on a part-time basis and therefore their remuneration has been annualised to reflect the full-time equivalent.

Our reward framework across the Group is based on a consistent set of principles, including managing reward by reference to external competitor benchmarks (see page 98). In the case of our Chief Executive, his total remuneration comprises a significant proportion in variable pay and therefore the single figure will vary considerably depending on the level of performance against the measures which drive the Annual and Long-Term Incentive Plans. In 2018, there was no vesting of long-term incentives for the Chief Executive in respect of performance ending in 2018 which has resulted in a decrease to the pay ratio. The employees in the calculation would not typically participate in any long-term incentive plans and receive a significantly higher proportion of their remuneration in the form of fixed pay. The difference in ratio at the three quartiles is consistent with our market-based approach to reward, with the ratio increasing as the Chief Executive's remuneration is compared with that of more junior employees.

£	25th percentile	50th percentile	75th percentile
Total pay and benefits	41,918	53,248	63,135
Salary component	29,498	39,286	47,404

Annual remuneration report

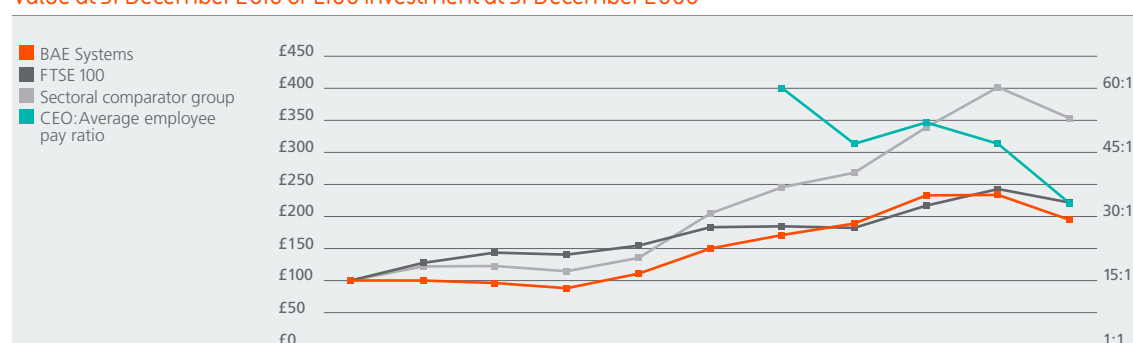
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Total Shareholder Return (TSR) performance and Chief Executive pay

The graph below shows the value by 31 December 2018, 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 graph includes the ratio of remuneration of the Chief Executive to the average employee of the Group for the past five years.

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 investment interests of our UK shareholder base. In addition, it forms 50% of the TSR performance measure for awards made from 2016 onwards. The equivalent data is shown for the sectoral comparator group which is of relevance to our international shareholder base.

Value at 31 December 2018 of £100 investment at 31 December 2008



Change in Chief Executive's remuneration over 10 years

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 ¹	2018
Chief Executive's single total figure (£'000)²											
Ian King		4,030	4,810	4,613	2,574	2,499	3,519	2,929	3,463	2,086	n/a
Charles Woodburn		—	—	—	—	—	—	—	—	1,279	2,416
		4,030	4,810	4,613	2,574	2,499	3,519	2,929	3,463	3,365	2,416
Bonus paid as a percentage of maximum											
Ian King		83.0%	71.0%	68.6%	55.6%	53.4%	74.3%	72.4%	82.3%	75.9%	n/a
Charles Woodburn		—	—	—	—	—	—	—	—	75.8%	65.6%
LTI as a percentage of maximum vesting²											
Ian King		65.5%	57.6%	44.3%	nil	nil	16.8%	nil	nil	11.3%	n/a
Charles Woodburn		—	—	—	—	—	—	—	—	n/a	nil

1. Ian King retired and stepped down as Chief Executive on 30 June 2017 and Charles Woodburn took over the position on 1 July 2017. Ian King's remuneration is shown from the start of the financial year until 30 June 2017. Charles Woodburn's remuneration is shown from 1 July 2017 to the end of that financial year.

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

Percentage change in Chief Executive's remuneration

The percentage change from 2017 to 2018 in remuneration of the Chief Executive and average UK employee is shown in the table below. As required by statute, the table shows the details for the Chief Executive role and, therefore, includes a combination of the remuneration of Ian King and Charles Woodburn for the 2017 financial year. As Charles Woodburn's overall remuneration is lower than Ian King's, the calculation for 2018 results in a downward movement in the year-on-year percentage change. If the table below reflected Charles Woodburn's remuneration for the full financial year, the percentage movement on a like-for-like basis would be a 2.5% increase in salary, a 0.1% decrease in taxable benefits and a decrease of 11.3% in bonus.

	Change in Chief Executive's remuneration %	Change in average UK employee ¹ remuneration %
Base salary	-3.4	+2.5
Taxable benefits	-49	0
Bonus	-16.4	-17.8

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.

Gender pay

BAE Systems has published its second annual gender pay gap report in line with the UK regulations. For 2018, the average (mean) gender pay gap for our UK workforce was 9.0% (2017 11.2%), which is lower than the current UK national average of 17.9%. We have a gender pay gap because we employ around four times more men than women and a greater proportion of our senior leadership population is male. We rely on employing large numbers of employees with STEM qualifications and we, like other companies, face challenges recruiting females with these qualifications because there are significantly fewer women who study and work in these fields.

Relative importance of spend on pay

The following charts set out underlying EBITA¹, amounts paid in returns to shareholders, total employee costs and average headcount for the years ended 31 December 2017 and 2018.

Underlying EBITA ^{1,2} (£m)	Returns to shareholders (£m)	Total employee costs ³ (£m)	Average headcount ⁴ ('000)
-2%	+3%	+3%	0%
2018 1,928	2018 703	2018 5,986	2018 76
2017 1,974	2017 684	2017 5,830	2017 76

1. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items (see page 36).

2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 to the Group accounts for details regarding the restatement.

3. 2018 includes £110m relating to the Guaranteed Minimum Pension equalisation charge (see note 22 to the Group accounts).

4. Excluding share of equity accounted investments.

Single total figure of remuneration

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

	Fees		Benefits		Other		Total	
	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000
Chairman								
Sir Roger Carr	700	696	–	–	–	–	700	696
Non-executive directors								
R Advaiti ¹	80	n/a	9	n/a	23	n/a	112	n/a
E P L Corley	80	79	2	2	9	5	91	86
H Green	80	79	11	3	27	5	118	87
C M Grigg	80	79	4	2	9	5	93	86
P Rosput Reynolds	105	103	9	7	27	27	141	137
N C Rose	130	127	1	1	9	5	140	133
I P Tyler	105	103	3	1	9	5	117	109

1. Appointed to the Board on 1 January 2018.

Chairman

Sir Roger Carr's fee was increased to £700,000 per annum with effect from 1 February 2017 on the commencement of his second three-year term.

The Chairman's fee is set by the Remuneration Committee and will not be reviewed again for the remainder of his current three-year term.

Non-executive directors

The non-executive directors' fees are set by the Non-Executive Directors' Fees Committee which comprises Sir Roger Carr (Chairman), Philip Bramwell (Group General Counsel), Jerry DeMuro and Charles Woodburn.

With effect from 1 April 2017, the fee structure on a per annum basis was set as follows: (i) Chairman, Audit Committee: £105,000 (2016 £100,000); (ii) Chairman, Corporate Responsibility Committee: £105,000 (2016 £95,000); (iii) Chairman, Remuneration Committee: £105,000 (2016 £95,000); (iv) other non-executive directors: £80,000 (2016 £75,000); and (v) additional fee for Senior Independent Director: £25,000 (2016 £20,000). These amounts are shown in the 'Fees' column above.

A travel allowance of £4,500 (2016 £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 non-executive fee structure will not be reviewed again until 1 April 2020.

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		Pension ⁴		Other ⁵		Total	
	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000	2018 £'000	2017 £'000
C N Woodburn*	897	813	23	23	1,324	1,311	–	n/a	171	154	1	1	2,416	2,302
P J Lynas	642	592	25	29	653	724	145	327	460	570	–	1	1,925	2,243
J DeMuro ⁶	789	794	42	35	936	1,578	200	434	13	11	1,217	950	3,197	3,802
I G King**	n/a	491	n/a	33	n/a	838	n/a	497	n/a	219	n/a	1	n/a	2,079

* Appointed as Chief Executive on 1 July 2017 having been appointed to the Board in 2016 as Chief Operating Officer.

** Retired as Chief Executive and from the Board on 30 June 2017.

The above table has been subject to audit.

- The benefits received by Charles Woodburn include the provision of a car allowance and the private use of a chauffeur-driven car (2018 £23k; 2017 £23k). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2018 £23k; 2017 £21k). In addition, Peter Lynas received the final payments in respect of his second residence allowance of £2k (2017 £8k) on the basis disclosed in previous years. Jerry DeMuro's benefits include private use of a chauffeur-driven car and parking (2018 £2k; 2017 £3k); medical and dental benefits (2018 £13k; 2017 £14k); insured life and disability benefits (2018 £9k; 2017 £9k); and the private use of a company aircraft (2018 £18k; 2017 £9k). The prior year benefits figure for Ian King for the six months ended 30 June 2017 includes the provision of a car allowance and the private use of a chauffeur-driven car. In addition, upon his retirement, Ian King received a leaving gift totalling £5k as disclosed last year with the tax due on this being settled by the Company.
- Further detail on bonus payments is provided on page 107. One-third of the net bonus paid to Charles Woodburn, Peter Lynas and Jerry DeMuro will be deferred compulsorily into BAE Systems shares for a three-year period, without additional performance conditions.
- 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 values in the 2018 column are calculated on the basis of the three-month average share price of £5.17 as at 31 December 2018 and relate to the vesting portion (18.8%), including shares deriving from notional reinvested dividends, of the 2016 LTIP PS^{TSR} and LTIP SO awards granted to Peter Lynas and Jerry DeMuro for which the performance periods ended on 31 December 2018 (see page 109 for further detail).

An estimate of the amount of 2016 LTIP PS award attributable to share price appreciation is £4,114 in respect of Peter Lynas' awards and £5,623 in respect of Jerry DeMuro's awards. An estimate of the amount of 2016 LTIP SO award attributable to share price appreciation is £11,479 in respect of Peter Lynas' awards and £18,122 in respect of Jerry DeMuro's awards. An estimate of the amount of 2016 LTIP RS award for Jerry DeMuro that is attributable to share price appreciation is £27,483.

As required by regulation, the estimated vesting values for the awards shown in the 2017 column (which were calculated in the 2017 Annual Report on the basis of the three-month average share price of £5.75 as at 31 December 2017), have been adjusted to reflect the actual value on the vesting of the performance award in March 2018 based on the then share price of £5.66. The figures reported in the 2017 column in the 2017 Annual Report on the estimated basis were Peter Lynas: £332k; Jerry DeMuro: £441k; and Ian King: £504k. The respective figures in the 2017 Total column have been recast accordingly. The Chief Executive figures in the pay ratio and TSR performance/Chief Executive pay disclosures on pages 101 and 102 reflect the original 2017 total for Ian King (£2,086k).

- The figures for Peter Lynas in this column reflect defined benefit arrangements and 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 under review, net of inflation. These figures are also 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 his salary increase since 31 December 2017.
 - 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. For the 2018 figures, the reference CPI inflation was 3.0%.

The figures for Charles Woodburn relate to a salary supplement in lieu of Company pension contributions.

The figures for Jerry DeMuro include company contributions paid into his Section 401(k) defined contribution arrangement.

The prior year figures for Ian King in this column show the added pension value received in the defined benefit schemes from 1 January 2017 to the date of his retirement on 30 June 2017.

Further detail on pensions is given on page 110.

Annual remuneration report

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5. This column includes (i) the value of Free Share awards under the UK all-employee Share Incentive Plan (SIP) of £394 for Charles Woodburn, and his Matching Shares under voluntary investment in the SIP (and in the prior year figure for Ian King for the six months to 30 June 2017); and (ii) for Jerry DeMuro, the value of the 2018 grant of Restricted Shares (£1,138k). This award formed part of Jerry DeMuro's 2018 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached. The balance of the 2018 figure (£79k) relates to the value of notional reinvested dividends in respect of his 2015 Restricted Share Plan award which vested in March 2018, the third anniversary of grant. The value of the related award was reported in the 2015 Remuneration report. His prior year figure relates to a similar Restricted Shares award in 2017 and the value of the notional reinvested dividends in respect of his 2014 Restricted Share Plan award. For Peter Lynas, the value of his 2018 Free Share award under the SIP was £394.
6. Jerry DeMuro is paid in US dollars with the disclosed figures above being converted into sterling at the required exchange rate. The 2018 salary reflects his 3.0% salary increase and the exchange rate fluctuations experienced in 2018.

There were no other payments to former directors in 2018.

Executive directors' remuneration in the year ending 31 December 2019

For the purposes of the Companies Act 2006, the Directors' remuneration policy (the Policy) has been operating in practice since the date of its approval on 10 May 2017 at the 2017 AGM. The remuneration for 2019 will be implemented as follows:

- The salary of the Chief Executive is increased by 2.5% to £919,500 with effect from 1 January 2019.
- The salary of the Group Finance Director is increased by 2.5% to £657,700 with effect from 1 January 2019.
- The salary of the President and Chief Executive Officer of BAE Systems, Inc. is increased by 2.5% to \$1,080,000 with effect from 1 January 2019.
- Annual and Long-Term Incentive opportunity levels remain in line with 2017 approved Policy.
- Long-Term Incentive awards of Performance Shares only for UK executive directors, and Performance Shares and Restricted Shares for US executive director.
- The performance measures and weightings for 2019 for the Annual Incentive and Long-Term Incentives are set out on page 116.
- 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.

External directorships

Fees retained in 2018 by executive directors, during the period in which they served in that capacity, in respect of non-executive directorships were: Peter Lynas £86,912 in respect of his directorship of SSE plc and Jerry DeMuro \$12,500 in respect of his (then) directorship of Aero Communications, Inc.

These amounts are not included in the remuneration table on page 105.

Annual bonus

Annual bonuses for the 2018 year are paid in March 2019. Annual bonus is made up of financial metrics, safety and personal objectives, designed to support the achievement of certain strategic outcomes necessary for sustaining the Group's long-term vitality. 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

Charles Woodburn

		Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2018	Target for 2018	Stretch for 2018	Actual performance ¹	Percentage of maximum opportunity
Measures			Below	Threshold	Target	Stretch					
Financial	Group underlying EPS	38.0					40.0p	42.1p	43.2p	41.8p	45.7%
	Group net debt	23.0					£(1,816)m	£(1,592)m	£(1,248)m	£(951)m	100%
	Group order intake ²	14.0					n/a	£29.2bn	£30.1bn	£29.2bn	50%
Personal	Safety	5.0					See note 3 below				45%
	Key strategic objectives	20.0					See Key strategic objectives section on page 108				80%
Total bonus (as a percentage of maximum)											65.6%

Group Finance Director

Peter Lynas

		Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2018	Target for 2018	Stretch for 2018	Actual performance ¹	Percentage of maximum opportunity
Measures			Below	Threshold	Target	Stretch					
Financial	Group underlying EPS	38.0					40.0p	42.1p	43.2p	41.8p	45.7%
	Group net debt	23.0					£(1,816)m	£(1,592)m	£(1,248)m	£(951)m	100%
	Group order intake ²	14.0					n/a	£29.2bn	£30.1bn	£29.2bn	50%
Personal	Safety	5.0					See note 3 below				45%
	Key strategic objectives	20.0					See Key strategic objectives section on page 108				70%
Total bonus (as a percentage of maximum)											63.6%

President and Chief Executive Officer of BAE Systems, Inc.

Jerry DeMuro

		Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2018	Target for 2018	Stretch for 2018	Actual performance ¹	Percentage of maximum opportunity
Measures			Below	Threshold	Target	Stretch					
Financial	Group underlying EPS	12.7					40.0p	42.1p	43.2p	41.8p	45.7%
	Group net debt	7.7					£(1,816)m	£(1,592)m	£(1,248)m	£(951)m	100%
	Group order intake ²	4.7					n/a	£29.2bn	£30.1bn	£29.2bn	50%
	BAE Systems, Inc. underlying EBITA	25.3					\$1,259.9m	\$1,304.8m	\$1,327.2m	\$1,227.9m	0%
	BAE Systems, Inc. debt	15.3					\$2,480m	\$2,553m	\$2,656m	\$2,547m	73.8%
	BAE Systems, Inc. order intake	9.3					n/a	\$11.09bn	\$11.65bn	\$12.5bn	100%
Personal	Safety	5.0					See note 3 below				45%
	Key strategic objectives	20.0					See Key strategic objectives section on page 108				70%
Total bonus (as a percentage of maximum)											52.7%

The above table has been subject to audit.

- Adjusted to be on a like-for-like basis with the targets.
- The Committee exercised its discretion in respect of the Group order intake measure and assessed the actual outcome of £28.3bn as on-target achievement, even though the on-target level had been set at £29.2bn. In doing so, the Committee recognised the order intake for 2018 was a record achievement, and that the prevailing geopolitical climate has created an unavoidable delay in translating the March 2018 Memorandum of Intent between the UK government and the Kingdom of Saudi Arabia for a further 48 Typhoon aircraft, support and transfer of technology and capability into a confirmed order.
- Performance against the safety element of the bonus was determined by the Corporate Responsibility Committee (whose composition is stated on page 87). The objective requires a reduction in the level of significant risk and improvement in safety culture, as well as targeted improvements against key safety indicators including a reduction in recordable injuries. Although the Company met its stretch target for reduction in recordable injuries, the amount awarded was reduced by the Committee to reflect the incident at Radford, Virginia, which resulted in an employee fatality and two other employees being seriously injured.

Annual remuneration report

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Key strategic objectives

Achievement against key strategic objectives represents 20% of the annual bonus opportunity applicable to each of the executive directors. These objectives relate to the delivery of the Group's strategic objectives and demonstration of leadership behaviours. In 2018, a new framework was introduced whereby the executive directors and Executive Committee members were assigned primary responsibility for, or required to support, a set of shared common strategic objectives. The objectives were both technical and organisational, grouped under the three key areas of Operational Excellence, Competitive Edge and Technology Innovation. On the technical side, the objectives ranged from leveraging technology, engineering and manufacturing capabilities and driving flawless programme execution to delivering savings through global collaboration across the broader enterprise. From an organisation perspective, objectives ranged from embedding the new organisation structure and maintaining the highest standards of business conduct, to implementing a strategy for talent management that included strategic workforce planning and the ability to attract and retain a diverse workforce.

Key achievements in the year included:

Charles Woodburn Chief Executive	Peter Lynas Group Finance Director	Jerry DeMuro President and Chief Executive Officer of BAE Systems, Inc.
Operational Excellence		
– Achieved significant orders across the sectors including Amphibious Combat Vehicle, F-35 production and SEA5000. – Improved execution and performance on a number of programmes, particularly in the Maritime sector. – Achieved key project salients and milestones.	– Ensured plan performance for profit, cash and orders achieved or exceeded. – Reinforced growth strategy. – Developed and implemented contractual constructs to support financial performance.	– Achieved significant orders including Amphibious Combat Vehicle and F-35 production. – Delivered key project salients and milestones against ambitious performance goals. – Maintained Group's licence to trade in US.
Competitive Edge		
– Delivered significant global procurement savings. – Drove global collaboration opportunities and streamlined procurement process, thereby improving the Company's ability to compete for future business. – Strengthened the role of functional councils and increased commitment to research and development. – Embedded the new organisation structure. – Implemented strategy to strengthen performance management and to support succession planning, talent management and diversity and inclusion targets. – Increased employee engagement to support culture change and strategy.	– Delivered significant global procurement savings. – Addressed challenging capital allocation issues, including pension funding. – Maintained transparent and credible communications with investors, rating agencies and other stakeholders. – Embedded stronger performance accountability and culture throughout the organisation.	– Implemented organisational changes to enhance execution in key platform areas. – Collaborated successfully with rest of Group on various programmes including M777 India and F-35 flight trials on HMS Queen Elizabeth. – Provided strong leadership to achievement of procurement savings, succession and performance culture change in the US business.
Technology Innovation		
– Made progress in strengthening Company's technology capability and positioning.		– Met IT improvement objectives. – Strengthened technology capabilities and continued to expand the product suite to enhance competitive positioning in the US defence market.
Achievements were offset by shortcomings in programme performance and the need to continue to drive safety culture.	Performance achievements were offset by lack of progress in rationalising certain non-core businesses.	Achievements were offset by shortcomings in programme performance under certain legacy contracts and safety outcomes.
Payout (% of maximum): 80%	Payout (% of maximum): 70%	Payout (% of maximum): 70%

Long-Term Incentive Plan (LTIP) performance

Annual average diluted underlying EPS growth

Outperformance of performance conditions ending on 31 December 2018	Threshold	Maximum	Actual	Percentage of maximum achieved
2018 EPS requirement	43.7p	48.5p	42.8p	
Annual average EPS growth	3%	7%	<3%	0%

Relative TSR against comparator groups

Outperformance of performance conditions ending on 31 December 2018	Threshold	Maximum	Actual	Percentage of maximum achieved
TSR against sectoral comparator group	56.8%	70.3%	21.9%	0%
TSR against FTSE 100 comparator group	14.9%	56.0%	21.9%	37.6%
Overall vesting against TSR				18.8%

2016 Performance Shares (LTIP PS)

- Performance conditions: half on relative TSR against two comparator groups (with equal weighting), half on EPS growth of 3% to 7% per annum. The TSR three-year performance period ended on 31 December 2018 and resulted in 18.8% vesting of the TSR portion. The Committee is satisfied that there has been a sustained improvement in the Company's underlying financial performance and that it is appropriate for vesting of 18.8% of the TSR portion. With respect to the 2016 LTIP PS^{EPS} award, for which the performance period also ended on 31 December 2018, the related performance condition was not met and thus this portion of the award will lapse.

2016 Share Options (LTIP SO)

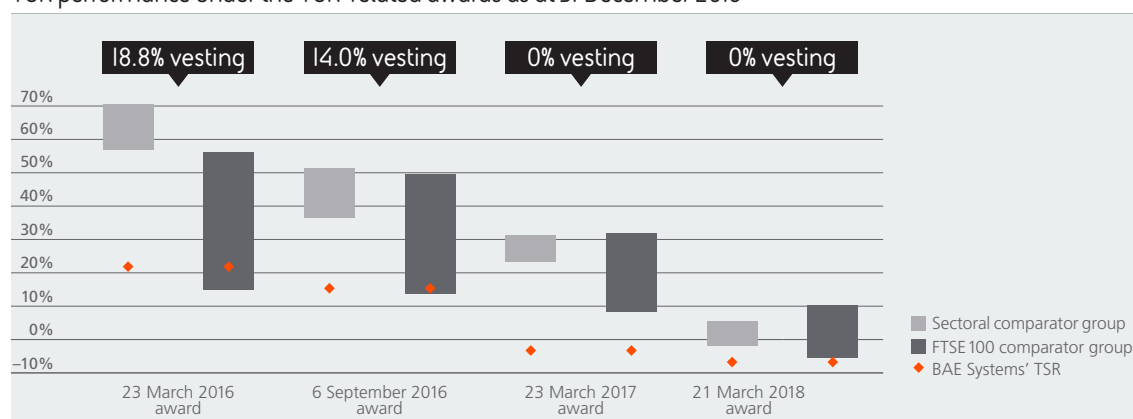
- Performance condition: relative TSR against two comparator groups (with equal weighting). The TSR three-year performance period ended on 31 December 2018 and resulted in 18.8% vesting.

In respect of the 2016 LTIP PS^{TSR} and LTIP SO awards made to Charles Woodburn in September 2016, the performance period ends on 30 June 2019 with the TSR performance condition tested at that time and the outcome due to be reported in the 2019 Remuneration Report. The EPS portion of his 2016 LTIP PS, for which the performance period ended on 31 December 2018, will lapse as the related performance condition was not met.

A summary of TSR performance to 31 December 2018 on outstanding TSR-related LTIP awards is illustrated in the chart below. The vesting percentage for the 23 March 2016 award is the actual vesting outcome referred to above.

The grey boxes show the range of TSR required for 25% vesting to full vesting in respect of the sectoral international defence and FTSE 100 comparator groups, as appropriate, and the orange diamonds 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 2018



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Pension entitlements

Total pension entitlements

Director	Age	Normal retirement age	Accrued benefit at 1 January 2018 ^{1,2} £ per annum	Accrued benefit at 31 December 2018 ^{1,2} £ per annum	Figures included in the remuneration table on page 105		
					Added pension value received in the year from defined benefit scheme ² £	Added pension value received in the year from defined contribution scheme £	Total £
Charles Woodburn	47	65	17,486	27,037	n/a	—	—
Peter Lynas	60	62	285,564	319,969	460,311	n/a	460,311
Jerry DeMuro	63	65	136,043	169,031	n/a	12,954	12,954

1. Accrued benefit for Charles Woodburn is the total value of his defined contribution account, including employee contributions and investment returns. Accrued benefit for Jerry DeMuro is the total value of his Section 401(k) account, including both employee and company contributions as well as investment returns.
2. The figure includes both funded and unfunded defined benefit arrangements for Peter Lynas. Accrued benefit for Peter Lynas is annual pension payable on retirement prior to any reduction for early payment or exchanging pension for cash. In addition, a longevity adjustment factor is applied to pension accrued after 5 April 2006 to mitigate against life expectancy changes. The figures allow for the current factors in force, whereas in practice the factors are updated annually and those in force at retirement will be applied.

The above table has been subject to audit.

Charles Woodburn participates in the BAE Systems Executive Pension Scheme Defined Contribution Retirement Plan (EPS DCRP), which is a defined contribution arrangement for senior executives. Charles Woodburn contributes the maximum £10,000 per annum into the EPS DCRP arrangement as permitted by the Annual Allowance and a 19% salary supplement is paid in lieu of the Company contributions.

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 (2019 \$19,000; 2018 \$18,500). In 2018, the company paid contributions of \$16,500 into this arrangement.

Peter Lynas is a member 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 average final salary for each year of service subject to the payment of members' contributions (currently 8%). Benefits paid prior to age 62 for ExPS and age 65 for 2000 Plan 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. Spouses' pensions 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. Peter Lynas joined the ExPS in 1999.

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. Peter Lynas has 33 years and two months' service in the 2000 Plan.

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 and the impact of the reduced Annual Allowance. Peter Lynas was given the choice to remain in the current arrangement and pay the increased tax or to take an unfunded promise; he 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.

Therefore, Peter Lynas' total pension is the sum of his 2000 Plan benefits plus the top-up from the ExPS, most of which is provided through the unfunded promise referred to above.

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
Charles Woodburn									
LTIP PS ^{TSR}	Performance Shares/nil cost option	20.03.18	285,227	185% of salary	1,659,451	nil	Three years to 31.12.20	TSR/secondary financial measure	25%
LTIP PS ^{EPS}	Performance Shares/nil cost option	20.03.18	285,227	185% of salary	1,659,451	nil	Three years to 31.12.20	EPS/secondary financial measure	25%
Peter Lynas									
LTIP PS ^{TSR}	Performance Shares/nil cost option	20.03.18	184,731	167.5% of salary	1,074,765	nil	Three years to 31.12.20	TSR/secondary financial measure	25%
LTIP PS ^{EPS}	Performance Shares/nil cost option	20.03.18	184,731	167.5% of salary	1,074,765	nil	Three years to 31.12.20	EPS/secondary financial measure	25%
Jerry DeMuro									
LTIP PS ^{TSR}	Performance Shares	20.03.18	194,279	149% of salary	1,130,315	n/a	Three years to 31.12.20	TSR/secondary financial measure	25%
LTIP PS ^{EPS}	Performance Shares	20.03.18	194,280	149% of salary	1,130,321	n/a	Three years to 31.12.20	EPS/secondary financial measure	25%
LTIP RS	Retention	20.03.18	195,584	150% of salary	1,137,908	n/a	n/a	n/a	n/a

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. RS – Restricted Shares.

Note: Performance Shares and Restricted Shares – Shares under award attract notional reinvested 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 conditional share awards (rather than share options) and are deliverable on the third, fourth and fifth anniversary of grant, subject to attainment of the performance condition. For the UK executive directors, shares vest on the fifth anniversary of grant.

The table above has been subject to audit.

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Description of share plans and summary of performance conditions

Long-term incentives operate under the BAE Systems Long-Term Incentive Plan (LTIP) approved by shareholders at the 2014 AGM. The three main vehicles in use are Performance Shares, Share Options and Restricted Shares.

LTIP Performance Shares

Up to 2017, shares under award vest after satisfaction of the three-year performance condition. Awards that vest are capable of exercise in three equal tranches on a phased basis from the third, fourth and fifth anniversary of grant. Any unexercised awards will lapse on the seventh anniversary of grant. From 2018, awards to non-US executive directors remain subject to the three-year performance period but will not vest until the fifth anniversary of grant. They will be exercisable until the seventh 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. Shares under award attract notional reinvested dividends prior to tranche vesting.

Awards are weighted 50% on the EPS performance condition and 50% on the TSR performance condition as set out below. The TSR sectoral comparator group is shown below.

Plan	Performance condition
LTIP PS ^{EPS}	Rate of average annual diluted underlying 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.
LTIP PS ^{TSR}	For awards made from 2016, the proportion of the award capable of exercise is determined by: (i) 50% of the TSR measure is on the current sectoral comparator group of 13 other international defence companies and 50% is 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 less than median TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if the Company's TSR 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; EBITA¹; order book; turnover; risk; and project performance.

1. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments.

The TSR sectoral comparator group for awards from 2016 comprises:

Cobham	Leonardo ³	SAIC
General Dynamics	Lockheed Martin	Thales
Harris Corporation	Meggitt	United Technologies
L3 Technologies ²	Northrop Grumman	
Leidos	Raytheon	

2. Formerly named L-3 Communications.

3. Formerly named Finmeccanica.

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. Awards are subject to a further two-year clawback period after the initial three-year vesting period. From 2018 executive directors no longer receive share option awards.

Plan	Performance condition
LTIP SO	For awards made from 2016, 50% of the TSR measure is on the current sectoral comparator group of 13 other international defence companies and 50% is 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 less than median TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if the Company's TSR is in the top quintile and vesting on a straight-line basis between these two parameters.

LTIP Restricted Shares

Restricted Shares are not subject to a performance condition as they are 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 notional reinvested dividends prior to vesting. Awards made to the US executive director are subject to a further two-year clawback period after the initial three-year vesting period.

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 (including the portion of net annual bonus deferred compulsorily into BAE Systems shares) and his/her spouse count towards the MSR. Any case of non-compliance would be dealt with by the Committee.

The MSR does not currently apply after the individual has ceased to be a director. The Committee intends to make necessary changes to the existing policy to ensure an appropriate post-cessation holding policy is in place, as part of the broader executive remuneration policy proposals to be submitted for approval at the Company's Annual General Meeting (AGM) in May 2020.

The following table sets out MSR Initial Value and Subsequent Value and actuals as at 31 December 2018:

	Initial Value	Subsequent Value	Actual
Charles Woodburn	150%	300%	71%
Peter Lynas	100%	200%	188%
Jerry DeMuro	212.5%	425%	186%

The actual MSR figures in the table are provided as at 31 December 2018, based on the year-end share price of £4.59. The share price fluctuated throughout the year such that for the majority of the year, the actual MSR figures held by the executive directors were accordingly higher.

Charles Woodburn and Jerry DeMuro joined the Board in 2016 and 2014 respectively, and have been gradually building up their shareholdings. The higher MSR values applicable to Jerry DeMuro (which were increased at the beginning of 2018) recognise the higher LTI opportunity and broader US market practice.

There are MSR requirements in place for all of the employee population who receive LTIPs.

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

Share interests as at 31 December 2018

The interests of the directors who served during the year ended 31 December 2018 in the shares of BAE Systems plc, or scheme interests in relation to those shares, were as follows:

	Shares	Scheme interests: Options and awards over shares				Total scheme interests
		Share awards with performance conditions	Share awards without performance conditions	Share options with performance conditions	Share options with performance conditions, vested but unexercised	
Sir Roger Carr	126,093	–	–	–	–	–
R Advaiti ¹	–	–	–	–	–	–
E P L Corley	19,000	–	–	–	–	–
J DeMuro	335,766	1,082,993	463,597	1,045,249	–	2,591,839
H Green	–	–	–	–	–	–
C M Grigg	24,555	–	–	–	–	–
P J Lynas	264,289	–	–	1,457,948	–	1,457,948
P Rosput Reynolds	25,200	–	–	–	–	–
N C Rose	55,000	–	–	–	–	–
I P Tyler	–	–	–	–	–	–
C N Woodburn	138,226	–	–	2,257,641	–	2,257,641

1. Appointed to the Board on 1 January 2018.

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 6,300 American Depositary Shares. Details of the share interests in options and awards held by the executive directors as at 31 December 2018 are given on page 114 together with details of nil-cost options exercised in 2018.

Performance Shares granted under the LTIP are classified as share awards with performance conditions for the US executive director and as nil-cost options with performance conditions for the UK executive directors.

Since 31 December 2018, Charles Woodburn has acquired an additional 87 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 138,313.

There have been no changes in the interests of the remaining directors in the shares of BAE Systems plc between 31 December 2018 and the date of this report.

Annual remuneration report

continued

Breakdown of scheme interests: Options and awards held as at 31 December 2018

Charles Woodburn

	31 December 2018	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{TSR}	334,833 ¹	06.09.16	nil	06.09.19
LTIP PS ^{EPS}	334,833 ²	06.09.16	nil	06.09.19
LTIP PS ^{TSR}	132,897 ¹	21.03.17	nil	21.03.20
LTIP PS ^{EPS}	132,897 ¹	21.03.17	nil	21.03.20
LTIP PS ^{TSR}	285,227 ¹	20.03.18	nil	20.03.23
LTIP PS ^{EPS}	285,227 ¹	20.03.18	nil	20.03.23
	1,505,914			
LTIP SO	405,040 ¹	06.09.16	5.56	06.09.19
LTIP SO	346,687 ¹	21.03.17	6.49	21.03.20
	751,727			

Peter Lynas

	31 December 2018	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{EPS}	34,510 ³	25.03.15	nil	25.03.19
LTIP PS ^{TSR}	123,060 ⁴	23.03.16	nil	23.03.19
LTIP PS ^{EPS}	123,060 ²	23.03.16	nil	23.03.19
LTIP PS ^{TSR}	96,944 ¹	21.03.17	nil	21.03.20
LTIP PS ^{EPS}	96,945 ¹	21.03.17	nil	21.03.20
LTIP PS ^{TSR}	184,731 ¹	20.03.18	nil	20.03.23
LTIP PS ^{EPS}	184,731 ¹	20.03.18	nil	20.03.23
	843,981			
LTIP SO	343,424 ⁴	23.03.16	4.99	23.03.19
LTIP SO	270,543 ¹	21.03.17	6.49	21.03.20
	613,967			

1. Subject to a performance condition that is yet to be tested.
2. The outstanding option or award will lapse after the end of the financial year having not met the full performance condition.
3. Subject to a performance condition that has been met.
4. The outstanding option or award will partially lapse after the end of the financial year having not met the full performance condition.

Performance Shares – nil cost options exercised during 2018

Peter Lynas

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
LTIP PS ^{EPS}	17,254	nil	25.03.15	12.04.18	5.92

The Performance Shares nil-cost option exercised by Peter Lynas attracted notional reinvested dividends which equated to an additional 1,976 shares on exercise of this tranche.

The tables above have been subject to audit.

Performance conditions

Performance conditions for the LTIP are detailed on page 112.

Jerry DeMuro

	31 December 2018	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{EPS}	45,844 ³	25.03.15	n/a	25.03.19
LTIP PS ^{TSR}	168,203 ⁴	23.03.16	n/a	23.03.19
LTIP PS ^{EPS}	168,203 ²	23.03.16	n/a	23.03.19
LTIP PS ^{TSR}	156,092 ¹	21.03.17	n/a	21.03.20
LTIP PS ^{EPS}	156,092 ¹	21.03.17	n/a	21.03.20
LTIP PS ^{TSR}	194,279 ¹	20.03.18	n/a	20.03.21
LTIP PS ^{EPS}	194,280 ¹	20.03.18	n/a	20.03.21
	1,082,993			
LTIP SO	542,143 ⁴	23.03.16	4.99	23.03.19
LTIP SO	503,106 ¹	21.03.17	6.49	21.03.20
	1,045,249			
LTIP RS	139,011	23.03.16	n/a	23.03.19
LTIP RS	129,002	21.03.17	n/a	21.03.20
LTIP RS	195,584	20.03.18	n/a	20.03.21
	463,597			

Remuneration Committee composition and advisers

The Committee members comprise Paula Rosput Reynolds (Chairman), Elizabeth Corley and Nick Rose. Advisers to the Remuneration Committee are shown below.

During the year, the Committee received material assistance and advice on remuneration policy from the Group Human Resources Director, Karin Hoeing, and the Human Resources Director, Reward, Paul Farley. Charles Woodburn in his role as Chief Executive, also provided advice that was of material assistance to the Committee.

Adviser	Services provided	Appointment	Governance	Fees (in respect of services provided to the Committee)
PricewaterhouseCoopers (PwC)	Independent adviser to the Committee, including attendance at Remuneration Committee meetings. Also provided information on market practice in relation to different aspects of remuneration, market trends and benchmarking of the remuneration packages for the executive population.	Committee appointment. By the Company at the request of the Committee.	The Committee is aware that PwC provides a variety of other services to the Company, including tax and pensions advice. PwC also provides a range of consultancy services. PwC is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£81,652 Fee basis: Hourly
Linklaters	Provided legal services, principally regarding all-employee share plans and plan rule changes relating to the EU's General Data Protection Regulations.	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 provide legal advice and services to the Company on a range of matters. Linklaters is regulated by the Law Society.	£8,574 Fee basis: Hourly
Aon	Advises on the TSR outcomes as required for assessing the performance condition under the BAE Systems Long-Term Incentive Plan 2014.	By the Company.	The Committee is aware that Aon provides a variety of other human resources-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. Aon is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£19,400 Fee basis: Fixed fee

Preface to the Directors' remuneration policy

The Directors' remuneration policy (the Policy) set out on pages 117 to 129 was agreed by shareholders at the Annual General Meeting (AGM) on 10 May 2017 and took legal effect on that date. The approved policy has been re-printed verbatim from the 2016 Annual Report, updated only so that the page numbers, where appropriate, refer to the 2018 Annual Report in order to aid readability, and to report subsequent Board membership changes.

Directors' remuneration for 2019

For 2019, it remains our intention to operate the Policy that was agreed by shareholders at the 2017 AGM. This section sets out how the Policy will apply in 2019.

Metrics and weightings applicable in 2019

- The performance metrics and weightings applicable to the 2019 annual incentive are 75% on financial metrics relating to Group underlying EPS, Group net debt and Group order intake, 5% on safety and 20% on personal objectives designed to support the Group's strategy. As set out in our Remuneration Committee Chairman's letter on page 92, recognising the significant focus on delivering earnings growth in 2019, the following weighting of financial measures will apply:

	Group underlying EPS/EBITA %	Group debt %	Order intake %	Total %
2019				
Allocation	45	22.5	7.5	75
Weighting	60	30	10	100

- There are no changes proposed to the quantum applicable to the executive directors, and one-third of the net annual incentive will continue to be deferred into shares for three years on a compulsory basis.
- Performance Shares will continue to have 50% of the award based on TSR performance as follows: 50% of the TSR measure on the current sectoral comparator group of 13 other international defence companies and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. For 2019, the remaining 50% of the award is subject to the EPS condition with a performance range of 3% to 7% average annual EPS growth requirement. For US participants, other than members of the Executive Committee, 50% of the awards made in 2019 are subject to the long-term operating cash performance of the US business in place of TSR performance.
- There is no change in 2019 to the criteria and weightings applying to Restricted Shares.
- UK executive directors will receive Performance Shares only. The US executive director will receive an equal weight in expected value in Performance Shares and Restricted Shares.

Illustration of application of policy for 2019

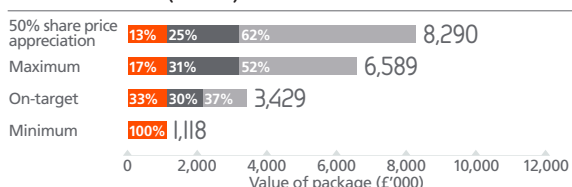
The following charts show the value of the package each of the executive directors would receive based on 2019 base salaries, remuneration and 2019 LTI awards assuming the following scenarios:

- minimum fixed pay (including salary, benefits and pension as provided in the single total figure table on page 105), and the Restricted Shares award for the US executive director;
- pay receivable assuming on-target performance is met;
- maximum pay assuming all variable elements pay out in full; and
- 50% share price appreciation on maximum pay out.

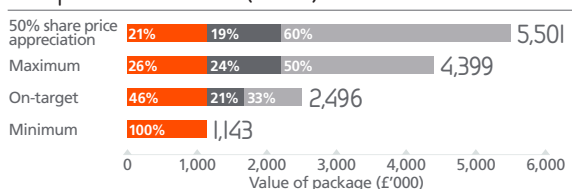
The minimum, on-target and maximum scenarios exclude any share price appreciation and dividends. 50% share price appreciation assumes all variable elements pay out in full and there is 50% gain in share price in respect of Performance Shares and Restricted Shares awards received.

UK legislation requires that these charts are given in relation to the first year in which the remuneration policy takes legal effect (see page 125). The charts below are reporting the actual levels for 2019.

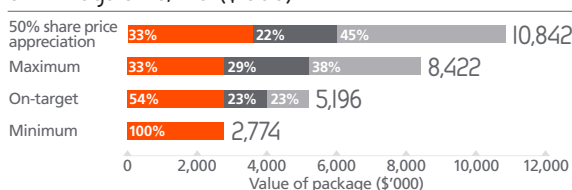
Chief Executive (£'000)



Group Finance Director (£'000)



President and Chief Executive Officer of BAE Systems, Inc. (\$'000)



- Fixed elements of remuneration
- Annual bonus
- Performance Shares

Directors' remuneration policy

This Directors' remuneration policy (the Policy) will take legal effect from the conclusion of the 2017 Annual General Meeting (AGM) subject to shareholder approval at the 2017 AGM¹.

The Remuneration Committee (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.

The 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 Plan provides the Committee with discretion in respect of vesting outcomes that affect the actual level of reward payable to individuals, as explained on page 120, such discretion would only be used in exceptional circumstances and, if exercised, disclosed at the latest in the report on implementation of the Policy (i.e. the Annual remuneration report) for the year in question.

Changes compared to the policy approved at the 2014 AGM

The Policy contains no components which were not in the remuneration policy approved at the 2014 AGM. However, the material changes from the policy approved in 2014 are summarised below with the supporting rationale provided in the Remuneration Committee Chairman's letter on pages 79 to 82 of the 2016 Annual Report.

Salary

- Clarity on cap on salary increases.

Annual incentive

- Introduction of separate maximum for Chief Operating Officer.
- Introduction of limits for new executive director role.
- Incorporation of malus and clawback mechanisms.

Long-Term Incentives (LTI)

- Introduction of reasonableness discretion.
- Introduction of separate maximum for Chief Operating Officer.
- Introduction of limits for new executive director role.
- Clarity on flexibility to vary weightings of different award types and the associated impact on opportunity levels subject to the parameters set out.
- Incorporation of malus and clawback mechanisms.
- Introduction of two-year holding period for shares acquired on vesting of awards to non-US directors.
- Introduction of Earnings per Share (EPS) alongside Total Shareholder Return (TSR) on share options with equal weighting.
- Removal of Share Options for US executive director and redistribution into Performance Shares and Restricted Shares to maintain current Expected Value.
- Increase in Minimum Shareholding Requirement for US executive director.

Pension

- Participation in executive defined contribution retirement plan (or cash equivalent) introduced as default pension vehicle for new directors.
- Inclusion of salary supplement as vehicle to offset impact of Lifetime Allowance and/or Annual Allowance.

Non-executive directors' fees

- Introduction of maximum for Chairman's fees and benefits.

1. Approved at the AGM on 10 May 2017.

Directors' remuneration policy

continued

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 setting and 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 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 while performing the same role, 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 for executive directors performing the same role. If an individual's role changes then a salary increase above 10% may be awarded in any single year to position their salary appropriately in accordance with the base salary principles described under 'Operation' above. As a matter of policy, no new executive director role will have a salary greater than the Chief Executive at that time.

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

The annual incentive is driven off in-year financial performance, corporate responsibility and other non-financial objectives measured at the Group and individual level.

One-third of the total annual incentive amount is subject to compulsory deferral for three years in BAE Systems shares without any matching.

A malus mechanism may be applied to any bonus, and a clawback mechanism may be applied to the deferred bonus shares until up to the end of the three-year deferral period, in respect of 2015 or subsequent years where:

- the Company is entitled to terminate employment for cause or the participant has engaged in misconduct (including breach of policy) which gives rise to other disciplinary sanction;
- the results of the Company and/or relevant business or businesses for any period have been restated or subsequently appear materially inaccurate or misleading; and/or
- any Group company or business unit has made a material financial loss.

Cash dividends are payable to the participants on the shares during this three-year deferral period.

Annual incentive continued**Maximum opportunity**

Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc.: 225% of salary

Chief Operating Officer: 200% of salary

Group Finance Director: 160% of salary

Where a new executive director role is established, the maximum opportunity will not exceed that of the Chief Operating Officer role as set out above.

The pay-out for maximum performance is double the payout for on-target performance. The pay-out for target performance is half of the respective maximum percentages above. The pay-out for achieving a threshold performance is 40% of the payout for on-target performance (i.e. 20% of maximum), with no pay-out for achieving less than this. Pay-out for performance between targets is calculated on a straight-line basis.

Performance metrics used, weighting and time period applicable

Performance is assessed on an annual basis, using a combination of the Group's main performance indicators for the year and other objectives designed to support the Group's strategy. Metrics, which will include financial and non-financial metrics as well as the achievement of personal objectives, will be determined and weighted each year according to business priorities. 75-80% will relate to financial metrics.

Metrics and weightings to be determined annually. Proposed metrics and weightings applicable in 2017:

Group EPS – 40%

Group cash – 25%

Order intake – 15%

Safety – 5%

Personal objectives designed to support the Group's strategy – 15%

See notes 4 and 5 on page 124 regarding the selection and weighting of performance metrics.

Notwithstanding performance against the applicable metrics, all bonus payments are at the discretion of the 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**

Long-term incentives will operate under the BAE Systems Long-Term Incentive Plan approved by shareholders at the 2014 AGM.

The size of awards granted is based on a percentage of salary, which is divided by the share price to determine the number of shares subject to the award.

Dividend equivalents in respect of vested shares may be paid at the time of vesting (or exercise, in the case of options) and are not taken into account when determining individual limits.

A malus and clawback mechanism may be applied, until two years after vesting, or if sooner, the fifth anniversary of grant, or the occurrence of certain corporate events, to all awards granted on or after 25 March 2015 where:

- the Company is entitled to terminate employment for cause or the participant has engaged in misconduct (including breach of policy) which gives rise to other disciplinary sanction;
- the results of the Company and/or relevant business or businesses for any period have been restated or subsequently appear materially inaccurate or misleading;
- any Group company or business unit has made a material financial loss; and/or
- the measurement of any performance condition does not reflect the actual performance of the Company over the performance period.

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 of awards already granted may be amended in accordance with their terms or if anything happens which causes the Committee reasonably to consider it appropriate to do so.

Performance metrics used, weighting and time period applicable

See notes 4 and 5 on page 124 regarding the selection and weighting of performance metrics.

Directors' remuneration policy

continued

Executive directors' policy table continued

Long-Term Incentives (LTI) continued

Maximum opportunity

Over the lifetime of this Policy, the Committee will have discretion to vary the weighting of different types of awards within the framework set out below, but the overall LTI Expected Value (EV) will remain the same (assuming the LTI EV is calculated as 50% of face value for Performance Shares, 20% of face value for Share Options and 100% of face value for Restricted Shares):

- UK executive directors' awards will consist of a mix of Performance Shares and Share Options (with Share Options comprising no more than 50% of overall LTI EV).
- US executive directors' awards will consist of a mix of Performance Shares and Restricted Shares (with Restricted Shares comprising no more than 50% of overall LTI EV).

Performance metrics used, weighting and time period applicable

See below in relation to Performance Shares and Share Options.

In addition to the primary performance tests set out below, the Committee confirms and recognises its obligation to judge the overall reasonableness of the rewards received relative to the overall business actions and results achieved. When determining the final performance condition outcome under Performance Share and Share Option awards, the Committee will have discretion over the number of awards vesting in light of other important factors in the business (reasonable discretion). The discretion may result in vesting of awards going upwards (subject to maximum 100% vesting of awards) as well as downwards. Any factors will be properly considered as they arise and any discretion to the calculated results will be applied in a highly disciplined manner and the rationale and impact will be reported transparently. The use of reasonableness discretion would apply to LTI awards granted to executive directors after the commencement of this Policy.

See notes 4 and 5 on page 124.

Long-Term Incentives – Performance Shares

Purpose and link to strategy

Drive and reward delivery of sustained long-term EPS and TSR performance aligned to the interests of shareholders.

Operation

For non-US executive directors, awards, typically in the form of nil-cost options, will vest subject to performance and service conditions on the fifth anniversary of grant. These will be exercisable between the fifth and tenth anniversary of grant or such shorter period as may be specified by the Committee.

For US executive directors, awards are delivered as conditional share awards (RSUs). To maintain the competitiveness of the LTI offering in the US, awards will vest automatically on the third, fourth and fifth anniversary of grant, subject to performance conditions.

Policy maximum opportunity

Award levels applicable to UK executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Share Options) are as follows:

Chief Executive: 250% of salary

Chief Operating Officer: 230% of salary

Group Finance Director: 215% of salary

Award levels applicable to US executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Restricted Shares) are as follows:

President and Chief Executive Officer of BAE Systems, Inc.: 298% of salary

Note the percentages above could be exceeded if the LTI EV weightings were to be varied (see above).

Where a new executive director role is established, the maximum opportunity will not exceed that of the Chief Operating Officer role as set out above.

Long-Term Incentives – Performance Shares continued

Performance metrics used, weighting and time period applicable

Metrics and weightings will be as follows (subject to the Committee's ability to adjust as set out below):

- 50% of award based on TSR relative to one or more appropriate comparator groups over the three-year performance period as selected by the Committee at the time of grant:
 - Vesting of each comparator group is determined as: nil vesting if TSR ranked below median in the peer group; 25% vesting if TSR ranked at the median; 100% vesting if TSR ranked in the upper quintile; pro-rata vesting for performance between median and upper quintile.
 - If more than one comparator group is used, vesting of the TSR portion of the award will be determined by the average of the vesting outcomes from each comparator group.
 - Award subject to a secondary financial measure as set out on page 112.
- 50% of award based on average annual EPS growth over the three financial years starting with that in which the award is granted, with 25% vesting for threshold performance, 50% vesting for target performance and 100% vesting for stretch performance. Pro-rata vesting for intermediate performance.

The metrics and weightings applicable in 2017 are as follows:

- 50% of award based on TSR relative to the following two comparator groups over the three-year performance period:
 - At least ten other international defence companies selected by the Committee at the time of grant.
 - All companies in the FTSE 100 index.
- 50% of award based on average annual EPS growth over the three financial years starting with that in which the award is granted, with threshold performance requirement as average annual EPS growth of 3%, target performance requirement as average annual EPS growth of 5% and stretch performance requirement as average annual EPS growth of 7%.

Note that awards granted to executive directors from the date of the 2017 AGM would be subject to application of reasonableness discretion in light of other important factors in the business as described earlier.

The Committee can adjust the weighting of the EPS and TSR conditions and, if considered appropriate, the Committee may introduce an alternate performance condition aligned to the Company's strategy.

See notes 4 and 5 on page 124.

Long-Term Incentives – Share Options

Purpose and link to strategy

Drive and reward delivery of sustained long-term EPS and TSR performance and sustained improvement in the Company's share price.

Operation

Share Options have an exercise price set at market value at grant.

For non-US executive directors, awards vest subject to performance and service conditions on the fifth anniversary of grant and will be exercisable between the fifth and tenth anniversary of grant.

US executive directors are not eligible.

Policy maximum opportunity

Award levels applicable to UK executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Share Options) are as follows:

Chief Executive: 300% of salary

Chief Operating Officer: 300% of salary

Group Finance Director: 300% of salary

Note the percentages above could be exceeded if the LTI EV weightings were to be varied (see page 120).

Where a new executive director role is established, the maximum opportunity will not exceed that of the Chief Operating Officer role as set out above.

Performance metrics used, weighting and time period applicable

For Share Option awards made to the executive directors, exercise is subject to the TSR and EPS performance conditions (subject to any adjustment described above) and application of reasonableness discretion as set out above.

Note that for Share Option awards granted to the executive directors prior to the 2017 AGM, exercise is subject to the TSR performance conditions as set out in our policy approved at the 2014 AGM.

See notes 4 and 5 on page 124.

Directors' remuneration policy

continued

Executive directors' policy table continued

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 competitive market practice and retention issues principally in the US. Non-US executive directors are not eligible.

Policy maximum opportunity

Award levels applicable to US executive directors for normal annual grants (assuming the current LTI EV weightings in Performance Shares and Restricted Shares) are as follows:

President and Chief Executive Officer of BAE Systems, Inc.: 150% of salary

Performance metrics used, weighting and time period applicable

None.

See notes 4 and 5 on page 124.

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. The main benefits in the UK include a car allowance (currently £16,000 per annum), private use of a chauffeur-driven car and annual medical screening, plus life assurance and ill-health benefit cover provided 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.

In the US, benefits include a cash allowance for car and parking (currently \$20,900 per annum) and private use of a chauffeur-driven car, medical and dental benefits, and insured life and disability benefits.

Additional benefits, such as relocation assistance, may also be provided in certain circumstances if considered reasonable and appropriate by the Committee. Relocation assistance comprises reimbursement for direct items of expenditure, such as legal, estate agency, removals and temporary accommodation.

Directors' and Officers' insurance cover is also provided for all executive directors.

Maximum opportunity

Benefits are set at a level which the Committee considers to be appropriate against comparable roles in companies of similar size in the relevant market.

Benefits are as reported and itemised within the single total figure shown as part of the Annual remuneration report on page 99. The maximum cost of such benefits will reflect the associated market-competitive cost of provision. Relocation assistance is based on actual costs incurred which are linked to the size and value of the property, plus a maximum relocation allowance of £2,500.

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

The current Chief Executive¹ and Group Finance Director as at 22 February 2017² are members of the BAE Systems Executive Pension Scheme and members of an underlying employee pension plan, which together 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% of salary. Further detail is provided on page 107 as part of the Annual remuneration report.

The current Chief Operating Officer¹ as at 22 February 2017² is a member of the defined contribution section of the BAE Systems Executive Pension Scheme (EPS DCRP). In line with our policy, Company contributions are 19% of salary and member contributions are 6% of salary. Where the Annual Allowance (AA) is breached, as is the case with the Chief Operating Officer, he will pay member contributions up to the AA limit and the Company contributions will be paid as a salary supplement.

For any new externally-appointed UK executive directors, or internally appointed UK executive directors who are not members of a BAE Systems defined benefit scheme, membership of the BAE Systems EPS DCRP is offered with contribution requirements set as a percentage of base salary dependent on grading. Individuals may elect to receive some or all of their Company contributions as a cash allowance. For any internally-appointed UK executive directors who are already members of a BAE Systems defined benefit scheme, the Company may offer to maintain their membership in that pension arrangement (with the contribution rates appropriate to that arrangement), or the choice of membership of the BAE Systems EPS DCRP as set out above.

Where UK executive directors' pension entitlement or accrual is restricted to the Lifetime Allowance (LTA) and/or the AA, the Company may offer an unfunded pension promise or salary supplement to offset the impact of these restrictions.

The current President and Chief Executive Officer of BAE Systems, Inc. as at 22 February 2017² participates in a Section 401(k) defined contribution arrangement in which the company matches his contributions up to a maximum of 6% of salary, subject to US regulatory limits.

Any new externally-appointed US executive directors, or internally-appointed US executive directors who are not members of a pension plan, would be offered membership of the US Section 401(k) defined contribution plan. For any internally-appointed US executive directors who are members of the 2006 Plan and Non-Qualified Plan, these plans provide a cash sum at retirement equal to the sum of the annual accruals, currently set at \$1,000 from the 2006 Plan and \$500 from the Non-Qualified Plan. The Company may offer to maintain membership of the 2006 Plan and Non-Qualified Plan, in addition to membership of the US Section 401(k) defined contribution plan.

Maximum opportunity

The BAE Systems EPS DCRP provides a maximum Company contribution of 19% (in addition to employee contribution of 6%) of base salary.

Under the existing executive defined benefit scheme, a maximum of two-thirds of FPE is accrued at 1/30th for each year of service.

Where UK executive directors' pension entitlement or accrual is restricted to the LTA and/or the AA, the Company may offer an unfunded pension promise or salary supplement to offset the impact of these restrictions.

The US Section 401(k) defined contribution plan provides 100% company matching contributions up to a maximum of 6% of base salary, subject to US statutory limits.

For US executive directors who are members of the 2006 Plan and Non-Qualified Plan, these plans provide a cash sum at retirement equal to the sum of the annual accruals, currently set at \$1,000 from the 2006 Plan and \$500 from the Non-Qualified Plan.

1. Ian King, Chief Executive as at 22 February 2017, retired on 30 June 2017. Charles Woodburn, Chief Operating Officer as at 22 February 2017, was appointed as Chief Executive with effect from 1 July 2017.

2. Date of approval of the Company's 2016 Annual Report in which this policy was originally published.

Directors' remuneration policy

continued

Executive directors' policy table 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. LTI grants may be made to the most senior managers in the business (approximately 400 individuals globally). The nature of the awards depends on the individual's location, roles and responsibilities, in particular:
 - performance conditions and targets for performance share grants made to UK and Rest of World participants are made in line with those applying to executive directors;
 - for US participants below Executive Committee level, performance share grants are normally subject to BAE Systems, Inc. operating cash flow and EPS performance conditions and targets;
 - Performance Shares applicable to participants below executive director level vest on the third anniversary subject to performance conditions and are exercisable (or released in the case of US participants) in equal tranches on the third, fourth and fifth anniversary of grant;
 - Share Options are granted to participants below executive director level; there are no performance conditions attached and they vest and are exercisable after three years; and
 - Restricted Share grants are currently made to the most senior managers in the US businesses reflecting competitive market practice and vest after three years.

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. Any non-financial performance targets are determined by the Committee in consultation with the Corporate Responsibility Committee.
5. The performance conditions and targets are determined annually by the Committee (within the parameters set out above), 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 LTI 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. The Committee has discretion to increase the Initial Value and/or Subsequent Value (see below). 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.

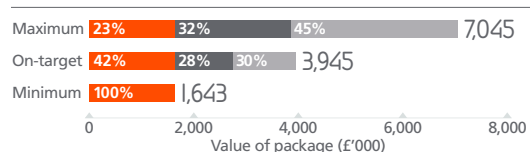
The following table sets out MSR Initial Value and Subsequent Value applicable from 2018:

	Initial Value	Subsequent Value
Chief Executive	150%	300%
Chief Operating Officer	100%	200%
Group Finance Director	100%	200%
President and Chief Executive Officer of BAE Systems, Inc.	212.5%	425%

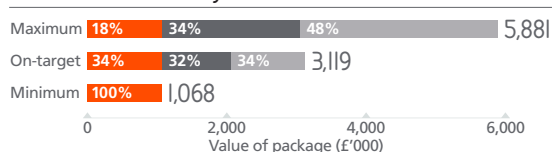
Illustration of application of remuneration policy

The charts below show the value of the package each of the executive directors would receive in the first year of operation of the Policy. The values are based on 2017 levels for base salaries, benefits and pension and assume that the office-holders at the date of this Policy coming into effect are employed throughout the first year of operation of the Policy. Annual and long-term incentives are based on awards applying in 2018. The charts assume the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single figure table on page 85 of the 2016 Annual Report); 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.

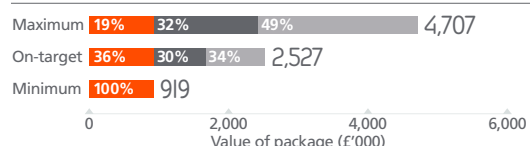
Chief Executive¹ (£'000)



Chief Executive designate¹ (£'000)



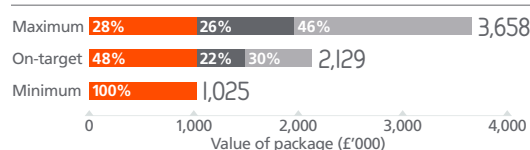
Chief Operating Officer¹ (£'000)



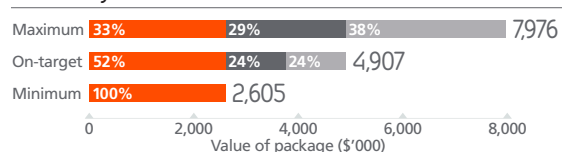
Executive directorship changes

As announced on 22 February 2017, Ian King will retire as Chief Executive on 30 June 2017 and Charles Woodburn, Chief Operating Officer, will be appointed as Chief Executive on 1 July 2017¹. The left-hand chart above illustrates Ian King's remuneration if he were Chief Executive throughout the year, and the right hand chart above illustrates Charles Woodburn's remuneration if he were Chief Executive throughout the year. The chart to the left illustrates Charles Woodburn's remuneration if he were Chief Operating Officer throughout the year.

Group Finance Director (£'000)



President and Chief Executive Officer of BAE Systems, Inc. (\$'000)



- Fixed elements of remuneration
- Annual bonus
- Performance Shares and Share Options

1. Ian King, Chief Executive as at 22 February 2017, retired on 30 June 2017. Charles Woodburn, Chief Operating Officer as at 22 February 2017, was appointed as Chief Executive with effect from 1 July 2017.

Directors' remuneration policy

continued

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 £700,000 from 1 February 2017 and is fixed at this level for three years.

The aggregate cost of fees and benefits paid to NEDs (including the Chairman) will not exceed an annual limit of £2.5m and the cost of fees and benefits paid to the Chairman will not exceed £1.25m annually.

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. Directors' and Officers' insurance cover is also provided for all directors.

Maximum opportunity

See the aggregate limit under 'Fees' above.

Prior commitments

For the duration of this Policy, the Company will honour any commitments made in respect of executive director and non-executive director remuneration and benefits 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 set out in this report or 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 ExSOP²⁰¹² that remain outstanding, Peter Lynas' second residence allowance as detailed on page 93 of the 2013 Annual Report, and any commitments entered into (such as grants of share awards) consistent with a previously approved Directors' remuneration policy that was applicable at the relevant time.

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 126.

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 500% 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 principles for setting base salary 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 and under 'Opportunity' above.

Long-Term Incentive Plan

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 Plan.

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 and under 'Opportunity' above.

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 122.

Directors' remuneration policy

continued

Service contracts and letters of appointment

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 ¹	1 September 2008	12 months either party
Charles Woodburn ²	1 July 2017	12 months either party
Peter Lynas	1 April 2011	12 months either party
Jerry DeMuro	1 February 2014	90 days either party ³

1. Retired on 30 June 2017.

2. Appointed to the Board as Chief Operating Officer on 9 May 2016; appointed as Chief Executive with effect from 1 July 2017.

3. Jerry DeMuro's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives at least 90 days' notice of non-renewal.

Notice period

The Committee's policy is that the service contracts of executive directors will not exceed 12 months. In exceptional circumstances, in relation to newly recruiting an executive director operating in a US environment, the notice period may be extended to a maximum of 24 months and structured such that it reduces to no more than 12 months by no later than 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 (which commenced on 1 February 2014) will automatically terminate if he ceases to be a director of the Company. The Chairman's appointment was reviewed by the Nominations Committee prior to the end of his initial three-year term and has been extended until February 2020, unless it is 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.

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
Revathi Advaiti ¹	01.01.2018	31.12.2020
Elizabeth Corley	01.02.2016	01.02.2022
Harriet Green	01.11.2010	31.10.2019
Chris Grigg	01.07.2013	30.06.2022
Paula Rosput Reynolds	01.04.2011	31.03.2020
Nick Rose	08.02.2010	31.12.2019
Ian Tyler	08.05.2013	07.05.2022

1. Appointed to the Board on 1 January 2018.

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. Non-executive directors do not have periods of notice.

In accordance with the UK Corporate Governance Code, all directors are subject to annual election or re-election at the Company's AGM.

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 payments for loss of office will be the policy that was in place at the point when the payments for loss of office were agreed for the executive director in question.

Any termination payment made in connection with the departure of an executive director will be subject to approval by the Committee, having regard to the terms of the service contract or other legal obligations 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.

In addition to payments described below, the Committee may pay such amounts as are necessary to settle or compromise any claim or by way of damages, where the Committee views it as in the best interests of the Company to do so. In the event of the termination of an executive director's contract, it is the Committee's policy to seek to limit any payment to not more than one year's base salary.

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 of base salary 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. Any new executive director contracts since 2016 (including the Chief Operating Officer) concerning payment in lieu of notice provisions allow for the Committee to exercise discretion to apply phased payments and mitigation on that executive director securing alternative employment.

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 bonus payable at target level pro-rated for service 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).

Other than notice payments, the Company has no obligation to make any termination payments when the Chairman's appointment terminates. Non-executive directors do not have periods of notice and the Company has no obligation to make any termination payments when their appointment terminates, other than to pay fees in accordance with the appointment letters.

Retirement benefits

As governed by the rules of the relevant pension plan. No enhancement for leavers will be made.

Annual Incentive Plan

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.

The Committee may, as set out below, exercise its discretion to allow an annual incentive payment for the year of cessation as part of the termination package for executive directors. Where it does so, the exercise of the discretion and reason why the Committee considered such action appropriate will be disclosed.

Where an executive director leaves during the relevant performance year by reason of death, ill-health, disability, retirement, a transfer of business or redundancy, the Committee may use its discretion to determine that an executive director will remain entitled to receive a bonus (subject to an assessment based on performance over the performance year and pro-rated for time) in respect of the financial year in which the individual ceased employment. One third of the bonus will be subject to compulsory deferral as set out previously, unless the Committee decides otherwise.

The Committee's policy is not to award an annual incentive for any portion of the notice period not served.

The treatment set out above does not apply to the President and Chief Executive Officer of BAE Systems, Inc.

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 Plan, where an executive director leaves the Group by reason of ill-health, injury, disability, retirement with the agreement of the Company, sale of a business or employing company, redundancy or leaving in such circumstances as the Committee determines (each an 'approved leaver'), unvested awards and options generally continue and vest on the normal vesting date (or, in the case of Performance Shares held by US executive directors, the first normal vesting date or, if later, cessation), unless the Committee determines that the awards should vest on cessation. Any performance conditions will be applied at the time of vesting.

On vesting, the number of shares under award 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 period (or in the case of Performance Shares held by US executive directors or Performance Shares granted prior to the 2017 AGM, as a proportion of the initial three-year vesting period).

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 above.

Where an executive director's employment is terminated for any other reason, his unvested awards and options will lapse. Options normally remain exercisable for six months after cessation (or vesting, if later) and 12 months after death.

If the Committee exercises its discretion to treat a director as an approved leaver as permissible under the leaver provisions of the share plan rules, the exercise of the discretion and reason why the Committee considered such action appropriate will be disclosed.

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 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 Committee considers the general level of salary increase across the Group and in the external market.

Stakeholder considerations

The 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 2018 financial year are listed on pages 78 and 79. Revathi Advaiti was appointed to the Board on 1 January 2018.

The Board has agreed to appoint Nicole Piasecki and Stephen Pearce as non-executive directors with effect from 1 June 2019.

Dividend

An interim dividend of 9.0p per share was paid on 30 November 2018. The directors propose a final dividend of 13.2p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 3 June 2019 to shareholders on the share register on 23 April 2019. Information on dividend waivers is given on page 190.

Annual General Meeting (AGM)

The Company's AGM will be held on 9 May 2019. The Notice of Annual General Meeting is enclosed with this Annual Report and details the resolutions to be proposed at the meeting.

Certain information in the Strategic report

The following items are set out in the Strategic report on pages 1 to 71:

- disclosures in relation to the use of financial instruments;
- particulars of important events affecting the Group which have occurred since 31 December 2018;
- 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, Energy and Industrial Strategy). In February 2007, the Company was released from the majority of these undertakings and the remainder have been superseded and varied by a new set of undertakings. Compliance with the undertakings is monitored by a compliance officer. Further information regarding the undertakings and the contact details of the compliance officer may be obtained through the Company Secretary at the Company's registered office or through the Company's website.

Profit forecast

In its half-year results announcement on 1 August 2018, 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 amended the profit forecast made in the Group's full-year results announcement on 22 February 2018 and in the Annual Report 2017):

"In aggregate, we expect the Group's underlying earnings per share for 2018 to be in line with the full-year underlying earnings per share for 2017, with some small additional benefit from exchange translation.*

*Compared with the Group's actual performance for 2017 as re-presented to reflect the impact of the adoption of IFRS 15 from 43.5p to 42.1p and assuming a US\$1.35 to sterling exchange rate."

Underlying earnings per share was 42.9p in 2018.

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 2018.

Issued share capital

As at 31 December 2018, 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.

Treasury shares

As at 1 January 2018, the number of shares held in treasury totalled 281,232,739 (having a total nominal value of £7,030,818 and representing 8.1% of the Company's called up share capital at 1 January 2018). During 2018, the Company used 9,582,602 treasury shares (having a total nominal value of £239,565 and representing 0.3% of the Company's called up share capital at 31 December 2018) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (5,739,686 shares in aggregate), awards under the Free and Matching elements of the International Share Incentive Plan (763,754 shares in aggregate), awards vested under the Performance Share Plan and Performance Shares element of the Long-Term Incentive Plan (1,098,521 shares), awards vested under the Restricted Shares element of the Long-Term Incentive Plan (1,123,760 shares), and options exercised under the Executive Share Option Plan (856,881 shares). The treasury shares utilised in respect of the Share Incentive Plan, the International Share Incentive Plan, and the Performance Share Plan and the Performance and Restricted Shares elements of the Long-Term Incentive Plan were disposed of by the Company for nil consideration. The 856,881 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 £3,735,882. As at 31 December 2018, the number of shares held in treasury totalled 271,650,137 (having a total nominal value of £6,791,253 and representing 7.8% of the Company's called up share capital at 31 December 2018).

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.

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, Energy and Industrial Strategy (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 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 2018 (and unchanged as at 20 February 2019), 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.	9.94%
Franklin Resources Inc., and affiliates	4.92%
Invesco Limited	4.97%
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.

Statutory and other information continued

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 2019 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 2018 AGM, the directors were given the power to buy back a maximum number of 318,730,061 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 by Regulatory Technical Standards adopted by the European Commission pursuant to article 5(6) of the Market Abuse Regulation.

This power will expire at the earlier of the conclusion of the 2019 AGM or 30 June 2019. A special resolution will be proposed at the 2019 AGM to renew the Company's authority to acquire its own shares.

At the 2018 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,558,182. This power will expire on the earlier of the conclusion of the 2019 AGM or 30 June 2019. Accordingly, a resolution will be proposed at the 2019 AGM to renew the Company's authority to issue further new shares.

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 2018 which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

The directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited, BAE Systems Executive Pension Scheme Trustees Limited and Alvis Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan, the BAE Systems Executive Pension Scheme and the Alvis Pension Scheme, respectively, which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

All such indemnity provisions are in force as at the date of this Directors' report.

Change of control – significant agreements

The following significant agreements contain provisions entitling the counterparties to exercise termination, alteration or other similar rights in the event of a change of control of the Company:

- The Group entered into a £2bn Revolving Credit Facility dated 12 December 2013 which was amended and restated on 30 April 2018. The facility 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 2018.
- 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 June 2017, BAE Systems Surface Ships Limited entered into a contract with the UK Ministry of Defence (MoD) for the manufacture of the first batch of three Type 26 frigates. 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 or where the change of control would result in increased costs to the MoD under the contract, 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 on such grounds, then the MoD may terminate the contract with immediate effect.
- 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. In March 2016, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 6 of the Astute Class Programme. In March 2018, BAE Systems Marine Limited entered into a contract with the MoD for the design, construction, testing and commissioning of Boat 7 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 December 2011, BAE Systems Marine Limited entered into a contract with the MoD for the design of the Dreadnought submarines. Where the MoD considers that a change of control of BAE Systems Marine Limited would be contrary to the defence, national interest or national security of the UK, then the change of control shall not take place until agreement is reached with the MoD on how to proceed. In the event that there is a change of control notwithstanding the objection of the MoD on such grounds, the MoD shall be entitled to terminate the contract with immediate effect.
- In September 2016, BAE Systems Marine Limited entered into a contract with the MoD for the initial phase of manufacturing activities for the Dreadnought Class programme. This contract was extended and amended to include additional manufacturing activities in March 2018. 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 December 2018, BAE Systems' subsidiary, ASC Shipbuilding Pty Limited, entered into a contract providing the framework for the design and manufacture of Hunter Class frigates for the Royal Australian Navy (Head Contract). As part of the acquisition of ASC Shipbuilding Pty Limited from the Australian Commonwealth, BAE Systems Australia Limited entered into a Sovereign Capability and Option Deed (SCOD). Under the Head Contract and the SCOD, if there is a change of control of ASC Shipbuilding Pty Limited, BAE Systems Australia Limited or BAE Systems plc, consent is required from the Australian Commonwealth Government prior to any change of control occurring. If there is a change of control without notice or notwithstanding an objection, the Commonwealth may terminate the Head Contract, take any action to mitigate an actual or potential threat to Australia's national security interests, or exercise its call option under the SCOD and regain ownership of ASC Shipbuilding Pty Limited.

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.

Statutory and other information

continued

Auditor

Deloitte LLP have indicated their willingness to be re-appointed as the Company's auditor and a resolution proposing their re-appointment will be put to the 2019 AGM.

Statement of directors' responsibilities in respect of the Annual Report and the 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 as adopted by the European Union (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, 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, relevant, reliable 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;
- assess the Group and parent company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the Group or the parent company or to cease operations, or have no realistic alternative but to do so.

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 are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and 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' 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 auditor

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 auditor is 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 auditor is aware of that information.

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
Charles Woodburn	Chief Executive
Jerry DeMuro	President and Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	Group Finance Director
Revathi Advaiti	Non-executive 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
20 February 2019

Directors' report

The Directors' report was approved by the board of directors on 20 February 2019.

David Parkes
Company Secretary

Independent Auditor's report to the members of BAE Systems plc only

Opinion

In our opinion:

- the financial statements of BAE Systems plc (the Parent company) and its subsidiaries (the Group) give a true and fair view of the state of the Group's and of the Parent company's affairs as at 31 December 2018 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 (IFRSs) as adopted by the European Union;
- the Parent company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 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.

We have audited the financial statements which comprise:

- the consolidated income statement;
- the consolidated and Parent company statement of comprehensive income;
- the consolidated and Parent company statements of changes in equity;
- the consolidated and Parent company balance sheets;
- the consolidated cash flow statement; and
- the related notes 1 to 38, including the associated accounting policies.

The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and IFRSs as adopted by the European Union. The financial reporting framework that has been applied in the preparation of the Parent company financial statements is applicable law and United Kingdom Accounting Standards, including FRS 101 Reduced Disclosure Framework (United Kingdom Generally Accepted Accounting Practice).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Group and the Parent company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the FRC's) Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Parent company.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters

The key audit matters that we identified in the current year were:

- revenue and margin recognition on long-term contracts;
- valuation of goodwill; and
- valuation of retirement benefit obligations.

These key audit matters were also identified by the Group's auditor in the prior year, KPMG. In addition, they also identified key audit matters in relation to tax accruals and deferred tax assets, and, with respect to the Parent company, amounts relating to Group affiliates. We did not consider these matters to have the greatest effect on our overall audit strategy and consequently on the allocation of resources or the engagement team's audit efforts in the current year.

Materiality

The materiality that we used for the Group financial statements was £70m, which was determined on the basis of adjusted profit before tax on continuing operations as defined on page 138 below. Our materiality equates to 4.7% of adjusted profit before tax and 5.7% of profit before tax.

Scoping

18 components were subject to audit. Of these, six were subjected to a full-scope audit whilst the remaining 12 were subject to an audit of specified account balances. These components give us audit coverage of 89% of revenue and 88% of profit before tax.

First year audit transition

We developed a detailed audit transition plan, designed to deliver an effective transition from the Group's predecessor auditor, KPMG. Our transition activities were performed across the Group's business units and included, but were not limited to, meeting with management across all business units, obtaining an understanding of the Group's system of internal control and evaluating the Group's accounting policies and areas of accounting judgement.

The key transition activities included (but were not limited to) the following:

1. In May 2017 we established a detailed audit transition plan in conjunction with BAE Systems' management, including setting key milestone dates to monitor transition progress. This was monitored with management on at least a monthly basis;
2. On 1 October 2017 we confirmed our independence to the Audit Committee and commenced our audit planning in relation to the 2018 audit;
3. In October 2017, a global transition workshop was held with senior members of our Group and global component audit teams in order to develop our audit strategy. Senior members of client management also participated in this workshop;
4. We shadowed KPMG throughout the 2017 year-end audit and attended key audit meetings. This included, but was not limited to, attendance at the business unit year-end audit close meetings in January 2018 and the Audit Committee meeting in February 2018 where the final report on the audit was presented;

5. We reviewed KPMG's 2017 audit work papers and met with relevant partners and senior staff from KPMG to further our understanding of the predecessor auditor's approach;
6. We attended key management and contract meetings throughout the 2018 financial year across the business to deepen our understanding of BAE Systems' key contract judgements and continue to develop our understanding of the business and audit risks; and
7. In May 2018 a second global workshop was held with senior members of our global Group and component teams as part of our audit planning, in order to further develop our audit strategy and deep dive into certain areas of our audit approach.

This transition process helped us build an understanding of the Group, which, in turn, informed our risk assessment process and identification of the risks of material misstatement to the Group's financial statements.

We presented our proposed audit plan to the Audit Committee in June 2018 and re-confirmed the scope, significant risks and audit approach at the meeting in December 2018.

Conclusions relating to going concern, principal risks and viability statement

Going concern

We have reviewed the directors' statement in the Basis of Preparation on page 142 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's and Parent company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

We considered as part of our risk assessment the nature of the Group, its business model and related risks including, where relevant, the impact of the applicable political and economic environments including Brexit, the requirements of the applicable financial reporting framework and the system of internal control. We evaluated the directors' assessment of the Group's ability to continue as a going concern, including challenging the underlying data and key assumptions used to make the assessment, and evaluated the directors' plans for future actions in relation to their going concern assessment.

We are required to state whether we have anything material to add or draw attention to in relation to that statement required by Listing Rule 9.8.6R(3) and report if the statement is materially inconsistent with our knowledge obtained in the audit.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Independent Auditor's report

continued

Principal risks and viability statement

Based solely on reading the directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the directors' assessment of the Group's and the Parent company's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on pages 68 to 71 that describe the principal risks and explain how they are being managed or mitigated;
- the directors' confirmation on page 81 that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity; or
- the directors' explanation on page 81 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We are also required to report whether the directors' statement relating to the prospects of the Group required by Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those that had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Revenue and margin recognition on long-term contracts

Refer to page 84 (Audit Committee report), note 1 (accounting policy and financial disclosure) and note 37 (for IFRS 15 restatement disclosure)

Revenue:

£16,821m (2017 restated £17,224m)

Key audit matter description

The estimation of both overall lifetime contract margin and the appropriate level of revenue and profit to recognise in any single accounting period require the exercise of management judgement. Within BAE Systems' contract portfolio there are a number of programmes where the estimates required in reaching these judgements are highly complex and could lead to a material error within the financial statements if reached incorrectly. Consequently, we consider that revenue and margin recognition represents a significant risk to our audit and a key audit matter. This risk is further heightened in 2018 owing to it being the first year that the businesses will be required to account for the contracts under IFRS 15. The standard has a number of judgements that the Group is required to apply to its contracts, including the identification of performance obligations and estimation of the amount of consideration to be recognised.

We focus a greater proportion of audit effort on a number of contracts where we consider there to be the highest degree of management judgement required, and design contract specific tests and procedures to mitigate the associated risks.

In order to identify the key contracts over which there is a significant risk of material misstatement, we undertook a contract risk assessment process at each component, utilising the latest contract information and our understanding of the business. We held meetings with key finance and contract managers, attended Quarterly Business Reviews and other key management meetings, read and understood underlying contract documentation and reviewed management support for key contract judgements (from both a qualitative and quantitative perspective). In addition we looked for contracts that might have higher levels of judgement associated with the risk of schedule delivery or technical complexity, fixed price contracts which increase the risk of contract losses and other indicators that could increase the risk of a material impact on the financial statements.

As a result of our risk assessment we identified a number of contracts where we consider there to be the highest degree of management judgement required. These are:

- Astute Class submarines;
- Queen Elizabeth Class (QEC) aircraft carrier;
- Offshore Patrol Vessel (OPV);
- Saudi Salam Typhoon (Salam);
- Saudi British Defence Co-operation Programme (SBDGP); and
- Radford Nitrocellulose plant.

How the scope of our audit responded to the key audit matter

Our contract testing approach included:

Testing the relevant controls

- We assessed the design and implementation and, where deemed appropriate, tested the operating effectiveness of key controls within management's Lifecycle Management (LCM) Framework and project accounting processes which management have established to ensure that contracts are appropriately managed, challenged and accounted for.
- As part of this we observed the controls in operation by attending a sample of project contract status review meetings, Quarterly Business Review meetings and Group-level meetings to validate the various levels of challenge applied to the contracts.

Challenging management's assumptions and estimates

To gain assurance over the contract judgements and estimates made, our work included:

- making enquiries of contract project teams and other personnel to obtain an understanding of the performance of the project throughout the year and at year-end;
- analysing historical contract performance and understanding the reason for in-year movements or changes;
- testing the underlying calculations used in the contract assessments for accuracy and completeness, including the estimated costs to complete the contract;
- examining external correspondence to support the timeframe for delivery of the product or service and any judgements made in respect of these;
- examining external evidence to support contract status and recoverability of receivables, such as customer correspondence and for certain contracts, meeting with the customer directly;
- enquiring with in-house and external legal counsel regarding contract-related litigation and claims;
- using Deloitte subject matter experts to provide support in evaluating specific contract judgements taken; and
- considering whether there were any indicators of management override of controls or bias in arriving at their reported position.

Assessing the impact of IFRS 15

In respect of ensuring that the Group is appropriately applying IFRS 15 we:

- reviewed and challenged management's accounting papers on the impact of the transition;
- reviewed and challenged management's updated accounting policies manual;
- embedded IFRS 15 considerations in our contract review work, in particular determining whether management had appropriately considered the existence of performance obligations and elements of variable consideration; and
- reviewed the Annual Report disclosures.

Key observations

The results of our testing were satisfactory.

Through our testing of significant risk contracts we did not identify any audit adjustments and consider the judgements made by management in recognising revenue and profit to be balanced.

Our testing of the remaining population identified certain immaterial audit adjustments but we conclude overall that the judgements made by management are reasonable.

Valuation of goodwill

Refer to page 84 (Audit Committee report) and note 8 (accounting policy and financial disclosures)

Goodwill:

£10,239m (2017 £9,996m)

Key audit matter description

The Group holds material goodwill balances relating to UK and overseas acquisitions, the majority of which are in the US. Management performs an impairment review of the carrying value of each Cash-Generating Unit (CGU) on an annual basis in line with the requirements of IAS 36.

The impairment assessment involves management judgement in considering whether the carrying value of the cash-generating units is recoverable and hence we considered this to be a key audit matter. Determining the recoverable amount involves significant estimation including:

- forecasting future cash flows;
- determining the discount rate; and
- determining future growth rates.

In planning our audit, we determined there to be a significant risk in relation to the valuation of the Applied Intelligence (AI) CGU which has a carrying value of £257m, including goodwill of £237m, at 31 December 2018. In 2017, the Group recorded a goodwill impairment charge of £384m in relation to this CGU. Given the goodwill is now held at fair value based on forecast future cash flows, small changes in assumptions could trigger further impairment.

Through our risk assessment we determined that the key drivers of future growth in AI are the Government and Technology & Commercial divisions. As a result, we have performed additional procedures over the revenue and cost assumptions in these divisions.

How the scope of our audit responded to the key audit matter

We have performed a series of specific audit procedures to address the key audit matter identified in relation to the AI CGU. This included the following:

- we obtained a detailed understanding of management's process for identifying indicators of impairment and for performing the CGU impairment assessment. As part of this we assessed the design and implementation of the key controls. Specific focus was given to understanding management's process and controls over forecasting future cash flows and determination of the key assumptions as detailed above;

- we evaluated and challenged underlying assumptions and cash flows, including forecast revenue and cost assumptions, with reference to the recent and historical performance of the AI CGU, external industry benchmarks and specific forecast events. This included performing sensitivity analysis to evaluate the impact of changing a range of assumptions including suppressed growth and changes in the discount rate;
- we tested the integrity of management's impairment model used to derive the recoverable amount; and
- we involved Deloitte valuation specialists to support our challenge of the applicable discount rate and other assumptions.

Key observations

We completed our audit of the forecasts of the AI business and are satisfied that management's assumptions are reasonable and supportable based on available evidence, both internal and external.

Valuation of retirement benefit obligations

Refer to page 84 (Audit Committee report) and note 22 (accounting policy and financial disclosures)

Group's share of the net IAS 19 deficit:
£3,932m (2017 £4,022m)

Valuation of retirement benefit scheme assets:
£25,653m (2017 £26,883m)

Valuation of retirement benefit scheme liabilities:
£29,889m (2017 £31,237m)

Key audit matter description

The principal retirement benefit schemes are held in the UK and US and are funded defined benefit schemes, with assets held in separate trustee-administered funds.

We identified the following areas which were the focus of our procedures in auditing the Group's net retirement benefit obligations as a key audit matter:

Liabilities

The key judgements relating to the retirement benefit obligations include inflation assumptions, discount rates and mortality assumptions applied to its members. Given the significant size of the deficit at year-end, small changes to these input assumptions can lead to large changes in the valuation. Assumptions are also made in the determination of the Group's share of assets and liabilities of multi-employer schemes in which it participates and the corresponding amounts attributed to other participating employers.

Assets

Given the size of the scheme assets there is significant audit effort required in ensuring the valuation of assets is supportable.

GMP equalisation

During the year, the High Court ruled that companies are required to equalise Guaranteed Minimum Pensions (GMPs) between men and women. Previously, the Group made no allowance in the accounting liabilities for GMP equalisation and therefore for 2018 the Group is required to estimate the impact of equalising GMP payments. This was estimated to be £114m. Given the high level of estimation required in determining the impact of GMP and the size of the Group's deficit this has also been considered a key audit matter in the period.

Restatement

During the year, management identified an error in relation to the treatment of asset collateral on longevity swaps that impacted previously reported asset values of the Group's pension schemes. It was determined that the prior year asset values had been overstated by £108m leading to a corresponding understatement of the net retirement benefit obligation as at 31 December 2017. Given the size of the adjustment, the Group has restated the 2017 comparatives as described in note 37.

How the scope of our audit responded to the key audit matter

Liabilities

In relation to the retirement benefit obligation we have performed the following procedures:

- we obtained a detailed understanding and performed walkthroughs of management's process, with specific focus on assessing the design and implementation of key controls relating to the valuation of the retirement benefit obligation;
- in conjunction with Deloitte actuarial specialists, we challenged the assumptions used in the IAS 19 valuation, including assessing and challenging the reasonableness of the assumptions against available market data and benchmarking against their peers; and
- we assessed the objectivity, independence and competence of the actuaries engaged by management to perform the valuations of the schemes.

Assets

We performed audit procedures relating to the assets held within the pension schemes through seeking third party confirmation from asset managers and/or custodians or other supporting evidence as appropriate. Our work has included reviewing publicly available information on these assets, comparing to internal benchmarks and reconciling inputs used by management to determine the asset values.

GMP equalisation

In conjunction with Deloitte actuarial specialists, we challenged the methodology and assumptions applied by management to estimate the impacts of GMP equalisation in the current year.

Restatement

We audited management's restatement of the 2017 financial statements for the prior year error identified and are satisfied with the treatment and disclosure made.

Disclosure

We also audited the disclosures made in the 2018 financial statements for compliance with IAS 19.

Key observations

We have completed our audit work in line with the procedures outlined above. Overall we consider the discount rate and other key pension assumptions used by management in calculating the retirement benefit obligation to be within our independently developed reasonable range. The Group's approach to estimating the impacts of GMP equalisation was also considered to be reasonable and in line with market practice. We concluded our testing of the assets and are satisfied they are appropriately valued.

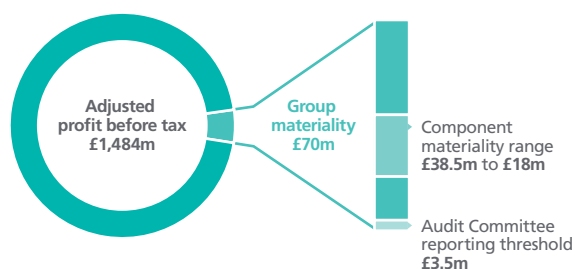
Independent Auditor's report continued

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Parent company financial statements
Materiality	£70m (2017 £55m)	£38.5m (2017 £32m)
Basis for determining materiality	4.7% of adjusted profit before tax of £1,484m. This includes adjustment for non-recurring items of £154m (see note 1), impairment of intangible assets of £33m (see note 8) and fair value and foreign exchange adjustments on financial instruments and investments of £73m (see note 5). The predecessor auditor determined materiality using 4.9% of Group profit before taxation.	Materiality has been set with reference to the net assets of the Parent company.
Rationale for the benchmark applied	Adjusted profit before tax from continuing operations was considered to be the most relevant benchmark as it is considered the most stable and comparable profit metric. The adjustments excluded relate to items that are considered one-off in nature or relate to complex financial instrument valuations, which are volatile and not reflective of the underlying performance of the business. We consider the measure suitable having also considered the other relevant benchmarks: our materiality equates to 5.7% of profit before tax and 1.2% of net assets. The increase in the materiality is driven by the increase in profit before tax and adjusted profit before tax.	This represents 0.9% of the Parent company net assets. In addition, we consider the materiality of the Parent company in the context of the Group materiality and have capped this at 55% of that of the Group. We consider net assets the key benchmark used by members of the Parent company in assessing financial performance.



We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £3.5m (2017 £3m), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the audit scope

Our Group audit was scoped by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the audit risks. This exercise has considered the relative size of each reporting unit's contribution to revenue, profit before tax and adjusted profit before tax, alongside further financial or contractual risks which we consider to be present. In doing this, we also considered the impact of the reorganisation of reporting lines in the business to ensure that we have appropriate coverage across the new segments, as well as the Group as a whole. We have considered units that contribute more than 10% of the Group's revenue or adjusted

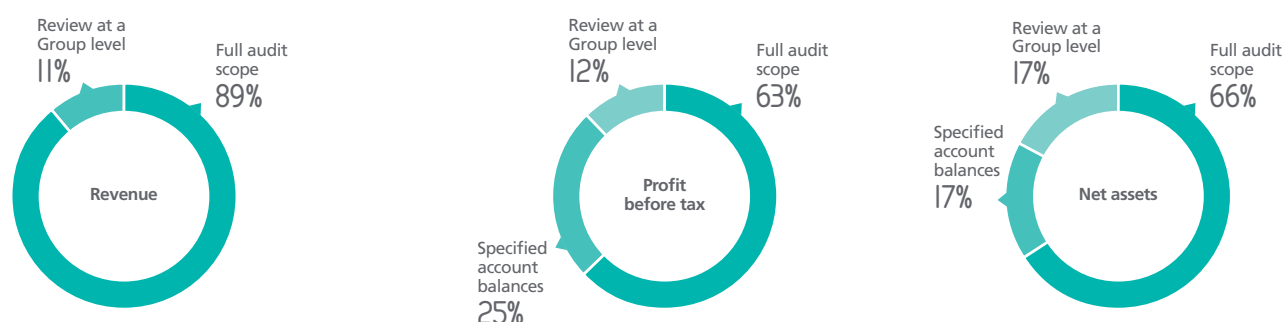
profit before tax to be 'financially significant', and requiring a full-scope audit. In addition, we have used our knowledge of the business obtained throughout transition and as part of our risk assessment procedures to assess where else we consider it appropriate to perform a full-scope audit. This resulted in full-scope audits for six business units located in the UK, Saudi Arabia and the US, as well as the Group's largest joint venture, MBDA.

Additionally our audit planning identified 12 non-financially significant components, located in the UK, Saudi Arabia, Australia and the US, where we consider there to be a reasonable possibility

of material misstatement in specific balances within the financial statements. Accordingly, we have directed component auditors to perform an audit of specified account balances and additional analytical procedures on the respective income statements and balance sheets for these components. For all in-scope components, whether designated financially significant or subject to an audit of specified account balances, revenue was determined to be in scope for the audit.

For all other reporting units not included in full-scope or audit of specified account balance scope, we performed centrally-directed analytical review procedures.

The scope of our work gives us coverage over the following proportions of the total Group results:



As each of the business units maintains separate financial records, we have engaged component auditors from the Deloitte member firms in the US, UK, Saudi Arabia and Australia to perform procedures at all the wholly-owned components under our direction and supervision. This approach also allows us to engage local auditors who have appropriate knowledge of local regulations to perform the audit work, under a common Deloitte audit approach.

In respect of MBDA, we have engaged with the entity's non-Deloitte auditor to perform a full-scope audit under our direction and supervision.

We have issued detailed instructions to the component auditors, directed and supervised their work through a number of visits to each of the component auditors during the transition, planning and performance stages of our audit, alongside frequent remote communication and review of their work.

Our oversight of component auditors focused on the planning of their audit work and understanding of their risk assessment process to identify key areas of estimates and judgement, as well as the execution of their audit work in line with our Group-issued referral instructions. All teams were involved in our transition workshops and other transition activities as outlined on page 135, which were overseen and directed by the Group audit team. We are satisfied that the level of involvement of the Group audit partner and team in the component audits has been extensive and has enabled us to conclude that sufficient appropriate audit evidence has been obtained in support of our opinion on the Group financial statements as a whole.

The BAE Systems, Inc. business units in the US are subject to a Department of Defense Special Security Arrangement (SSA), which is a government requirement setting out specific protocol that foreign-controlled companies must comply with in order to be able to undertake government defence contracts. As part of this there is restriction on the flow of information outside of the US. Therefore, for the US components there are restrictions around access to the audit file and specific workpapers for non-US nationals. As such we have designed alternative procedures, including involvement of an additional independent US national partner, to ensure that appropriate oversight of the US component team is obtained.

In addition to the work performed at a component level, at Group level we have audited the consolidation process and carried out analytical procedures over the residual financial information of the remaining components not subject to audit or audit of specified account balances. At a Group level we also perform audit procedures on centrally held balances including treasury, retirement benefit obligations, goodwill, tax, head office costs and litigation and claims.

Other information

The directors are responsible for the other information. The other information comprises the information included in the Annual Report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

- **Fair, balanced and understandable** – the statement given by the directors that they consider 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, is materially inconsistent with our knowledge obtained in the audit; or
- **Audit Committee reporting** – the section describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee; or
- **Directors' statement of compliance with the UK Corporate Governance Code** – the parts of the directors' statement required under the Listing Rules relating to the Group's compliance with the UK Corporate Governance Code containing provisions specified for review by the auditor in accordance with Listing Rule 9.8.10R(2) do not properly disclose a departure from a relevant provision of the UK Corporate Governance Code.

We have nothing to report in respect of these matters.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Parent company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Parent company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Independent Auditor's report

continued

Extent to which the audit was considered capable of detecting irregularities, including fraud

We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

Identifying and assessing potential risks related to irregularities

In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, our procedures included the following:

- enquiring of management, internal legal counsel, internal audit and the Audit Committee, including obtaining and reviewing supporting documentation, concerning the Group's policies and procedures relating to:
 - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
 - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud; and
 - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations, including obtaining an understanding of the Group's bribery & corruption and whistleblowing policies;
- discussing among the engagement team, including significant component audit teams and involving relevant internal specialists, including tax, valuations, pensions and IT specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud. As part of this discussion, we identified potential for fraud in relation to the level of judgement involved in estimating costs to complete on long-term contracts and the subsequent impact on revenue and margin recognition; and
- obtaining an understanding of the legal and regulatory frameworks that the Group operates in, focusing on those laws and regulations that had a direct effect on the financial statements, including the UK Companies Act, Listing Rules, pension and taxation legislation. In addition, owing to the sector the Group operates in, we considered laws and regulations that had a fundamental effect on the operations of the Group, including in respect of export controls, defence contracting and anti-bribery and corruption legislation. These areas were identified through enquiries with directors, management and legal counsel, our knowledge and understanding of the Group accumulated throughout the audit and our sector-specific experience.

Audit response to risks identified

As a result of performing the above, we identified revenue and margin recognition on long-term contracts as a key audit matter. The key audit matters section of our report explains the matters in more detail and also describes the specific procedures we performed in response to the key audit matter.

In addition to the above, our procedures to respond to risks identified included the following:

- reviewing the financial statement disclosures and testing of supporting documentation to assess compliance with relevant laws and regulations discussed above;
- enquiring of management, the Audit Committee and in-house legal counsel concerning actual and potential litigation and claims;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with HMRC;
- obtaining a detailed understanding of and performing process walkthroughs in relation to the Group's process for engaging third parties to support business development;
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments;
- assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and
- evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists and significant component audit teams and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Companies Act 2006

In our opinion the part of the directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

In our opinion, based on the work undertaken in the course of the audit:

- 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; and
- the strategic report and the directors' report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the Group and of the Parent company and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the directors' report.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- 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 are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made or the part of the directors' remuneration report to be audited is not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Other matters

Auditor tenure

Following the recommendation of the Audit Committee, we were appointed by the members on 10 May 2018 to audit the financial statements for the year ending 31 December 2018 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is therefore one year.

Consistency of the audit report with the additional report to the Audit Committee

Our audit opinion is consistent with the additional report to the Audit Committee we are required to provide in accordance with ISAs (UK).

Use of our report

This report is made solely to the Parent company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Parent company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Parent company and the Parent company's members as a body, for our audit work, for this report, or for the opinions we have formed.

John Adam Senior Statutory Auditor

For and on behalf of
Deloitte LLP
Statutory Auditor

London, United Kingdom
20 February 2019

Financial statements

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Group accounting policies

Accounting policies are included within the relevant note to the 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 Directors' report on page 82, 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 certain 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, with the resulting exchange differences 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.

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. 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	The Group accounts for revenue in accordance with IFRS 15 Revenue from Contracts with Customers. For most of the Group's contracts, revenue and associated margin are recognised progressively over time as costs are incurred, and as risks have been mitigated or retired. The ultimate profitability of contracts is 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.	1
Carrying value of goodwill	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 of the future profitability and cash-generating ability of the acquired businesses based on the Group's five-year Integrated Business Plan and the pre-tax discount rate used in discounting these projected cash flows.	8
Deferred tax asset on retirement benefit obligations	The Group has recognised a deferred tax asset in respect of the deficits in its pension/retirement schemes. It is management's judgement that the Group will generate sufficient taxable profits to recover the net deferred tax asset recognised. This judgement requires the use of estimates of future taxable profits based on the Group's Integrated Business Plan.	14
Tax provisions	Provision is made for known issues based on management's interpretation of country-specific legislation and management's assessment of the likely outcome of negotiations or litigation. The Group's approach is to consider each uncertain tax position separately. Where management considers it is probable that there will be a future outflow of funds to a tax authority, a provision is recognised. The position is reviewed on an ongoing basis. Provisions are measured using management's best estimate of the most likely amount, being the single most likely amount in a range of possible outcomes. The Group discloses any significant uncertainties in relation to tax matters to the relevant tax authority. 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.	16
Valuation of retirement benefit obligations	Defined benefit pension scheme accounting valuations are prepared by independent actuaries. The liabilities of the pension schemes are valued based on a number of actuarial assumptions. For each of the actuarial assumptions used there is a range of possible values and management estimates 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.	22

Judgements made in applying accounting policies

In the course of preparing the financial statements, no judgements have been made in the process of applying the Group's accounting policies, other than those involving estimates, that have had a significant effect on the amounts recognised in the financial statements.

Preparation continued

Sources of estimation uncertainty

The application of the Group's accounting policies requires the use of estimates. In the event that these estimates prove to be incorrect, there may be an adjustment to the carrying amounts of assets and liabilities within the next financial year. The key significant risks of a material adjustment to the carrying amounts of assets and liabilities during 2019 have been considered and assessed as relating to the following:

- The determination of the discount rate and inflation assumptions underpinning the valuation of the liabilities of the Group's defined benefit pension schemes, where there is a range of possible values for each of the actuarial assumptions and small changes in assumptions may have a significant impact on the size of the deficit. Note 22 provides information on the key assumptions and analysis of their sensitivities.
- The consideration of the carrying value of goodwill for impairment requires an assessment of future cash flows expected to be generated from the associated cash-generating unit, as well as the appropriate discount rate to apply to these projections. Note 8 provides information on the key assumptions adopted by the Group and associated sensitivity analysis.
- Revenue and profit recognition on contracts is based on estimates of future costs as well as an assessment of contingencies for technical and other risks, such as the Group's inability to obtain or maintain the necessary export licences. Note 1 includes information on revenue recognised in the year in respect of performance obligations satisfied or partially satisfied in previous periods providing an indication of the range of outcomes relating to these estimates.
- Tax provisioning is based on estimates of the potential outcomes of tax litigation or negotiations, the amount recorded being the single most likely amount in a range of possible outcomes. Such provisions can be difficult to estimate due to the complexity involved and the uncertainty in the process for their resolution. Note 16 provides information relating to potential material changes regarding tax provisions in the next financial year.

Changes in accounting policies

IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers became effective on 1 January 2018. The impact of adoption is set out in note 37.

IFRS 16 Leases will be effective from 1 January 2019. The expected impact of adoption is set out in note 38.

The following other standards, interpretations and amendments to existing standards became effective on 1 January 2018 and have not had a material impact on the Group:

- Amendments to IFRS 2: Classification and Measurement of Share-based Payment Transactions;
- Amendments to IAS 40: Transfers of Investment Property;
- IFRIC 22 Foreign Currency Transactions and Advance Consideration; and
- Annual Improvements to IFRS Standards 2014–2016 Cycle.

The following other standards, interpretations and amendments to existing standards have been issued but were not mandatory for accounting periods beginning on 1 January 2018 and are not expected to have a material impact on the Group:

- IFRIC 23 Uncertainty over Income Tax Treatments, effective from 1 January 2019;
- Amendments to IFRS 9: Prepayment Features with Negative Compensation, effective from 1 January 2019;
- Amendments to IAS 28: Long-term Interests in Associates and Joint Ventures, effective from 1 January 2019;
- Amendments to IAS 19: Plan Amendment, Curtailment or Settlement, effective from 1 January 2019 (not yet endorsed by the EU);
- Annual Improvements to IFRS Standards 2015–2017 Cycle, effective from 1 January 2019 (not yet endorsed by the EU);
- Amendments to IFRS 3: Definition of a Business, effective from 1 January 2020 (not yet endorsed by the EU);
- Amendments to References to the Conceptual Framework in IFRS Standards, effective 1 January 2020 (not yet endorsed by the EU);
- Amends to IAS 1 and IAS 8: Definition of Material, effective from 1 January 2020 (not yet endorsed by the EU);
- IFRS 17 Insurance Contracts, effective from 1 January 2021; and
- Amendments to IFRS 10 and IAS 28: Sale or contribution of assets between an investor and its associate or joint venture, effective date deferred indefinitely.

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

		2018	2017 (restated) ¹
	Notes	£m	£m
Continuing operations			
Sales	1	18,407	18,487
Deduct Share of sales by equity accounted investments	1	(2,812)	(2,534)
Add Sales to equity accounted investments	1	1,226	1,271
Revenue	1	16,821	17,224
Operating costs	2	(15,514)	(16,043)
Other income	4	158	131
Group operating profit		1,465	1,312
Share of results of equity accounted investments	1	140	107
<i>Underlying EBITA</i>	1	1,928	1,974
<i>Non-recurring items</i>	1	(154)	(13)
<i>EBITA</i>		1,774	1,961
<i>Amortisation of intangible assets</i>	1	(85)	(86)
<i>Impairment of intangible assets</i>	1	(33)	(384)
<i>Financial expense of equity accounted investments</i>	5	(13)	(34)
<i>Taxation expense of equity accounted investments</i>	6	(38)	(38)
Operating profit	1	1,605	1,419
<i>Financial income</i>		228	416
<i>Financial expense</i>		(609)	(762)
Net finance costs	5	(381)	(346)
Profit before taxation		1,224	1,073
Taxation expense	6	(191)	(216)
Profit for the year		1,033	857
Attributable to:			
Equity shareholders		1,000	827
Non-controlling interests		33	30
		1,033	857
Earnings per share	7		
Basic earnings per share		31.3p	26.0p
Diluted earnings per share		31.2p	25.9p

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

Consolidated statement of comprehensive income for the year ended 31 December

	Notes	2018			2017 (restated) ¹		
		Other reserves ² £m	Retained earnings £m	Total £m	Other reserves ² £m	Retained earnings £m	Total £m
Profit for the year		–	1,033	1,033	–	857	857
Other comprehensive income							
Items that will not be reclassified to the income statement:							
Subsidiaries:							
Remeasurements on retirement benefit schemes		–	74	74	–	2,056	2,056
Tax on items that will not be reclassified to the income statement	6	–	5	5	–	(481)	(481)
Equity accounted investments (net of tax)		–	6	6	–	52	52
Items that may be reclassified to the income statement:							
Subsidiaries:							
Currency translation on foreign currency net investments		400	–	400	(630)	–	(630)
Amounts (charged)/credited to hedging reserve		(25)	–	(25)	59	–	59
Tax on items that may be reclassified to the income statement	6	5	–	5	(11)	–	(11)
Equity accounted investments (net of tax)		15	–	15	(18)	–	(18)
Total other comprehensive income for the year (net of tax)		395	85	480	(600)	1,627	1,027
Total comprehensive income for the year		395	1,118	1,513	(600)	2,484	1,884
Attributable to:							
Equity shareholders		391	1,085	1,476	(595)	2,454	1,859
Non-controlling interests		4	33	37	(5)	30	25
		395	1,118	1,513	(600)	2,484	1,884

Consolidated statement of changes in equity for the year ended 31 December

Notes	Attributable to equity holders of BAE Systems plc						Non-controlling interests £m	Total equity £m
	Issued share capital £m	Share premium £m	Other reserves ² £m	Retained earnings £m	Total £m			
Balance at 1 January 2018 as originally presented	87	1,249	6,098	(2,693)	4,741	43		4,784
Restatement ¹	–	–	(8)	(21)	(29)	–		(29)
Restated total equity at 1 January 2018	87	1,249	6,090	(2,714)	4,712	43		4,755
<i>Profit for the year</i>	–	–	–	1,000	1,000	33		1,033
<i>Total other comprehensive income for the year</i>	–	–	391	85	476	4		480
Total comprehensive income for the year	–	–	391	1,085	1,476	37		1,513
Share-based payments (inclusive of tax)	30	–	–	63	63	–		63
Net sale of own shares	–	–	–	1	1	–		1
Ordinary share dividends	24	–	–	(703)	(703)	(28)		(731)
Partial disposal of shareholding in subsidiary undertaking	–	–	–	(3)	(3)	20		17
At 31 December 2018	87	1,249	6,481	(2,271)	5,546	72		5,618
Balance at 1 January 2017 as originally presented	87	1,249	6,685	(4,583)	3,438	26		3,464
Restatement ¹	–	–	–	47	47	–		47
Restated total equity at 1 January 2017	87	1,249	6,685	(4,536)	3,485	26		3,511
<i>Profit for the year</i>	–	–	–	827	827	30		857
<i>Total other comprehensive income for the year</i>	–	–	(595)	1,627	1,032	(5)		1,027
Total comprehensive income for the year	–	–	(595)	2,454	1,859	25		1,884
Share-based payments (inclusive of tax)	30	–	–	53	53	–		53
Net purchase of own shares	–	–	–	(1)	(1)	–		(1)
Ordinary share dividends	24	–	–	(684)	(684)	(8)		(692)
At 31 December 2017	87	1,249	6,090	(2,714)	4,712	43		4,755

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.
2. An analysis of other reserves is provided in note 24.

Consolidated balance sheet as at 31 December

	Notes	2018 £m	2017 (restated) ¹ £m	2016 (restated) ¹ £m
Non-current assets				
Intangible assets	8	10,658	10,378	11,264
Property, plant and equipment	9	2,365	2,230	2,098
Investment property	10	98	101	110
Equity accounted investments	11	429	322	250
Other investments		13	6	6
Other receivables	12	352	387	351
Retirement benefit surpluses	22	308	302	223
Other financial assets	13	245	226	345
Deferred tax assets	14	702	702	1,181
		15,170	14,654	15,828
Current assets				
Inventories	15	774	733	776
Trade, other and contract receivables	12	5,177	4,244	3,959
Current tax	16	81	20	5
Other financial assets	13	166	89	204
Cash and cash equivalents	17	3,232	3,271	2,769
Assets held for sale	18	146	26	2
		9,576	8,383	7,715
Total assets	19	24,746	23,037	23,543
Non-current liabilities				
Loans	20	(3,514)	(4,069)	(4,425)
Other payables	21	(1,536)	(1,723)	(1,040)
Retirement benefit obligations	22	(4,240)	(4,324)	(6,330)
Other financial liabilities	13	(104)	(133)	(102)
Deferred tax liabilities	14	–	(4)	(10)
Provisions	23	(427)	(435)	(392)
		(9,821)	(10,688)	(12,299)
Current liabilities				
Loans and overdrafts	20	(785)	(14)	–
Trade and other payables	21	(7,740)	(6,755)	(6,917)
Other financial liabilities	13	(74)	(104)	(212)
Current tax	16	(334)	(305)	(311)
Provisions	23	(334)	(400)	(291)
Liabilities held for sale	18	(40)	(16)	(2)
		(9,307)	(7,594)	(7,733)
Total liabilities		(19,128)	(18,282)	(20,032)
Net assets		5,618	4,755	3,511
Capital and reserves				
Issued share capital	24	87	87	87
Share premium		1,249	1,249	1,249
Other reserves	24	6,481	6,090	6,685
Retained earnings – deficit		(2,271)	(2,714)	(4,536)
Total equity attributable to equity holders of BAE Systems plc		5,546	4,712	3,485
Non-controlling interests		72	43	26
Total equity		5,618	4,755	3,511

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

Approved by the Board on 20 February 2019 and signed on its behalf by:

C N Woodburn
Chief Executive

P J Lynas
Group Finance Director

Consolidated cash flow statement for the year ended 31 December

	Notes	2018 £m	2017 (restated) ¹ £m
Profit for the year		1,033	857
Taxation expense	6	191	216
Research and development expenditure credits	4	(27)	(20)
Share of results of equity accounted investments	1	(140)	(107)
Net finance costs	5	381	346
Depreciation, amortisation and impairment	2	411	728
Gain on investment revaluation		(7)	–
Profit on disposal of property, plant and equipment, and investment property	2,4	(18)	(10)
Loss in respect of held for sale assets and business disposals	2	9	13
Cost of equity-settled employee share schemes		64	61
Movements in provisions		(101)	150
Decrease in liabilities for retirement benefit obligations		(153)	(138)
(Increase)/decrease in working capital:			
Inventories		(16)	(29)
Trade, other and contract receivables		(757)	(397)
Trade and other payables		530	454
Taxation paid		(200)	(227)
Net cash flow from operating activities		1,200	1,897
Dividends received from equity accounted investments	11	57	72
Interest received		25	23
Purchase of property, plant and equipment, and investment property		(358)	(389)
Purchase of intangible assets		(139)	(87)
Proceeds from sale of property, plant and equipment, and investment property		34	34
Proceeds from sale of intangible assets		–	1
Purchase of subsidiary undertakings		–	(3)
Purchase of equity accounted investment		(2)	–
Partial disposal of shareholding in subsidiary undertaking		17	–
Equity accounted investment funding	11	(1)	(3)
Cash and cash equivalents acquired with subsidiary undertakings	34	14	–
Cash flow in respect of held for sale assets and business disposals		12	(6)
Cash and cash equivalents disposed of with subsidiary undertakings		–	(2)
Net cash flow from investing activities		(341)	(360)
Interest paid		(203)	(204)
Net sale/(purchase) of own shares		1	(1)
Equity dividends paid	24	(703)	(684)
Dividends paid to non-controlling interests		(28)	(8)
Cash flow from matured derivative financial instruments (excluding cash flow hedges)		6	(83)
Cash flow from movement in cash collateral		2	(15)
Cash flow from repayment of loans		(7)	–
Net cash flow from financing activities	26	(932)	(995)
Net (decrease)/increase in cash and cash equivalents		(73)	542
Cash and cash equivalents at 1 January		3,264	2,771
Effect of foreign exchange rate changes on cash and cash equivalents		41	(49)
Cash and cash equivalents at 31 December		3,232	3,264
Comprising:			
Cash and cash equivalents	17	3,232	3,271
Overdrafts	20	–	(7)
Cash and cash equivalents at 31 December		3,232	3,264

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

1. Segmental analysis

Revenue and profit recognition

Revenue represents income derived from contracts for the provision of goods and services, over time or at a point in time, by the Group to customers in exchange for consideration in the ordinary course of the Group's activities.

Performance obligations

Upon approval by the parties to a contract, the contract is assessed to identify each promise to transfer either a distinct good or service or a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Goods and services are distinct and accounted for as separate performance obligations in the contract if the customer can benefit from them either on their own or together with other resources that are readily available to the customer and they are separately identifiable in the contract.

The Group provides warranties to its customers to give them assurance that its products and services will function in line with agreed-upon specifications. Warranties are not provided separately and, therefore, do not represent separate performance obligations.

Transaction price

At the start of the contract, the total transaction price is estimated as the amount of consideration to which the Group expects to be entitled in exchange for transferring the promised goods and services to the customer, excluding sales taxes. Variable consideration, such as price escalation, is included based on the expected value or most likely amount only to the extent that it is highly probable that there will not be a reversal in the amount of cumulative revenue recognised. The transaction price does not include estimates of consideration resulting from contract modifications, such as change orders, until they have been approved by the parties to the contract. The total transaction price is allocated to the performance obligations identified in the contract in proportion to their relative stand-alone selling prices. Given the bespoke nature of many of the Group's products and services, which are designed and/or manufactured under contract to the customer's individual specifications, there are typically no observable stand-alone selling prices. Instead, stand-alone selling prices are typically estimated based on expected costs plus contract margin consistent with the Group's pricing principles.

Whilst payment terms vary from contract to contract, on many of the Group's contracts, an element of the transaction price is received in advance of delivery. The Group therefore has significant contract liabilities (note 21). The Group's contracts are not considered to include significant financing components on the basis that there is no difference between the consideration and the cash selling price. UK Ministry of Defence contracting rules prohibit the inclusion of financing in the sales price. Negotiations on competitive international export contracts do not make allowance for the cash payment profile.

Revenue and profit recognition

Revenue is recognised as performance obligations are satisfied as control of the goods and services is transferred to the customer.

For each performance obligation within a contract, the Group determines whether it is satisfied over time or at a point in time. Performance obligations are satisfied over time if one of the following criteria is satisfied:

- the customer simultaneously receives and consumes the benefits provided by the Group's performance as it performs;
- the Group's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the Group's performance does not create an asset with an alternative use to the Group and it has an enforceable right to payment for performance completed to date.

The Group has determined that most of its contracts satisfy the over time criteria, either because the customer simultaneously receives and consumes the benefits provided by the Group's performance as it performs (typically services or support contracts) or the Group's performance does not create an asset with an alternative use to the Group and it has an enforceable right to payment for performance completed to date (typically development or production contracts).

For each performance obligation to be recognised over time, the Group recognises revenue using an input method, based on costs incurred in the period. Revenue and attributable margin are calculated by reference to reliable estimates of transaction price and total expected costs, after making suitable allowances for technical and other risks. Revenue and associated margin are therefore recognised progressively as costs are incurred, and as risks have been mitigated or retired. The Group has determined that this method appropriately depicts the Group's performance in transferring control of the goods and services to the customer.

If the over time criteria for revenue recognition are not met, revenue is recognised at the point in time that control is transferred to the customer, which is usually when legal title passes to the customer and the business has the right to payment, for example, on delivery.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

1. Segmental analysis continued

Software licences

The Group sells software licences either separately or together with other goods and services, including computer hardware and implementation, hosting and support. Revenue recognition in respect of software licences sold as part of a bundle of goods and services is considered separately when the licence is determined to be a separate performance obligation. Software licences either represent a right to access the Group's intellectual property as it exists throughout the licence period or a right to use the Group's intellectual property as it exists at the point in time at which the licence is granted. Revenue in respect of right to access licences is recognised over the licence term or, in relation to perpetual licences, over the related customer relationship and revenue in respect of right to use licences is recognised upfront on delivery to the customer. A software licence is considered to be a right to access the Group's intellectual property as it exists throughout the licence period if all of the following criteria are satisfied:

- the contract requires, or the customer reasonably expects, that the Group will undertake activities that significantly affect the intellectual property; and
- the licence directly exposes the customer to the effects of those activities; and
- those activities do not result in the transfer of a good or service to the customer.

Contract modifications

The Group's contracts are often amended for changes in customers' requirements and specifications. A contract modification exists when the parties to the contract approve a modification that either changes existing or creates new enforceable rights and obligations. The effect of a contract modification on the transaction price and the Group's measure of progress towards the satisfaction of the performance obligation to which it relates is recognised in one of the following ways:

1. prospectively, as an additional, separate contract;
2. prospectively, as a termination of the existing contract and creation of a new contract; or
3. as part of the original contract using a cumulative catch-up.

The majority of the Group's contract modifications are treated under either 1 (for example, the requirement for additional distinct goods or services) or 3 (for example, a change in the specification of the distinct goods or services for a partially completed contract), although the facts and circumstances of any contract modification are considered individually as the types of modifications will vary contract-by-contract and may result in different accounting outcomes.

Costs to obtain a contract

The Group expenses pre-contract bidding costs which are incurred regardless of whether a contract is awarded. The Group does not typically incur costs to obtain contracts that it would not have incurred had the contracts not been awarded, such as sales commission.

Costs to fulfil a contract

Contract fulfilment costs in respect of over time contracts are expensed as incurred. Contract fulfilment costs in respect of point in time contracts are accounted for under IAS 2 Inventories.

Reporting segments

With effect from 1 January 2018, the Group revised its reporting segments to reflect the organisational changes announced in 2017. The five principal reporting segments are Electronic Systems; Cyber & Intelligence; Platforms & Services (US); Air; and Maritime. These align with the strategic direction of the Group. Financial information for 2017 has been re-presented to reflect these new reporting segments.

- **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, precision guidance and seeker solutions, 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)**, with operations in the US, UK and Sweden, manufactures combat vehicles, weapons and munitions, and delivers services and sustainment activities, including ship repair, and the management and operation of government-owned munitions facilities;
- **Air** comprises the Group's UK-based air activities for European and International Markets, and US Programmes, and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the European MBDA joint venture;
- **Maritime** comprises the Group's UK-based maritime and land activities; and
- **HQ** comprises the Group's head office and UK-based shared services activities, together with a 49% interest in Air Astana.

The Board (the chief operating decision maker as defined by IFRS 8 Operating Segments) monitors the results of these reporting segments to assess performance and make decisions about the allocation of resources. Segmental performance is evaluated based on Key Performance Indicators – sales (see page 150) and underlying EBITA (see page 151). Finance costs and taxation expense are managed on a Group basis.

Notes to the Group accounts continued

1. Segmental analysis continued

Key Performance Indicator – Sales

Definition Revenue plus the Group's share of revenue of equity accounted investments.

Purpose Allows management to monitor the sales performance of subsidiaries and equity accounted investments.

Sales and revenue by reporting segment¹

	Sales		Deduct Share of sales by equity accounted investments		Add Sales to equity accounted investments		Revenue	
	2018 £m	2017 (restated) ² £m	2018 £m	2017 (restated) ² £m	2018 £m	2017 (restated) ² £m	2018 £m	2017 (restated) ² £m
Electronic Systems	3,965	3,598	(101)	(95)	101	95	3,965	3,598
Cyber & Intelligence	1,678	1,818	–	–	–	–	1,678	1,818
Platforms & Services (US)	3,005	2,951	(141)	(103)	–	–	2,864	2,848
Air	6,712	7,210	(2,224)	(2,006)	1,091	1,108	5,579	6,312
Maritime	2,975	2,877	(37)	(41)	2	9	2,940	2,845
HQ	350	336	(309)	(289)	–	–	41	47
	18,685	18,790	(2,812)	(2,534)	1,194	1,212	17,067	17,468
Intra-group sales/revenue	(278)	(303)	–	–	32	59	(246)	(244)
	18,407	18,487	(2,812)	(2,534)	1,226	1,271	16,821	17,224

	Intra-group revenue		Revenue from external customers	
	2018 £m	2017 (restated) ² £m	2018 £m	2017 (restated) ² £m
Electronic Systems	54	73	3,911	3,525
Cyber & Intelligence	91	88	1,587	1,730
Platforms & Services (US)	39	23	2,825	2,825
Air	10	9	5,569	6,303
Maritime	40	40	2,900	2,805
HQ	12	11	29	36
	246	244	16,821	17,224

1. Reporting segments have been re-presented to reflect the organisational changes which took effect on 1 January 2018.

2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

Sales and revenue by customer location

	Sales		Revenue	
	2018 £m	2017 (restated) ¹ £m	2018 £m	2017 (restated) ¹ £m
UK	3,819	3,623	3,622	3,390
Rest of Europe ²	2,007	2,046	1,176	1,472
US	7,729	7,460	7,713	7,457
Canada	115	100	115	100
Saudi Arabia	2,593	3,085	2,464	2,964
Rest of Middle East	801	912	694	826
Australia	562	608	560	607
Rest of Asia and Pacific	636	503	430	314
Africa, and Central and South America	145	150	47	94
	18,407	18,487	16,821	17,224

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

2. Includes £0.7bn (2017 £0.9bn) generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

1. Segmental analysis continued

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2018 £m	2017 (restated) ¹ £m
US Department of Defense	5,148	4,543
UK Ministry of Defence ²	3,848	3,933
Kingdom of Saudi Arabia Ministry of Defence and Aviation	2,366	2,799

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.
2. Includes £0.7bn (2017 £0.9bn) generated under the Typhoon workshare 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 Air and Maritime reporting segments.

Key Performance Indicator – Underlying EBITA

Definition Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items.

Purpose Provides a measure of operating profitability that is comparable over time.

Amortisation and impairment of intangible assets are excluded because they are not related to the in-year operational performance of the business, being driven by the timing and amount of investment in acquired businesses and software.

Finance costs and taxation expense of equity accounted investments are excluded for consistency with pre-interest, pre-tax business performance.

Non-recurring items are items of financial performance which have been determined by management as being material by their size or incidence and not relevant to an understanding of the Group's underlying business performance. The Group's definition of non-recurring items includes profit or loss on business transactions, and costs incurred which are one-off in nature, for example non-routine costs or income relating to post-retirement benefit schemes, and other exceptional items which management has determined as not being relevant to an understanding of the Group's underlying business performance.

2018

The non-recurring loss of £154m represents a Guaranteed Minimum Pension equalisation charge of £114m (see note 22), and a loss on disposal of the Mobile, Alabama, shipyard of £40m.

2017

The non-recurring loss of £13m represented the loss on disposal of the BAE Systems San Francisco Ship Repair business.

Operating profit/(loss) by reporting segment¹

	Underlying EBITA		Non-recurring items		Amortisation and impairment of intangible assets		Financial and taxation expense of equity accounted investments		Operating profit/(loss)	
	2018 £m	2017 (restated) ² £m	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 (restated) ² £m	2018 £m	2017 (restated) ² £m
Electronic Systems	606	541	–	–	(16)	(20)	–	–	590	521
Cyber & Intelligence	111	58	–	–	(52)	(419)	–	–	59	(361)
Platforms & Services (US)	210	237	(40)	(13)	(8)	(9)	(1)	(2)	161	213
Air	859	967	–	–	(12)	(8)	(37)	(41)	810	918
Maritime	209	251	–	–	(16)	(8)	(2)	(3)	191	240
HQ	(67)	(80)	(114)	–	(14)	(6)	(11)	(26)	(206)	(112)
	1,928	1,974	(154)	(13)	(118)	(470)	(51)	(72)	1,605	1,419
Net finance costs									(381)	(346)
Profit before taxation									1,224	1,073
Taxation expense									(191)	(216)
Profit for the year									1,033	857

1. Reporting segments have been re-presented to reflect the organisational changes which took effect on 1 January 2018.
2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

Notes to the Group accounts

continued

1. Segmental analysis continued

Share of results of equity accounted investments within reporting segments¹

	Underlying EBITA		Non-recurring items		Amortisation of intangible assets		Financial and taxation expense		Share of results of equity accounted investments	
	2018 £m	2017 (restated) ² £m	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 (restated) ² £m	2018 £m	2017 (restated) ² £m
Electronic Systems	9	6	–	–	–	–	–	–	9	6
Platforms & Services (US)	23	13	–	–	–	–	(1)	(2)	22	11
Air	150	132	–	–	(7)	(4)	(37)	(41)	106	87
Maritime	7	8	–	–	–	–	(2)	(3)	5	5
HQ	13	24	(4)	–	–	–	(11)	(26)	(2)	(2)
	202	183	(4)	–	(7)	(4)	(51)	(72)	140	107

1. Reporting segments have been re-presented to reflect the organisational changes which took effect on 1 January 2018.

2. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

Key Performance Indicator – Order backlog

Definition Funded and unfunded unexecuted customer orders including the Group's share of order backlog of equity accounted investments. Unfunded orders include the elements of US multi-year contracts for which funding has not been authorised by the customer.

Purpose Supports future years' sales performance of subsidiaries and equity accounted investments.

Performance obligations

The Group's order book¹, reconciled to order backlog as defined by the Group, is shown below.

	2018 £bn
Order backlog as defined by the Group	48.4
Deduct Unfunded order backlog	(2.0)
Deduct Share of order backlog of equity accounted investments	(9.9)
Add Order backlog in respect of orders from equity accounted investments	3.3
Order book ¹	39.8

1. Order book represents the transaction price allocated to unsatisfied and partially satisfied performance obligations as defined by IFRS 15 Revenue from Contracts with Customers. As permitted under the transitional provisions of IFRS 15, comparative information in respect of the Group's order book is not disclosed.

The Group expects that approximately 35% of the order book as at 31 December 2018 will be recognised as revenue during the next year, with the remainder largely recognised over the following four years.

For each performance obligation to be recognised over time, the Group recognises revenue using an input method, based on costs incurred in the period. Revenue and attributable margin are calculated by reference to reliable estimates of transaction price and total expected costs, after making suitable allowances for technical and other risks. Revenue and associated margin are therefore recognised progressively as costs are incurred, and as risks have been mitigated or retired. The Group has determined that this method appropriately depicts the Group's performance in transferring control of the goods and services to the customer. Accordingly, revenue of £0.3bn was recognised during the year ended 31 December 2018 in respect of performance obligations satisfied or partially satisfied in previous periods.

2. Operating costs

Leases

Lease payments made under operating leases, including any incentives granted, are recognised in the income statement on a straight-line basis over the lease term.

Research and development

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Group-funded expenditure on research, and on 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 recognised in the income statement in accordance with the Group's revenue recognition policy.

	2018 £m	2017 (restated) ¹ £m
Raw materials, subcontracts and other bought-in items used	5,816	6,098
Change in inventories of finished goods and work-in-progress	44	(74)
Staff costs (note 3)	5,876	5,830
Guaranteed Minimum Pension equalisation charge (note 22)	110	–
Depreciation	269	263
Amortisation	78	82
Impairment – property, plant and equipment (note 9), and investment property (note 10)	31	(1)
Impairment – intangible assets (note 8)	33	384
Lease expense	287	295
Loss on disposal of property, plant and equipment, and investment property	1	1
Loss in respect of held for sale assets and business disposals	9	13
Other operating charges	2,960	3,152
Operating costs	15,514	16,043

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

Operating costs includes research and development expenditure of £212m (2017 £238m) funded by the Group. Development investment of £10m (2017 £nil) was capitalised during the year (see note 8).

Notes to the Group accounts

continued

2. Operating costs continued

Fees payable to the Company's auditor and its associates included in operating costs¹

	2018			2017		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts	2,000	–	2,000	2,034	–	2,034
Fees payable to the Company's auditor and its associates for other services to the Group:						
The audit of the Company's subsidiaries	2,687	4,091	6,778	2,809	4,471	7,280
Total audit fees	4,687	4,091	8,778	4,843	4,471	9,314
Audit-related assurance services ²	690	–	690	1,086	108	1,194
Tax compliance services	–	–	–	–	107	107
Tax advisory services	–	–	–	–	35	35
Other assurance services	175	–	175	–	–	–
Other services ³	1,776	–	1,776	38	53	91
Total non-audit fees	2,641	–	2,641	1,124	303	1,427
Total fees payable to the Company's auditor and its associates	7,328	4,091	11,419	5,967	4,774	10,741
Fees in respect of BAE Systems pension schemes:						
Audit	–	–	–	–	292	292
Tax compliance	–	–	–	–	5	5
Tax advisory	–	–	–	–	–	–
	–	–	–	–	297	297

1. 2017 fees are payable to KPMG LLP. Deloitte LLP replaced KPMG LLP as the Company's auditor at the Annual General Meeting on 10 May 2018. 2018 fees are payable to Deloitte LLP.

2. 2018 primarily relates to the review of the half-yearly financial report. 2017 includes advice from KPMG LLP in respect of IFRS 15.

3. 2018 primarily relates to consultancy work undertaken by Deloitte LLP in relation to the Group's Submarines business (see page 83).

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	
	2018 Number '000	2017 ¹ Number '000	2018 Number '000	2017 ¹ Number '000
Electronic Systems	15	14	16	14
Cyber & Intelligence	10	11	10	11
Platforms & Services (US)	11	11	11	11
Air	22	22	23	22
Maritime	16	16	16	16
HQ	2	2	2	2
	76	76	78	76

1. Reporting segments have been re-presented to reflect the organisational changes which took effect on 1 January 2018.

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were as follows:

	2018 £m	2017 £m
Wages and salaries	5,019	4,972
Social security costs	367	360
Share-based payments (note 30)	63	61
Pension costs – defined contribution plans (note 22)	203	193
Pension costs – defined benefit plans (note 22)	223	242
US healthcare costs (note 22)	1	2
	5,876	5,830

4. Other income

Leases

Lease income under operating leases is recognised in the income statement on a straight-line basis over the lease term.

	2018 £m	2017 £m
Research and development expenditure credits	27	20
Rental income from operating leases – investment property	22	23
Rental income from operating leases – other	15	16
Profit on disposal of property, plant and equipment	13	2
Profit on disposal of investment property	6	9
Management recharges to equity accounted investments (note 31)	18	16
Royalties	11	9
Other ¹	46	36
Other income	158	131

1. Includes £15m for capital spend recovery in respect of Saudi Arabia Industrial Participation investments and an £8m (2017 £11m) recovery of site development costs for the Dreadnought programme in Barrow. There are no other individual amounts in excess of £10m.

Notes to the Group accounts

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5. Net 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.

	2018 £m	2017 £m
Interest income	26	24
Gain on remeasurement of financial instruments at fair value through profit or loss ¹	186	54
Foreign exchange gains ²	16	338
Financial income	228	416
Interest expense on bonds and other financial instruments	(204)	(202)
Facility fees	(4)	(4)
Net present value adjustments	(31)	(44)
Net interest expense on retirement benefit obligations (note 22)	(103)	(165)
Loss on remeasurement of financial instruments at fair value through profit or loss ¹	(40)	(317)
Foreign exchange losses ²	(227)	(30)
Financial expense	(609)	(762)
Net finance costs	(381)	(346)

1. Comprises gains and losses on derivative financial instruments, including derivative instruments to manage the Group's exposure to interest rate fluctuations on external borrowings and exchange rate fluctuations on balances with the Group's subsidiaries and equity accounted investments.
2. The foreign exchange gains and losses primarily reflect exchange rate movements on US dollar-denominated borrowings.

Additional analysis

	2018 £m	2017 £m
Net finance costs:		
Group	(381)	(346)
Share of equity accounted investments	(13)	(34)
	(394)	(380)
Analysed as:		
Underlying net interest expense ¹ :		
Group	(213)	(226)
Share of equity accounted investments	(2)	(19)
	(215)	(245)
Other:		
Group:		
Net interest expense on retirement benefit obligations	(103)	(165)
Fair value and foreign exchange adjustments on financial instruments and investments ²	(65)	45
Share of equity accounted investments:		
Net interest expense on retirement benefit obligations	(3)	(8)
Fair value and foreign exchange adjustments on financial instruments and investments	(8)	(7)
	(394)	(380)

1. Underlying net interest expense is defined as finance costs for the Group and its share of equity accounted investments, excluding net interest expense on retirement benefit obligations and fair value and foreign exchange adjustments on financial instruments and investments.
2. The net loss (2017 gain) primarily reflects foreign exchange translational losses (2017 gains) on US dollar-denominated bonds held by BAE Systems plc.

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

	2018 £m	2017 (restated) ¹ £m
Current taxation		
UK:		
Current year	(64)	(132)
Adjustments in respect of prior years	(2)	(21)
	(66)	(153)
Overseas:		
Current year	(183)	(160)
Adjustments in respect of prior years	42	40
	(141)	(120)
Total current taxation	(207)	(273)
Deferred taxation		
UK:		
Origination and reversal of temporary differences	15	52
Adjustments in respect of prior years	15	3
Tax rate adjustment	–	(1)
	30	54
Overseas:		
Origination and reversal of temporary differences	(1)	(42)
Adjustments in respect of prior years	(18)	(13)
Tax rate adjustment ²	5	58
	(14)	3
Total deferred taxation	16	57
Taxation expense	(191)	(216)
UK	(36)	(99)
Overseas	(155)	(117)
Taxation expense	(191)	(216)

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

2. The US federal tax rate was reduced from 35% to 21% with effect from 1 January 2018, while the estimated state tax rate increased from 5% to 6%. In line with this change, the rate applying to US deferred tax assets and liabilities at 31 December 2017 was reduced from 40% to 27%, creating a rate adjustment in 2017, which was partly reflected in the Consolidated income statement and partly in the Consolidated statement of comprehensive income. The rate applying to US deferred tax assets and liabilities has been further reduced to 25.7% at 31 December 2018, creating a rate adjustment in 2018, which is partly reflected in the Consolidated income statement and partly in the Consolidated statement of comprehensive income.

Notes to the Group accounts

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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.

	2018 £m	2017 (restated) ¹ £m
Profit before taxation	1,224	1,073
UK corporation tax rate	19%	19.25%
Expected income tax expense	(233)	(207)
Effect of tax rates in foreign jurisdictions, including US state taxes	(43)	(95)
Effect of intra-group financing	14	15
Expenses not tax effected	(14)	(8)
Income not subject to tax	18	46
Research and development tax credits and patent box benefits	14	18
Non-deductible goodwill impairment	–	(74)
Chargeable gains	(1)	(2)
Utilisation of previously unrecognised tax losses	1	3
Adjustments in respect of prior years	37	9
Adjustments in respect of equity accounted investments	27	21
Tax rate adjustment ²	5	57
Other	(16)	1
Taxation expense	(191)	(216)

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

2. 2017 included a £58m credit in respect of US tax reform enacted in December 2017.

Calculation of the underlying effective tax rate

	2018 £m	2017 (restated) ¹ £m
Profit before taxation	1,224	1,073
Add back:		
Taxation expense of equity accounted investments	38	38
Goodwill impairment (note 8)	–	384
Adjusted profit before taxation	1,262	1,495
Taxation expense	(191)	(216)
Taxation expense of equity accounted investments	(38)	(38)
Exclude: Impact of US tax reform enacted in December 2017	–	(58)
Adjusted taxation expense (including equity accounted investments)	(229)	(312)
Underlying effective tax rate	18%	21%

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

6. Taxation expense continued

Tax recognised in other comprehensive income

	2018			2017 (restated) ¹		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax (expense)/ benefit £m	Net of tax £m
Items that will not be reclassified to the income statement:						
Subsidiaries:						
Remeasurements on retirement benefit schemes	74	3	77	2,056	(398)	1,658
Tax rate adjustment ²	–	2	2	–	(83)	(83)
Equity accounted investments	8	(2)	6	65	(13)	52
Items that may be reclassified to the income statement:						
Subsidiaries:						
Currency translation on foreign currency net investments	400	–	400	(630)	–	(630)
Amounts (charged)/credited to hedging reserve	(25)	5	(20)	59	(11)	48
Equity accounted investments	16	(1)	15	(17)	(1)	(18)
	473	7	480	1,533	(506)	1,027

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.
2. 2017 comprised £67m in relation to the US and £16m in relation to the UK.

	2018			2017 (restated) ¹		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
Current tax						
Subsidiaries:						
Remeasurements on retirement benefit schemes	–	24	24	–	23	23
	–	24	24	–	23	23
Deferred tax						
Subsidiaries:						
Remeasurements on retirement benefit schemes	–	(21)	(21)	–	(421)	(421)
Tax rate adjustment ²	–	2	2	–	(83)	(83)
Amounts charged to hedging reserve	5	–	5	(11)	–	(11)
Equity accounted investments	(1)	(2)	(3)	(1)	(13)	(14)
	4	(21)	(17)	(12)	(517)	(529)
Tax on other comprehensive income	4	3	7	(12)	(494)	(506)

1. Prior year comparatives have been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.
2. 2017 comprised £67m in relation to the US and £16m in relation to the UK.

Notes to the Group accounts

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7. Earnings per share

Key Performance Indicator – Underlying earnings per share

Definition Basic earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items and, in 2017, the impact of US tax reform enacted in December 2017.

Purpose Provides a measure of underlying performance that is comparable over time.

Amortisation and impairment of intangible assets are excluded because they are not related to the in-year operational performance of the business, being driven by the timing and quantum of investment in acquired businesses and software.

Non-cash finance movements on pensions are excluded because they are driven by external factors, such as corporate bond yields and inflation.

Non-cash finance movements on financial derivatives are excluded because they are driven by external factors, such as foreign exchange rates and interest rates.

Non-recurring items (as defined in note 1) are items of financial performance which have been determined by management as being material by their size or incidence and not relevant to an understanding of the Group's underlying performance.

In 2017, the impact of US tax reform enacted in December 2017 was excluded because it did not reflect the Group's in-year underlying tax rate.

	2018			2017 (restated) ¹		
	£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	1,000	31.3	31.2	827	26.0	25.9
Add back/(deduct):						
Amortisation and impairment of intangible assets, post tax ²	97			68		
Impairment of goodwill	–			384		
Non-cash movements, being net interest expense on retirement benefit obligations, post tax ²	87			137		
Non-cash movements, being fair value and foreign exchange adjustments on financial instruments and investments, post tax ²	60			(30)		
Non-recurring items, post tax ²	126			10		
Impact of US tax reform enacted in December 2017 ³	–			(58)		
Underlying earnings, post tax	1,370	42.9	42.8	1,338	42.1	41.9
		Millions	Millions		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		3,192	3,192		3,182	3,182
Incremental shares in respect of employee share schemes			9			15
Weighted average number of shares used in calculating diluted earnings per share			3,201			3,197

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

2. The tax impact is calculated using the underlying effective tax rate of 18% (2017 21%).

3. Prior year comparatives have been restated to exclude an additional £18m benefit in respect of the impact of US tax reform enacted in December 2017 resulting from the restatement of prior year comparatives upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers.

8. Intangible assets

Intangible assets are carried at cost or valuation, less accumulated amortisation and impairment losses.

Cost or valuation

Goodwill

Under the acquisition method for business combinations, goodwill is the acquisition-date fair value of the consideration transferred, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed. 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.

Software

Software includes:

- **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; and
- **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.

Development costs

Development costs funded by the Group on activities applied to a plan or design for the production of new or substantially improved products are capitalised as an internally-generated intangible asset if certain conditions are met. The costs capitalised include materials, direct labour and related overheads.

Programme and customer-related

Intangible assets recognised by the Group include those relating to ongoing programmes within businesses acquired, mainly in respect of customer relationships and order backlog. These assets are initially recognised at their fair value at the acquisition date.

Other

Other intangible assets includes patents, trademarks and licences.

Amortisation

Goodwill is not amortised. Amortisation on intangible assets, excluding goodwill, is charged to the income statement on a straight-line basis over their estimated useful lives.

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:

Software	2 to 10 years
Development costs	up to 10 years
Programme and customer-related	up to 15 years
Other	up to 20 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 (excluding goodwill), 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 goodwill and 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 (CGU) 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 CGU 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

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8. Intangible assets continued

	Goodwill £m	Software £m	Development costs £m	Programme and customer- related £m	Other £m	Total £m
Cost or valuation						
At 1 January 2017	15,403	558	101	544	99	16,705
Additions:						
Acquired separately	–	42	–	–	–	42
Internally developed	–	45	–	–	–	45
Business acquisitions	3	–	–	–	–	3
Disposals ¹	–	(13)	–	(259)	(10)	(282)
Reclassification as held for sale	–	–	–	–	(4)	(4)
Transfer from property, plant and equipment	–	33	–	–	8	41
Foreign exchange adjustments	(684)	(18)	(11)	(20)	(4)	(737)
At 31 December 2017	14,722	647	90	265	89	15,813
Additions:						
Acquired separately	–	98	–	5	2	105
Internally developed	–	28	10	–	–	38
Disposals ¹	–	(16)	–	(43)	(2)	(61)
Reclassification as held for sale	(80)	(10)	–	–	–	(90)
Net transfer from property, plant and equipment	–	13	–	–	–	13
Foreign exchange adjustments	436	15	5	9	4	469
At 31 December 2018	15,078	775	105	236	93	16,287
Amortisation and impairment						
At 1 January 2017	4,501	298	59	496	87	5,441
Amortisation ²	–	43	8	20	14	85
Impairment charge	384	–	–	–	–	384
Disposals ¹	–	(13)	–	(259)	(9)	(281)
Reclassification as held for sale	–	–	–	–	(4)	(4)
Transfer from property, plant and equipment	–	7	–	–	–	7
Foreign exchange adjustments	(159)	(13)	(5)	(17)	(3)	(197)
At 31 December 2017	4,726	322	62	240	85	5,435
Amortisation ²	–	63	7	11	3	84
Impairment charge ³	–	–	–	33	–	33
Disposals ¹	–	(16)	–	(43)	(2)	(61)
Transfer to property, plant and equipment	–	(3)	–	–	–	(3)
Reclassification as held for sale	–	(3)	–	–	–	(3)
Reclassification between categories	–	23	–	(23)	–	–
Foreign exchange adjustments	113	14	4	9	4	144
At 31 December 2018	4,839	400	73	227	90	5,629
Net book value						
At 31 December 2018	10,239	375	32	9	3	10,658
At 31 December 2017	9,996	325	28	25	4	10,378
At 1 January 2017	10,902	260	42	48	12	11,264

1. Includes intangible assets with nil net book value no longer used by the Group.

2. Amortisation of £84m (2017 £85m) includes £78m (2017 £82m) charged to the income statement as an amortisation expense and £6m (2017 £3m) recoverable on customer contracts.

3. The impairment charge in Cyber & Intelligence relates to Silversky customer-related intangible assets.

8. Intangible assets continued

Impairment testing

The recoverable amount of the Group's goodwill is based on value in use estimated using risk-adjusted future cash flow projections from the five-year Integrated Business Plan (IBP) and a terminal value based on the projections for the final year of that plan, with growth rate assumptions in the range 0% to 2% applied. The IBP process includes the use of historical 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 7.24% (2017 6.60%) (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.

Significant CGUs

Goodwill allocated to CGUs which are largely dependent on US government spending on defence, aerospace and security represents £8.2bn (2017 £7.9bn) of the Group's total goodwill balance. The Group monitors changes in defence budgets on an ongoing basis.

Cash-Generating Unit	Key assumptions	Allocated goodwill		Pre-tax discount rate	
		2018 £bn	2017 £bn	2018 %	2017 %
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	4.0	3.8	9	8
Intelligence & Security (within Cyber & Intelligence)	Continued demand in the US for the Group's services in the areas of homeland security, law enforcement and counter-intelligence	0.7	0.7	9	8
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	3.5	3.4	9	8

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2018 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% and 2% increase in the discount rate used in the value in use calculations.

Cash-Generating Unit	Headroom as at 31 December		Headroom assuming a 1% reduction in the terminal value growth rate assumption		Headroom assuming a 1% increase in the discount rate		Headroom assuming a 2% increase in the discount rate	
	2018 £bn	2017 £bn	2018 £bn	2017 £bn	2018 £bn	2017 £bn	2018 £bn	2017 £bn
Electronic Systems	4.4	5.7	3.0	4.0	2.8	3.7	1.6	2.4
Intelligence & Security	0.7	0.6	0.5	0.4	0.5	0.4	0.4	0.2
Platforms & Services (US)	1.8	3.5	0.9	2.2	0.8	2.0	0.1	1.0

Other CGUs

The remaining goodwill balance of £2.0bn (2017 £2.1bn) is allocated across multiple CGUs, including £0.2bn (2017 £0.2bn) 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

In 2017, the impairment charge of £384m reflected lower growth assumptions in the Applied Intelligence CGU. The recoverable amount of the Applied Intelligence CGU was based on value in use calculated using a pre-tax discount rate of 16%.

Software

The software intangible assets balance includes £135m (2017 £107m) relating to an Enterprise Resource Planning transformation programme currently being implemented across the Air segment. In line with the Group's amortisation policy, the intangible asset will be amortised over a period of 10 years as the programme becomes operational from 2019.

Notes to the Group accounts

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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. The reimbursement of the cost of an item of property, plant and equipment by way of a government grant is presented as deferred income and recognised in the income statement on a basis consistent with the depreciation of the asset over its estimated useful life.

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 items 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 2017	2,176	3,229	5,405
Additions ¹	218	306	524
Reclassification as held for sale	–	(16)	(16)
Transfer to other intangible assets	(2)	(39)	(41)
Reclassification between categories	(42)	42	–
Disposals	(41)	(144)	(185)
Foreign exchange adjustments	(97)	(146)	(243)
At 31 December 2017	2,212	3,232	5,444
Additions ¹	154	288	442
Reclassification as held for sale	(11)	(12)	(23)
Transfer (to)/from other intangible assets	(17)	4	(13)
Reclassification between categories	44	(60)	(16)
Disposals	(117)	(141)	(258)
Foreign exchange adjustments	50	87	137
At 31 December 2018	2,315	3,398	5,713
Depreciation and impairment			
At 1 January 2017	1,148	2,159	3,307
Depreciation charge for the year	66	194	260
Impairment charge for the year	–	1	1
Impairment write back	(4)	–	(4)
Reclassification as held for sale	–	(11)	(11)
Transfer to other intangible assets	–	(7)	(7)
Reclassification between categories	(33)	33	–
Disposals	(39)	(139)	(178)
Foreign exchange adjustments	(55)	(99)	(154)
At 31 December 2017	1,083	2,131	3,214
Depreciation charge for the year	84	183	267
Impairment charge for the year ²	27	4	31
Reclassification as held for sale	(7)	(6)	(13)
Transfer from other intangible assets	–	3	3
Reclassification between categories	18	(34)	(16)
Disposals	(89)	(136)	(225)
Foreign exchange adjustments	29	58	87
At 31 December 2018	1,145	2,203	3,348
Net book value			
At 31 December 2018	1,170	1,195	2,365
At 31 December 2017	1,129	1,101	2,230
At 1 January 2017	1,028	1,070	2,098

1. Includes £70m (2017 £109m) of land and buildings, and £20m (2017 £42m) of plant and machinery at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.
2. The impairment charge in Platforms & Services (US) relates to the Mobile shipyard prior to its disposal.

Notes to the Group accounts

continued

9. Property, plant and equipment continued

Net impairment

	2018 £m	2017 £m
Electronic Systems	–	(4)
Platforms & Services (US)	31	–
Air	–	1
	31	(3)

2018

The impairment charge in Platforms & Services (US) relates to the Mobile shipyard prior to its disposal.

2017

The impairment write back in Electronic Systems related to the carrying value of a property in New Jersey, US.

Assets in the course of construction

	Land and buildings ¹ £m	Plant and machinery £m	Total £m
At 31 December 2018	198	230	428
At 31 December 2017	259	296	555

1. Includes £129m (2017 £178m) at Barrow-in-Furness, UK, relating to the Dreadnought 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:

	2018 £m	2017 £m
Receipts due:		
Not later than one year	24	24
Later than one year and not later than five years	95	95
Later than five years	28	51
	147	170

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 2017	170
Additions	15
Disposals	(24)
At 31 December 2017	161
Additions	8
Disposals	(9)
At 31 December 2018	160
Depreciation and impairment	
At 1 January 2017	60
Depreciation charge for the year	3
Impairment charge	2
Disposals	(5)
At 31 December 2017	60
Depreciation charge for the year	2
At 31 December 2018	62
Net book value	
At 31 December 2018	98
At 31 December 2017	101
At 1 January 2017	110
Fair value	
At 31 December 2018	176
At 31 December 2017	173

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.

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11. Equity accounted investments

Equity accounted investments comprises joint ventures and associates. A joint venture is a joint arrangement whereby the parties that have joint control have rights to the net assets of the arrangement. An associate is an entity over which the Group has significant influence.

The Group recognises its share of the profit or loss and other comprehensive income of equity accounted investments as a separate line in the Consolidated income statement and Consolidated statement of comprehensive income, respectively.

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

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.

	2018		2017 (restated) ¹	
	Eurofighter Jagdflugzeug £m	MBDA £m	Eurofighter Jagdflugzeug £m	MBDA £m
Revenue (100%)	3,110	2,799	3,011	2,614
Underlying EBITA ² excluding depreciation	12	398	10	330
Non-recurring items	–	(11)	–	–
Depreciation and amortisation	(1)	(95)	(1)	(46)
Financial income	–	(63)	2	64
Financial expense	–	60	–	(82)
Taxation expense	(2)	(86)	(4)	(87)
Profit/(loss) for the year (100%)	9	203	7	179
Remeasurements on retirement benefit schemes, net of tax	–	15	–	139
Amounts charged to hedging reserve, net of tax	–	(11)	–	(6)
Foreign exchange adjustments	–	9	–	(8)
Total comprehensive income for the year (100%)	9	216	7	304
Group's share of total comprehensive income for the year	3	81	2	114
Non-current assets	14	2,190	12	2,065
Cash and cash equivalents	32	2,324	30	2,420
Current assets excluding cash and cash equivalents	1,006	4,537	1,144	3,807
Current assets	1,038	6,861	1,174	6,227
Non-current financial liabilities excluding trade and other payables, and provisions	–	(8)	–	(4)
Other non-current liabilities	(33)	(719)	(29)	(795)
Non-current liabilities	(33)	(727)	(29)	(799)
Current financial liabilities excluding trade and other payables, and provisions	–	–	(3)	–
Other current liabilities	(988)	(7,808)	(1,130)	(7,136)
Current liabilities	(988)	(7,808)	(1,133)	(7,136)
Net assets (100%)	31	516	24	357

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.
2. Operating profit excluding amortisation and impairment of intangible assets (EBITA), and non-recurring items.

11. Equity accounted investments continued

	2018			2017 (restated) ¹		
	Eurofighter Jagdflyzeug £m	MBDA £m	Total £m	Eurofighter Jagdflyzeug £m	MBDA £m	Total £m
Group's share of net assets	10	193	203	8	134	142
Goodwill adjustment	–	6	6	–	6	6
Carrying value	10	199	209	8	140	148

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

	2018			2017		
	Eurofighter Jagdflyzeug £m	MBDA £m	Total £m	Eurofighter Jagdflyzeug £m	MBDA £m	Total £m
Dividends received	2	24	26	–	47	47

Group summary

The Group also has a number of individually immaterial joint ventures and associates, the carrying values of the most significant of which at 31 December 2018 are as follows: Advanced Electronics Company (£70m), FADEC International (£47m), Air Astana (£33m), FNSS (£33m) and Panavia Aircraft (£20m). 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 ¹ £m	Other £m	Total £m
At 1 January 2017	77	173	250
Group's share of profit for the year	70	37	107
Group's share of remeasurements on retirement benefit schemes	65	–	65
Tax on items that will not be reclassified to the income statement	(13)	–	(13)
Foreign exchange adjustments	(4)	(5)	(9)
Amounts (charged)/credited to hedging reserve	(2)	4	2
Tax on items that may be reclassified to the income statement	–	(1)	(1)
Group's share of total comprehensive income for the year	116	35	151
Equity accounted investment funding	–	3	3
Dividends received from equity accounted investments	(47)	(25)	(72)
Foreign exchange adjustments	2	(12)	(10)
At 31 December 2017	148	174	322
Group's share of profit for the year	79	61	140
Group's share of remeasurements on retirement benefit schemes	8	–	8
Tax on items that will not be reclassified to the income statement	(2)	–	(2)
Foreign exchange adjustments	3	–	3
Amounts (charged)/credited to hedging reserve	(4)	4	–
Tax on items that may be reclassified to the income statement	–	(1)	(1)
Group's share of total comprehensive income for the year	84	64	148
Purchase of equity accounted investments	–	2	2
Equity accounted investment funding	–	1	1
Dividends received from equity accounted investments	(26)	(31)	(57)
Foreign exchange adjustments	3	10	13
At 31 December 2018	209	220	429

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

Notes to the Group accounts

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12. Trade, other and contract receivables

Trade receivables are stated at amortised cost including a provision for expected credit losses. The Group measures the provision at an amount equal to lifetime expected credit losses, estimated by reference to past experience and relevant forward-looking factors.

The Group writes off a trade receivable when there is objective evidence that the debtor is in significant financial difficulty and there is no realistic prospect of recovery, for example, when a debtor enters bankruptcy or financial reorganisation.

Contract receivables represent amounts for which the Group has an unconditional right to consideration in respect of unbilled revenue recognised at the balance sheet date and comprise costs incurred plus attributable margin.

US deferred compensation plan assets are measured at fair value in accordance with IAS 19 Employee Benefits.

	2018 £m	2017 (restated) ¹ £m
Non-current		
Prepayments and accrued income	25	5
US deferred compensation plan assets	306	302
Other receivables ²	21	80
	352	387
Current		
Contract receivables	2,331	1,484
Trade receivables	1,427	1,664
Amounts owed by equity accounted investments (note 31)	67	86
Prepayments and accrued income	1,025	704
Other receivables ³	327	306
	5,177	4,244

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

2. Includes £11m (2017 £45m) which is reimbursable in respect of reorganisation costs.

3. Includes £35m (2017 £44m) which is reimbursable in respect of reorganisation costs.

Contract receivables increased in 2018, primarily as a result of build up of costs incurred on US Combat Vehicles, Electronic Systems and Saudi Arabian support programmes, ahead of invoicing customers.

Trade receivables are stated net of a provision for expected credit losses. Disclosures relating to the ageing of trade receivables and movements in the provision for expected credit losses are provided in note 29.

Current prepayments and accrued income increased in 2018 as a result of increased payments made into the supply chain including payments relating to the Qatar Typhoon and Hawk programme.

Disclosed as required on transition to IFRS 15 Revenue from Contracts with Customers, contract receivables as at 1 January 2017 were £1,609m.

13. Other financial assets and liabilities

Derivative financial instruments and hedging activities

The international 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 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 uses foreign exchange derivative instruments to manage the Group's exposure to currency fluctuations on its borrowings and deposits with the Group's subsidiaries and equity accounted investments.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes.

The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures.

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. The fair values are estimated by discounting expected future cash flows.

Fair value through profit or loss

Gains and losses on derivative financial instruments that are not designated as cash flow hedges are recognised within finance costs in the income statement for the period.

Cash flow hedges

Where a derivative financial instrument is designated as a hedge of the exposure to variability in cash flows relating to a highly probable forecast transaction (income or expense) or recognised asset or liability, 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 the hedging reserve 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. The Group treats the foreign currency basis element of the designated foreign exchange derivative hedging instruments as a cost of hedging and as such it is excluded from the hedge designation.

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 within finance costs in the income statement for the period.

	2018		2017	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	125	(95)	147	(114)
Other foreign exchange/interest rate contracts	33	(9)	–	(19)
Debt-related derivative financial instruments	87	–	79	–
	245	(104)	226	(133)
Current				
Cash flow hedges – foreign exchange contracts	79	(63)	77	(48)
Other foreign exchange/interest rate contracts	9	(9)	12	(37)
Debt-related derivative financial instruments ¹	78	(2)	–	(19)
	166	(74)	89	(104)

1. Liabilities include fair value hedges of £2m (2017 £nil).

Debt-related derivative financial instruments

The debt-related derivative financial instruments represent the fair value of cross-currency, interest rate and foreign exchange derivatives relating to the US\$500m 2.85% bond, repayable 2020, the US\$800m 3.8% bond, repayable 2024, the US\$750m 3.85% bond, repayable 2025, the US\$500m 7.5% bond, repayable 2027, and the US\$550m 4.75% bond, repayable 2044 (see note 20). These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

Additional information on the Group's financial risk management strategies and hedge accounting is provided in note 29.

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 in November 2017 under which the deficits are expected to be cleared between 2021 and 2026 (see note 22).

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	
	2018 £m	2017 (restated) ¹ £m	2018 £m	2017 (restated) ¹ £m	2018 £m	2017 (restated) ¹ £m
Property, plant and equipment	28	16	(85)	(94)	(57)	(78)
Intangible assets	2	13	(3)	(14)	(1)	(1)
Provisions and accruals	202	205	–	–	202	205
Goodwill	–	–	(283)	(275)	(283)	(275)
Pension/retirement schemes:						
Deficits	722	728	–	–	722	728
Additional contributions and other ²	97	100	(1)	(1)	96	99
Share-based payments	12	14	–	–	12	14
Financial instruments	–	–	(12)	(11)	(12)	(11)
Other items	14	27	(8)	(22)	6	5
Rolled over capital gains	–	–	(10)	(10)	(10)	(10)
Capital losses carried forward	10	10	–	–	10	10
Trading losses carried forward	17	12	–	–	17	12
Deferred tax assets/(liabilities)	1,104	1,125	(402)	(427)	702	698
Set off of tax	(402)	(423)	402	423	–	–
Net deferred tax assets/(liabilities)	702	702	–	(4)	702	698

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers and to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.
2. Includes deferred tax assets on US deferred compensation plans.

14. Deferred tax continued

Movement in temporary differences during the year

	At 1 January 2018 £m	Foreign exchange adjustments £m	Recognised in income £m	Recognised in equity £m	At 31 December 2018 £m
Property, plant and equipment	(78)	(5)	26	–	(57)
Intangible assets	(1)	–	–	–	(1)
Provisions and accruals	205	9	(12)	–	202
Goodwill	(275)	(16)	8	–	(283)
Pension/retirement schemes:					
Deficits	728	9	4	(19)	722
Additional contributions and other ¹	99	6	(9)	–	96
Share-based payments	14	–	(1)	(1)	12
Financial instruments	(11)	–	(6)	5	(12)
Other items	5	(1)	2	–	6
Rolled over capital gains	(10)	–	–	–	(10)
Capital losses carried forward	10	–	–	–	10
Trading losses carried forward	12	1	4	–	17
	698	3	16	(15)	702

	At 1 January 2017 £m	Foreign exchange adjustments £m	Recognised in income ² £m	Recognised in equity ³ £m	At 31 December 2017 £m
Property, plant and equipment	(99)	9	12	–	(78)
Intangible assets	(10)	(1)	10	–	(1)
Provisions and accruals ⁴	304	(19)	(80)	–	205
Goodwill	(428)	31	122	–	(275)
Pension/retirement schemes:					
Deficits ⁵	1,221	(17)	28	(504)	728
Additional contributions and other ¹	149	(12)	(38)	–	99
Share-based payments	23	–	(1)	(8)	14
Financial instruments	(5)	–	5	(11)	(11)
Other items ⁴	(1)	2	4	–	5
Rolled over capital gains	(11)	–	1	–	(10)
Capital losses carried forward	11	–	(1)	–	10
Trading losses carried forward	17	–	(5)	–	12
	1,171	(7)	57	(523)	698

1. Includes deferred tax assets on US deferred compensation plans.

2. Includes a credit of £57m recognised in income in respect of tax rate adjustments.

3. Includes a debit of £83m recognised in equity in respect of tax rate adjustments.

4. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

5. Prior year comparatives have been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

Unrecognised deferred tax assets and liabilities

Deferred tax assets have not been recognised in respect of the following items:

	2018		2017	
	Gross amount £m	Unrecognised deferred tax asset £m	Gross amount £m	Unrecognised deferred tax asset £m
Deductible temporary differences, including tax credits	2	2	1	1
Capital losses carried forward	233	41	207	36
Trading and other losses carried forward	217	26	389	38
	452	69	597	75

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.

The Group has not recognised any deferred tax liability on temporary differences totalling £354m (2017 £237m) relating to potentially taxable unremitted earnings of overseas subsidiaries and equity accounted investments because any withholding tax due on the remittance of those earnings is expected to be insignificant.

Notes to the Group accounts

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14. Deferred tax continued

Changes in tax rates

The US federal tax rate was reduced from 35% to 21% with effect from 1 January 2018. Recognised US deferred tax balances have been calculated at a combined federal and state tax rate of 25.7% (2017 27%).

The UK current tax rate reduced from 20% to 19% with effect from 1 April 2017 and will reduce to 17% with effect from 1 April 2020. This will reduce future UK current tax charges accordingly. Both recognised and unrecognised UK deferred tax balances as at 31 December 2018 have been calculated at a blended rate of 17.5% (2017 17.5%).

15. Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

	2018 £m	2017 (restated) ¹ £m
Raw materials and consumables	354	297
Work-in-progress	319	350
Finished goods and goods for resale	101	86
	774	733

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

The Group recognised £11m (2017 £9m) as a write down of inventories to net realisable value.

16. Current tax

Current tax for the current and prior periods is recognised as a liability to the extent that it has not yet been settled, and as an asset to the extent that the amounts already paid exceed the amount due or the benefit of a tax loss can be carried back to recover current tax of a prior period. Current tax assets and liabilities are measured at the amount expected to be paid to or recovered from taxation authorities, using the rates that have been enacted or substantively enacted by the balance sheet date.

	2018 £m	2017 £m
Tax provisions	(361)	(351)
Research and development expenditure credits receivable	163	131
Other	(55)	(65)
	(253)	(285)
Represented by:		
Current tax assets	81	20
Current tax liabilities	(334)	(305)
	(253)	(285)

Tax provisions of £361m (2017 £351m) are in respect of known tax issues, of which £316m (2017 £292m) relates to non-UK jurisdictions. Whilst there is inherent uncertainty regarding the timing of any resolution of tax positions, the Group considers there to be a possibility of a material change in overseas tax positions in the next financial year.

The Group continues to monitor developments in relation to the EU's State Aid investigation into the UK's Controlled Foreign Company regime. The Group has calculated its maximum potential liability relating to this issue to be around £86m as at 31 December 2018. The Group does not currently consider that any provision is required in respect of this amount.

17. Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call and term deposits, investments in money market funds 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.

	2018 £m	2017 £m
Cash	735	913
Money market funds	908	899
Short-term deposits	1,589	1,459
	3,232	3,271

Cash and cash equivalents includes £278m (2017 £228m) which is subject to regulatory restrictions and is therefore not available for general use by other entities within the Group.

18. Assets and liabilities of disposal groups classified as held for sale

Assets and liabilities of disposal groups classified as held for sale comprise assets and liabilities that are expected to be recovered primarily through sale rather than continuing use. Assets and liabilities of disposal groups classified as held for sale are measured at the lower of their carrying value and fair value less costs to sell.

UK-based combat vehicles

In January 2019, the Group announced an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business. Rheinmetall will purchase a 55% stake in the existing BAE Systems UK-based combat vehicles business, with BAE Systems retaining 45%. The establishment of the new joint venture is subject to regulatory approvals which are anticipated to be completed in the first half of 2019. Accordingly, the UK-based combat vehicles business is presented as held for sale at 31 December 2018.

The UK-based combat vehicles business is included in the Maritime segment.

AACC

As a part of a planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia, the Group completed the disposal of its 75.6% shareholding in Aircraft Accessories and Components Company (AACC) in January 2019. Accordingly, AACC is presented as held for sale at 31 December 2018.

AACC is included in the Air segment.

	2018			2017
	UK-based combat vehicles £m	AACC £m	Total £m	AACC £m
Intangible assets	87	–	87	–
Property, plant and equipment	9	6	15	5
Inventories	2	17	19	16
Trade, other and contract receivables	16	9	25	5
Assets held for sale	114	32	146	26
Trade and other payables	(19)	(14)	(33)	(16)
Provisions	(7)	–	(7)	–
Liabilities held for sale	(26)	(14)	(40)	(16)

Notes to the Group accounts

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19. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Notes	2018 £m	2017 (restated) ¹ £m
UK		3,610	3,405
Rest of Europe		909	807
US		8,466	8,309
Saudi Arabia		503	439
Australia		420	459
Rest of Asia and Pacific		7	5
Non-current segment assets		13,915	13,424
Retirement benefit surpluses	22	308	302
Other financial assets	13	411	315
Tax	14,16	783	722
Inventories	15	774	733
Current trade, other and contract receivables	12	5,177	4,244
Cash and cash equivalents	17	3,232	3,271
Assets held for sale	18	146	26
Consolidated total assets		24,746	23,037

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers (see note 37) and to more appropriately allocate certain of the Group's non-current assets between geographical locations.

20. 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.

	2018 £m	2017 £m
Non-current		
US\$1bn 6.375% bond, repayable 2019	–	741
US\$500m 2.85% bond, repayable 2020	391	368
US\$500m 4.75% bond, repayable 2021	392	369
£400m 4.125% bond, repayable 2022	399	398
US\$800m 3.8% bond, repayable 2024	626	590
US\$750m 3.85% bond, repayable 2025	583	548
US\$500m 7.5% bond, repayable 2027	391	368
US\$400m 5.8% bond, repayable 2041	311	292
US\$550m 4.75% bond, repayable 2044	421	395
	3,514	4,069
Current		
US\$1bn 6.375% bond, repayable 2019	785	–
Albertville Hangar bond, repayable 2018	–	7
Overdrafts	–	7
	785	14

20. Loans and overdrafts continued

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 2018 of 6.6%.

The US\$500m 2.85% bond, repayable 2020, has been converted to a sterling fixed rate bond by utilising foreign exchange swaps that mature in February 2019 and give an effective rate during 2018 of 1.3%.

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 2024 and give an effective rate during 2018 of 4.0%. US\$500m of the US\$800m bond is measured at amortised cost as adjusted for the fair value of the interest rate risk.

US\$734m of the US\$750m 3.85% bond, repayable 2025, has been converted to a sterling fixed rate bond by utilising cross-currency swaps that mature in June 2019 and give an effective rate during 2018 of 3.4%.

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 rate of 7.7%.

The US\$400m 5.8% bond, repayable 2041, has been converted to a floating rate bond by utilising interest rate swaps that mature in October 2024 and give an effective rate during 2018 of 5.8%.

US\$244m of the US\$550m 4.75% bond, repayable 2044, has been converted to a sterling fixed rate bond by utilising cross-currency swaps that mature in June 2019 and give an effective rate during 2018 of 4.6%.

21. Trade and other payables

Trade and other payables are stated at amortised cost.

Contract liabilities represent the obligation to transfer goods or services to a customer for which consideration has been received, or consideration is due, from the customer.

US deferred compensation plan liabilities represent the present value of expected future payments required to settle the obligation to employees in accordance with IAS 19 Employee Benefits.

	2018 £m	2017 (restated) ¹ £m
Non-current		
Contract liabilities	560	802
Amounts owed to equity accounted investments (note 31)	—	15
Accruals and deferred income ²	534	469
US deferred compensation plan liabilities	333	318
Other payables	109	119
	1,536	1,723
Current		
Contract liabilities	3,496	2,717
Trade payables	911	596
Amounts owed to equity accounted investments (note 31)	955	912
Other taxes and social security costs	130	239
Accruals and deferred income	1,993	1,997
Other payables	255	294
	7,740	6,755

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

2. Includes £439m (2017 £344m) of funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme.

Contract liabilities increased in 2018, driven by customer advance payments in excess of contract expenditure and before advance funding into the supply chain, primarily related to the Qatar Typhoon and Hawk programme.

Revenue recognised in the year includes £2,571m (2017 £2,743m) that was included in the opening contract liabilities balance.

Disclosed as required on transition to IFRS 15 Revenue from Contracts with Customers, non-current and current contract liabilities as at 1 January 2017 were £163m and £3,624m, respectively.

22. Retirement benefits

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 surpluses and obligations recognised in the Group's balance sheet represent the fair value of scheme assets, less the present value of the defined benefit obligations calculated using a number of actuarial assumptions as set out on page 182. 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.

IAS 19 Employee Benefits, limits the measurement of a defined benefit surplus to the lower of the surplus in the defined benefit scheme and the asset ceiling. The asset ceiling is the present value of any economic benefits available in the form of refunds from the scheme or reductions in future contributions to the scheme. IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction, issued in 2007, provides an interpretation of the requirements of IAS 19, clarifying that a refund is available if the entity has an unconditional right to a refund in certain circumstances. The Group has applied IFRIC 14 and has determined that there is no limit on the recognition of the surpluses in its defined benefit pension schemes as at 31 December 2018.

MBDA participates in the Group's defined benefit schemes and, as these are multi-employer schemes, the Group has allocated a share of the IAS 19 pension surpluses and deficits to MBDA based on the relative payroll contributions of active members, which is consistent with prior years. Whilst this methodology is intended to reflect a reasonable estimate of the share of the deficit, it may not accurately reflect the obligations of the participating employers.

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.

The Group's share of the IAS 19 pension deficit allocated to equity accounted investments is included in the balance sheet within equity accounted investments.

22. Retirement benefits continued

Background

Pension schemes

BAE Systems plc operates pension schemes for the Group's qualifying employees in the UK, US and other countries. The principal schemes in the UK and US are funded defined benefit schemes, and the assets are held in separate trustee-administered funds. The two largest funded defined benefit schemes are the BAE Systems Pension Scheme (Main Scheme) and the BAE Systems 2000 Pension Plan (2000 Plan) which, in aggregate, represent 82% (2017 81%) of the UK IAS 19 defined benefit obligation at 31 December 2018. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2018, the weighted average durations of the UK and US defined benefit pension obligations were 17 years (2017 18 years) and 11 years (2017 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	35	20	45
2000 Plan ²	16	30	54
US schemes ³	30	17	53

1. Source: Main Scheme actuarial valuation report as at 31 March 2017.

2. Source: 2000 Plan actuarial valuation report as at 31 March 2017.

3. Source: Annual updates of the US schemes as at 1 January 2018.

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 Guaranty 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.

A UK High Court judgment was delivered on 26 October 2018 concerning gender equalisation for the effect of Guaranteed Minimum Pensions (GMPs) for occupational pension schemes. It is expected that the impact of GMP equalisation will be in the region of £121m based on an estimate as at 26 October 2018 for the UK schemes that were contracted out of the State Earnings Related Pension Scheme between 1990 and 1997. This has been treated for IAS 19 purposes as a plan amendment and resulted in an increase in the pension deficit in the balance sheet and a corresponding non-recurring past service cost in the income statement.

The Group has allocated a share of the past service cost to MBDA based on the relative payroll contributions of active members. The Group's share of the £121m is £110m in respect of the Group's subsidiaries, plus £4m for the Group's share of MBDA's allocation. The remaining £7m relates to the share allocated to other participating employers.

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.

Other retirement benefits

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.

Notes to the Group accounts

continued

22. Retirement benefits continued

Funding

Introduction

Disclosures in respect of pension funding are provided below. Disclosures in respect of pension accounting under IAS 19 are provided on pages 182 to 188.

The majority of the UK and US defined benefit pension schemes are funded by the Group's subsidiaries and equity accounted investments. 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 at the valuation date, whilst the liabilities are measured on an actuarial funding basis using the projected unit credit method and discounted to their present value based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The funding valuations are performed by professionally qualified independent actuaries and include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 182. The purpose of the funding valuations is to design funding plans which ensure that the schemes have sufficient funds available to meet future benefit payments.

UK valuations

Funding valuations of the Group's nine UK defined benefit pension schemes are performed every three years. The latest valuations were performed as at 31 March 2017. The next funding valuations will have an effective date of no later than 31 March 2020.

In November 2017, the triennial funding valuations and, where necessary, deficit recovery plans were agreed with the trustees and certified by the scheme actuaries after consultation with the UK Pensions Regulator.

The results of the most recent triennial valuations are shown below:

	At 31 March 2017			
	Main Scheme £bn	2000 Plan £bn	Other £bn	Total £bn
Market value of assets	12.8	4.3	4.5	21.6
Present value of liabilities	(14.4)	(4.6)	(4.7)	(23.7)
Funding deficit	(1.6)	(0.3)	(0.2)	(2.1)
Percentage of accrued benefits covered by the assets at the valuation date	89%	93%	96%	91%

The valuations were determined using the following mortality assumptions:

	2017
Life expectancy of a male currently aged 65 (years)	86 – 89
Life expectancy of a female currently aged 65 (years)	88 – 90
Life expectancy of a male currently aged 45 (years)	88 – 92
Life expectancy of a female currently aged 45 (years)	91 – 93

The discount rate assumptions used in the 2017 valuations were directly based on prudent levels of expected returns for the assets held by the schemes, reflecting the planned investment strategies and maturity profiles of each scheme. The discount rates are curves which provide a different rate for each year into the future.

The inflation assumptions were derived using data from the Bank of England which is based on the difference between the yields on index-linked and fixed interest long-term government bonds. The inflation assumption is a curve which provides a different rate for each year into the future.

In aggregate, the net funding deficit across the UK schemes at 31 March 2017 was £2.1bn. The funding valuations resulted in a significantly lower deficit than under IAS 19, largely due to lower liabilities reflecting the higher discount rate assumption. Under IAS 19, the discount rate for accounting purposes is based on third-party AA corporate bond yields whereas, for funding valuation purposes, the discount rate is based on a prudent level of expected returns from the broader and mixed types of investments reflected in the schemes' investment strategies, which are expected overall to yield higher returns than bonds.

The agreements reached are underpinned by contingency plans, which include a commitment by the Group to a further £50m of deficit funding into the largest scheme prior to the next triennial valuation in the event that the scheme funding level was to fall below pre-determined parameters. In addition, the Group would be required to pay £187m across its schemes with deficits at the valuation date if the funding levels for those schemes were to fall significantly and were to remain at or below those levels for nine months.

There have been no changes to the contributions or benefits, as set out in the rules of the schemes, for pension scheme members as a result of the new funding valuations.

The results of future triennial valuations and associated funding requirements will be impacted by a number of factors, including the future performance of investment markets and anticipated members' longevity.

US valuations

The Group's US pension schemes are valued annually, with the latest valuations performed as at 1 January 2018.

22. Retirement benefits continued

Funding continued

Contributions

Under the terms of the trust deeds of the UK schemes, the Group is required to have a funding plan determined at the conclusion of the triennial funding valuations.

Equity accounted investments make regular contributions to the schemes in which they participate in line with the schedule of contributions and are allocated a share of deficit funding contributions.

In 2018, total employer contributions to the Group's pension schemes were £554m (2017 £433m), including amounts funded by equity accounted investments of £38m (2017 £31m), and included approximately £211m (2017 £209m) of deficit recovery payments in respect of the UK schemes, and £119m (2017 £62m) in respect of the US schemes.

Deficit contributions will further increase in line with any percentage growth in dividend payments made by the Group. Under the deficit recovery plans, these annual payments would subsequently fall by approximately £50m in 2022 as the deficits on certain schemes are expected to be cleared. The annual payments are expected to end in 2026 when all deficits are projected to be cleared. Under the last agreement made in 2014, all scheme deficits were projected to be cleared in 2026.

In 2019, the Group expects that contributions to its UK pension schemes will be broadly in line with 2018, whilst contributions to its US pension schemes are expected to reduce.

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 reduce the exposure of the total portfolio to a materially adverse impact from a single security or type of security. 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 43% (2017 47%) 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. The Main Scheme and one of the Group's other UK defined benefit pension schemes jointly have an equity option strategy protecting £1.8bn of assets against a significant fall in equity markets. In February 2019 this protection was extended to cover £2.6bn of assets.
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, some of the 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. The discount rate assumptions set as part of the 2017 UK funding valuations more directly reflect the expected returns on assets held by the schemes and, therefore, the liabilities are less sensitive to interest rate risk than they were in the 2014 funding valuation. Accordingly, the 2017 approach provides a more natural hedge against interest rate risk. The planned investment strategy, which is reflected in the discount rate and liability calculation, is for the schemes to increase their investments in bonds or other assets which match the liabilities as the schemes mature. Under the 2017 UK funding valuation, the Group expects the schemes to be fully hedged against interest rate movements following a five-year transition period to the planned investment strategy.
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. The Group's US schemes are not indexed with inflation. The approach to the 2017 UK funding valuation provides a more natural hedge against inflation movements and, therefore, the liabilities are less sensitive to inflation risk than they were in the 2014 funding valuation. Under the 2017 UK funding valuation approach, the Group is already fully hedged against inflation movements and, under the planned investment strategy, the Group aims to maintain a fully hedged position. In 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 2013, with the agreement of the Company, the trustees of the 2000 Plan, Royal Ordnance Pension Scheme and Shipbuilding Industries Pension Scheme entered into arrangements with Legal & General to insure against longevity risk for the current pensioner population, covering a total of £4.4bn of pension scheme liabilities. These arrangements reduce the funding volatility relating to increasing life expectancy.

Notes to the Group accounts

continued

22. Retirement benefits continued

IAS 19 accounting

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.

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		
	2018	2017	2016	2018	2017	2016
Financial assumptions						
Discount rate – past service (%)	2.9	2.6	2.7	4.2	3.7	4.2
Discount rate – future service (%)	3.0	2.7	2.7	4.2	3.7	4.2
Retail Prices Index (RPI) inflation (%)	3.1	3.1	3.2	n/a	n/a	n/a
Rate of increase in salaries (%)	3.1	3.1	3.2	n/a	n/a	n/a
Rate of increase in deferred pensions (%)	2.1/3.1	2.1/3.1	2.2/3.2	n/a	n/a	n/a
Rate of increase in pensions in payment (%)	1.6 – 3.7	1.6 – 3.7	1.7 – 3.7	n/a	n/a	n/a
Demographic assumptions						
Life expectancy of a male currently aged 65 (years)	86 – 88	86 – 88	86 – 89	87	87	87
Life expectancy of a female currently aged 65 (years)	88 – 90	88 – 90	89 – 90	89	89	89
Life expectancy of a male currently aged 45 (years)	88 – 90	88 – 90	88 – 91	87	87	87
Life expectancy of a female currently aged 45 (years)	90 – 91	90 – 92	91 – 92	89	89	89

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments using a third-party AA corporate bond yield curve to produce a single equivalent discount rate for the UK and US territories. This inherently captures the maturity profile of the expected benefit payments. For the UK territory, the discount rate used for future service differs from that used for past service as it only uses the cash flows relating to active members, which have a different duration. Further information on the duration of the schemes is detailed on page 179.

Retail Prices Index (RPI) 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 relevant 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 RPI inflation of 3.1% (2017 RPI inflation of 3.1%), 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 2.1% (2017 CPI inflation of 2.1%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.1% (2017 RPI inflation of 3.1%). 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' benefits 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 and information on the demographic profile of the scheme's membership. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2017 tables (published by the Institute of Actuaries) have been used (in 2017, the Continuous Mortality Investigation 2016 tables were used), with an assumed long-term rate of future annual mortality improvements of 1.25% (2017 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 2018 are a blend of the fully generational RP-2014 Aggregate table and the RP-2014 White Collar table, both projected using Scale MP-2018. The IRS have approved the new mortality tables to be adopted for funding valuation purposes from 2019.

US healthcare schemes

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 2018. These valuations were rolled forward to reflect the information at 31 December 2018. The method of accounting for these is similar to that used for defined benefit pension schemes.

The assumption for long-term healthcare cost increases is 4.9% (2017 4.9%) based on the assumptions that the increases are 7.8% in 2018 reducing to 4.5% by 2026 and 4.5% each year thereafter for pre-retirement, and 8.5% in 2018 reducing to 4.5% by 2026 and 4.5% each year thereafter for post-retirement.

22. Retirement benefits continued

IAS 19 accounting continued

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total net IAS 19 deficit at 1 January 2018 ¹	(3,788)	(566)	(4,354)
Actual return on assets excluding amounts included in net interest expense	(1,022)	(422)	(1,444)
Decrease in liabilities due to changes in financial assumptions	1,295	265	1,560
Decrease in liabilities due to changes in demographic assumptions	171	17	188
Experience losses	(176)	(17)	(193)
Contributions in excess of service cost	185	105	290
Past service cost – plan amendments	(131)	–	(131)
Net interest expense	(88)	(24)	(112)
Foreign exchange adjustments	–	(38)	(38)
Movement in US healthcare schemes	–	(2)	(2)
Total net IAS 19 deficit at 31 December 2018	(3,554)	(682)	(4,236)
Allocated to equity accounted investments	304	–	304
Group's share of net IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments at 31 December 2018	(3,250)	(682)	(3,932)

1. Prior year comparatives have been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

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.

	2018				2017			
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m	UK defined benefit pension schemes ¹ £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Present value of unfunded obligations	(100)	(142)	–	(242)	(49)	(146)	–	(195)
Present value of funded obligations	(24,700)	(4,782)	(165)	(29,647)	(26,071)	(4,803)	(168)	(31,042)
Fair value of scheme assets	21,246	4,213	194	25,653	22,332	4,352	199	26,883
Total net IAS 19 (deficit)/surplus	(3,554)	(711)	29	(4,236)	(3,788)	(597)	31	(4,354)
Allocated to equity accounted investments	304	–	–	304	332	–	–	332
Group's share of net IAS 19 (deficit)/surplus	(3,250)	(711)	29	(3,932)	(3,456)	(597)	31	(4,022)
Represented by:								
Retirement benefit surpluses	219	48	41	308	209	54	39	302
Retirement benefit obligations	(3,469)	(759)	(12)	(4,240)	(3,665)	(651)	(8)	(4,324)
	(3,250)	(711)	29	(3,932)	(3,456)	(597)	31	(4,022)
Group's share of net IAS 19 deficit of equity accounted investments	(119)	–	–	(119)	(128)	–	–	(128)

1. Prior year comparatives have been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £4.6bn (2017 £4.7bn).

Notes to the Group accounts

continued

22. Retirement benefits continued

IAS 19 accounting continued

Changes in the fair value of scheme assets before allocation to equity accounted investments

	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 2017 ¹	21,339	4,313	198	25,850
Interest income	568	169	8	745
Actual return on assets excluding amounts included in interest income ¹	1,030	444	19	1,493
Actual return on assets	1,598	613	27	2,238
Contributions by employer	352	81	2	435
Contributions by employer in respect of employee salary sacrifice arrangements	84	–	–	84
Total contributions by employer	436	81	2	519
Members' contributions	8	–	–	8
Administrative expenses	–	(16)	–	(16)
Foreign exchange translation	–	(394)	(19)	(413)
Benefits paid	(1,049)	(245)	(9)	(1,303)
Value of scheme assets at 31 December 2017 ¹	22,332	4,352	199	26,883
Interest income	575	156	7	738
Actual return on assets excluding amounts included in interest income	(1,022)	(422)	(12)	(1,456)
Actual return on assets	(447)	(266)	(5)	(718)
Contributions by employer	423	131	1	555
Contributions by employer in respect of employee salary sacrifice arrangements	80	–	–	80
Total contributions by employer	503	131	1	635
Members' contributions	7	–	–	7
Administrative expenses	(14)	(14)	(1)	(29)
Foreign exchange translation	–	248	12	260
Benefits paid	(1,135)	(238)	(12)	(1,385)
Value of scheme assets at 31 December 2018	21,246	4,213	194	25,653

1. Prior year comparatives have been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

22. Retirement benefits continued

IAS 19 accounting continued

Assets of defined benefit pension schemes

	2018								
	UK ¹			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK ²	3,192	1	3,193	–	–	–	3,192	1	3,193
Overseas	1,882	12	1,894	284	–	284	2,166	12	2,178
Pooled investment vehicles ³	1,280	3,713	4,993	659	2	661	1,939	3,715	5,654
Fixed interest securities:									
UK gilts	1,500	–	1,500	–	–	–	1,500	–	1,500
UK corporates	1,543	1,949	3,492	–	–	–	1,543	1,949	3,492
Overseas government	47	–	47	19	–	19	66	–	66
Overseas corporates	1,260	43	1,303	3,074	–	3,074	4,334	43	4,377
Index-linked securities:									
UK gilts	2,156	177	2,333	–	–	–	2,156	177	2,333
UK corporates	526	653	1,179	–	–	–	526	653	1,179
Property ⁴	–	1,935	1,935	–	125	125	–	2,060	2,060
Derivatives ⁵	–	(1,121)	(1,121)	–	–	–	–	(1,121)	(1,121)
Cash:									
Sterling	270	33	303	–	–	–	270	33	303
Foreign currency	10	5	15	49	–	49	59	5	64
Other	46	134	180	–	1	1	46	135	181
Total	13,712	7,534	21,246	4,085	128	4,213	17,797	7,662	25,459

	2017								
	UK ¹			US and other			Total		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:									
UK ²	4,453	1	4,454	–	–	–	4,453	1	4,454
Overseas	3,074	287	3,361	346	–	346	3,420	287	3,707
Pooled investment vehicles ³	1,327	2,269	3,596	797	2	799	2,124	2,271	4,395
Fixed interest securities:									
UK gilts	1,556	25	1,581	–	–	–	1,556	25	1,581
UK corporates	2,214	1,213	3,427	–	–	–	2,214	1,213	3,427
Overseas government	50	–	50	97	–	97	147	–	147
Overseas corporates	1,319	8	1,327	2,953	–	2,953	4,272	8	4,280
Index-linked securities:									
UK gilts	2,164	54	2,218	–	–	–	2,164	54	2,218
UK corporates	928	375	1,303	–	–	–	928	375	1,303
Property ⁴	–	1,648	1,648	–	129	129	–	1,777	1,777
Derivatives ⁵	–	(1,119)	(1,119)	–	–	–	–	(1,119)	(1,119)
Cash:									
Sterling	221	46	267	–	–	–	221	46	267
Foreign currency	–	3	3	27	–	27	27	3	30
Other	138	78	216	–	1	1	138	79	217
Total	17,444	4,888	22,332	4,220	132	4,352	21,664	5,020	26,684

1. The Main Scheme and two of the Group's smaller UK defined benefit pension schemes participate in a Combined Investment Fund (CIF), covering £13.6bn (2017 £13.6bn) of assets. The purpose of the CIF is to provide economies of scale for the CIF schemes' investment administration.
2. Includes £24m (2017 £33m) of the Company's own ordinary shares.
3. Primarily invested in private markets and exchange traded funds. The amounts classified as unquoted primarily comprise investments in private markets, with the majority held in infrastructure, alternatives and direct funds, valued in accordance with International Private Equity and Venture Capital Valuation Guidelines.
4. Valued on the basis of open market value at the end of the year determined in accordance with the Royal Institution of Chartered Surveyors' Appraisal and Valuation Standards and the Practice Note contained therein. Includes £245m (2017 £243m) of property occupied by Group companies.
5. Includes equity protection options, forward foreign exchange contracts, futures, and interest rate, inflation and longevity swaps. In addition, the total derivative figures shown are net of £479m (2017 £474m) of repurchase agreements. The valuations are based on valuation techniques using underlying market data and discounted cash flows. Prior year comparatives have been restated to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Group's defined benefit pension schemes. See note 37 for details regarding the restatement.

Notes to the Group accounts continued

22. Retirement benefits continued

IAS 19 accounting continued

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments

	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Defined benefit obligations at 1 January 2017	(27,173)	(5,134)	(169)	(32,476)
Current service cost	(254)	(12)	(1)	(267)
Contributions by employer in respect of employee salary sacrifice arrangements	(84)	–	–	(84)
Total current service cost	(338)	(12)	(1)	(351)
Members' contributions	(8)	–	–	(8)
Past service cost – plan amendments	(2)	–	(1)	(3)
Actuarial loss due to changes in financial assumptions	(242)	(291)	(13)	(546)
Actuarial gain due to changes in mortality assumptions	971	24	1	996
Actuarial gain due to changes in other demographic assumptions	202	–	–	202
Experience gains/(losses)	136	(29)	(1)	106
Interest expense	(715)	(201)	(7)	(923)
Foreign exchange translation	–	449	14	463
Benefits paid	1,049	245	9	1,303
Defined benefit obligations at 31 December 2017	(26,120)	(4,949)	(168)	(31,237)
Current service cost	(224)	(12)	(1)	(237)
Contributions by employer in respect of employee salary sacrifice arrangements	(80)	–	–	(80)
Total current service cost	(304)	(12)	(1)	(317)
Members' contributions	(7)	–	–	(7)
Past service cost – plan amendments	(131)	–	–	(131)
Actuarial gain due to changes in financial assumptions	1,295	265	9	1,569
Actuarial gain due to changes in demographic assumptions	171	17	–	188
Experience losses	(176)	(17)	(1)	(194)
Interest expense	(663)	(180)	(6)	(849)
Foreign exchange translation	–	(286)	(10)	(296)
Benefits paid	1,135	238	12	1,385
Defined benefit obligations at 31 December 2018	(24,800)	(4,924)	(165)	(29,889)

22. Retirement benefits continued

IAS 19 accounting continued

Amounts recognised in the income statement after allocation to equity accounted investments

	2018				2017			
	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	(201)	(12)	(1)	(214)	(228)	(12)	(1)	(241)
Past service cost – plan amendments	(10)	–	–	(10)	(2)	–	(1)	(3)
	(211)	(12)	(1)	(224)	(230)	(12)	(2)	(244)
Guaranteed Minimum Pension equalisation charge	(110)	–	–	(110)	–	–	–	–
Administrative expenses	(13)	(14)	(1)	(28)	–	(16)	–	(16)
	(334)	(26)	(2)	(362)	(230)	(28)	(2)	(260)
Included in net finance costs:								
Net interest (expense)/income on retirement benefit obligations	(80)	(24)	1	(103)	(134)	(32)	1	(165)
Group defined benefit schemes included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs ¹	(15)	–	–	(15)	(12)	–	–	(12)
Group's share of equity accounted investments' finance costs	(3)	–	–	(3)	(5)	–	–	(5)

1. The 2018 Group's share of equity accounted investments' operating costs includes £4m relating to the Guaranteed Minimum Pension equalisation charge.

The Group incurred a charge of £203m (2017 £193m) in relation to defined contribution schemes for employees.

Notes to the Group accounts

continued

22. Retirement benefits continued

IAS 19 accounting continued

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2018 and keeping all other assumptions as set out on page 182.

Financial assumptions

The estimated impact of changes in the discount rate and inflation assumptions on the defined benefit pension obligation, together with the estimated impact on scheme assets, is shown in the table below. The estimated impact on scheme assets takes into account the Group's risk management activities in respect of interest rate and inflation risk. The sensitivity analysis on the defined benefit obligation is measured on an IAS 19 accounting basis and, therefore, does not reflect the natural hedging in the discount rate used for funding valuation purposes.

	(Increase)/decrease in pension obligation ¹ £bn	Increase/(decrease) in scheme assets ¹ £bn
Discount rate:		
0.1 percentage point increase	0.5	(0.2)
0.1 percentage point decrease	(0.5)	0.2
Inflation:		
0.1 percentage point increase	(0.4)	0.2
0.1 percentage point decrease	0.4	(0.2)

1. Before allocation to equity accounted investments.

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 in pension obligation ¹ £bn
Inflation:	
0.5 percentage point increase	(1.3)
0.5 percentage point decrease	1.3
1.0 percentage point increase	(2.8)
1.0 percentage point decrease	2.5

1. Before allocation to equity accounted investments.

Demographic assumptions

Changes in the life expectancy assumption, including the benefit of longevity swap arrangements (see longevity risk on page 181), would have the following effect on the total net IAS 19 deficit:

	(Increase)/decrease in net deficit ¹ £bn
Life expectancy:	
One-year increase	(1.1)
One-year decrease	1.1

1. Before allocation to equity accounted investments.

23. 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 announced to those affected. 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. Management exercises judgement to determine the amount of these provisions. Provision is made for known issues based on past experience of similar items and other known factors. Each provision is considered separately and the amount provided reflects the best estimate of the most likely amount, being the single most likely amount in a range of possible outcomes.

	Warranties and after-sales service £m	Reorganisations £m	Legal, contractual and environmental ¹ £m	Other £m	Total £m
Non-current	51	73	281	30	435
Current	51	118	190	41	400
At 1 January 2018 (restated) ¹	102	191	471	71	835
Created	52	8	127	15	202
Utilised	(37)	(53)	(67)	(11)	(168)
Reclassified between categories	–	–	(3)	3	–
Transfer from other balance sheet categories	–	–	14	–	14
Transfer to held for sale	(5)	–	(2)	–	(7)
Released	(11)	(65)	(59)	(15)	(150)
Net present value adjustments	–	–	15	5	20
Foreign exchange adjustments	3	–	10	2	15
At 31 December 2018	104	81	506	70	761
Represented by:					
Non-current	46	51	294	36	427
Current	58	30	212	34	334
	104	81	506	70	761

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

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.

Other debtors includes £46m (2017 £89m) which is reimbursable in respect of reorganisation costs.

Legal, contractual and environmental

Reflecting the inherent uncertainty within many legal proceedings, the amount of the outflows could differ significantly from the amount provided and the timing of the outflows cannot be estimated reliably.

Other

There are no individually significant provisions included within other provisions.

Notes to the Group accounts

continued

24. 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 2017, 31 December 2017 and 31 December 2018	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, Energy and Industrial Strategy (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders, but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Treasury shares

As at 31 December 2018, 271,650,137 (2017 281,232,739) ordinary shares of 2.5p each with an aggregate nominal value of £6,791,253 (2017 £7,030,818) were held in treasury. During 2018, 9,582,602 (2017 10,216,622) treasury shares were used to satisfy awards and options under the Share Incentive Plan, International Share Incentive Plan, Performance Share Plan, the Performance Shares and Restricted Shares elements of the Long-Term Incentive Plan, and the 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 2018.

At 31 December 2018, the ESOP held 2,299,585 (2017 1,680,035) ordinary shares of 2.5p each, with a market value of £11m (2017 £10m). 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 2018 over shares within the Company's share incentive plan trusts 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.

	2018 £m	2017 £m
Prior year final 13.0p dividend per ordinary share paid in the year (2017 12.7p)	415	404
Interim 9.0p dividend per ordinary share paid in the year (2017 8.8p)	288	280
	703	684

After the balance sheet date, the directors proposed a final dividend of 13.2p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 3 June 2019 to shareholders registered on 23 April 2019. The ex-dividend date is 18 April 2019.

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 2019.

24. 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 2017	4,589	202	10	3	10	1,871	6,685
Subsidiaries:							
Currency translation on foreign currency net investments (restated) ¹	–	–	–	–	–	(625)	(625)
Amounts credited to hedging reserve	–	–	–	–	59	–	59
Tax on other comprehensive income	–	–	–	–	(11)	–	(11)
Equity accounted investments, net of tax (restated) ¹	–	–	–	–	1	(19)	(18)
At 1 January 2018 ¹	4,589	202	10	3	59	1,227	6,090
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	396	396
Amounts charged to hedging reserve	–	–	–	–	(25)	–	(25)
Tax on other comprehensive income	–	–	–	–	5	–	5
Equity accounted investments, net of tax	–	–	–	–	(1)	16	15
At 31 December 2018	4,589	202	10	3	38	1,639	6,481

1. Prior year comparatives have been restated upon the Group's adoption of IFRS 15 Revenue from Contracts with Customers. See note 37 for details regarding the restatement.

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.

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 2018, the Group's capital was £5,580m (2017 £4,696m), which comprises total equity of £5,618m (2017 £4,755m), excluding amounts accumulated in equity relating to cash flow hedges of £38m (2017 £59m). Net debt was £904m (2017 £752m).

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;
- pursuing 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 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.

25. Operating business cash flow

Key Performance Indicator – Operating business cash flow

Definition Net cash flow from operating activities excluding taxation and including net capital expenditure, financial investment and dividends from equity accounted investments.

Purpose Allows management to monitor the operational cash generation of the Group.

Taxation is excluded because it is not relevant to the pre-tax operational cash generation of the Group.

Net capital expenditure and financial investment are included as a measure of the investment in the business to support the operational performance of the Group.

Dividends received from equity accounted investments are included as a measure of the operating cash generation of the Group's equity accounted investments.

Reconciliation of net cash flow from operating activities to operating business cash flow

	2018 £m	2017 £m
Net cash flow from operating activities	1,200	1,897
Add back Taxation paid	200	227
Purchase of property, plant and equipment, and investment property	(358)	(389)
Purchase of intangible assets	(139)	(87)
Proceeds from sale of property, plant and equipment, and investment property	34	34
Proceeds from sale of intangible assets	–	1
Equity accounted investment funding	(1)	(3)
Net capital expenditure and financial investment	(464)	(444)
Dividends received from equity accounted investments	57	72
Operating business cash flow	993	1,752

Reconciliation of operating business cash flow to net cash flow from operating activities by reporting segment¹

	Operating business cash flow		Deduct Dividends received from equity accounted investments		Add back Net capital expenditure and financial investment		Net cash flow from operating activities	
	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 £m
Electronic Systems	431	450	(7)	(3)	151	122	575	569
Cyber & Intelligence	85	116	–	–	11	11	96	127
Platforms & Services (US)	(30)	222	(7)	(8)	68	72	31	286
Air	666	832	(36)	(57)	89	113	719	888
Maritime	67	278	(3)	(4)	126	122	190	396
HQ	(226)	(146)	(4)	–	19	4	(211)	(142)
	993	1,752	(57)	(72)	464	444	1,400	2,124
Taxation paid ²							(200)	(227)
Net cash flow from operating activities	1,200	1,897					1,200	1,897

1. Reporting segments have been re-presented to reflect the organisational changes which took effect on 1 January 2018.

2. Taxation is managed on a Group-wide basis.

26. Movement in assets and liabilities arising from financing activities

	As at 1 January 2017 £m	Cash (inflow)/ outflow £m	Non-cash movements Foreign exchange movements £m	Fair value and other movements £m	As at 31 December 2017 £m	Cash (inflow)/ outflow £m	Non-cash movements Foreign exchange movements £m	Fair value and other movements £m	As at 31 December 2018 £m
Non-current assets									
Other financial assets ¹	207	–	–	(128)	79	–	–	41	120
Current assets									
Other financial assets ¹	53	(164)	–	123	12	(112)	–	187	87
	260	(164)	–	(5)	91	(112)	–	228	207
Non-current liabilities									
Loans	(4,425)	–	350	6	(4,069)	–	(229)	784	(3,514)
Other financial liabilities ¹	–	6	–	(25)	(19)	–	–	10	(9)
Cash collateral ²	(32)	15	–	–	(17)	(2)	–	–	(19)
Current liabilities									
Loans	–	–	–	(7)	(7)	7	–	(785)	(785)
Other financial liabilities ¹	(28)	241	–	(269)	(56)	106	–	(61)	(11)
	(4,485)	262	350	(295)	(4,168)	111	(229)	(52)	(4,338)
		98				(1)			
Interest paid		204				203			
Net purchase/(sale) of own shares		1				(1)			
Equity dividends paid		684				703			
Dividends paid to non-controlling interests		8				28			
Net cash flow from financing activities		995				932			

1. Excluding cash flow hedges, for which the cash flow is reported within cash flow from operating activities.

2. Reported in other payables.

27. Net debt

Key Performance Indicator – Net debt

Definition Cash and cash equivalents, less loans and overdrafts (including debt-related derivative financial instruments).

Purpose Allows management to monitor the indebtedness of the Group.

Components of net debt

	Notes	2018 £m	2017 £m
Cash and cash equivalents	17	3,232	3,271
Debt-related derivative financial instrument assets – non-current	13	87	79
Debt-related derivative financial instrument assets – current	13	78	–
Loans – non-current	20	(3,514)	(4,069)
Loans and overdrafts – current	20	(785)	(14)
Debt-related derivative financial instrument liabilities – current	13	(2)	(19)
Net debt		(904)	(752)

Notes to the Group accounts

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28. 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 money market funds are calculated by multiplying the net asset value per share by the investment held at the balance sheet date.

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

		2018		2017	
	Notes	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Financial instruments measured at fair value:					
Non-current					
Available for sale		–	–	6	6
Equity investments at fair value through profit and loss		13	13	–	–
Other financial assets	13	245	245	226	226
Other financial liabilities	13	(104)	(104)	(133)	(133)
Current					
Other financial assets	13	166	166	89	89
Money market funds	17	908	908	899	899
Other financial liabilities	13	(74)	(74)	(104)	(104)

Financial instruments not measured at fair value:

Non-current					
Loans ¹	20	(3,514)	(3,597)	(4,069)	(4,478)
Current					
Cash and cash equivalents (excluding money market funds)	17	2,324	2,324	2,372	2,372
Loans and overdrafts	20	(785)	(794)	(14)	(14)

1. US\$500m of the US\$800m 3.8% bond, repayable 2024, has been converted to a floating rate bond by utilising interest rate swaps. These derivatives have been designated as fair value hedges. Changes in the fair value of the bond attributable to interest rate risk, and gains and losses on the derivatives are recognised in the income statement. The bond has been included in financial instruments not measured at fair value because its carrying value has only been adjusted for the fair value attributable to interest rate risk on a portion of the bond, which has been calculated by discounting the future cash flows and translating at the appropriate balance sheet rate.

All of the financial assets and liabilities measured at fair value are classified as level 2 using the fair value hierarchy, except for money market funds, which are classified as level 1. 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 loans presented in the table above is derived from market prices.

29. 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% (2017 50%) and a maximum of 90% (2017 90%) of gross debt is maintained at fixed interest rates. At 31 December 2018, the Group had 81% (2017 82%) of fixed rate debt and 19% (2017 18%) of floating rate debt based on a gross debt of £4.1bn, including debt-related derivative financial assets (2017 £4.0bn).

The only derivatives that have been designated as fair value hedges are the fixed-to-floating interest rate swaps converting US\$500m of the US\$800m 3.8% bond, repayable 2024. These derivative liabilities have a fair value of £2m (2017 £nil) and will mature in October 2019. Changes in the fair value of the bond attributable to interest rate risk, and gains and losses on the derivatives are recognised in the income statement.

The loss arising in the income statement on fair value hedging instruments was £2m (2017 £4m). The gain arising in the income statement on the fair value of the underlying hedged item was £1m (2017 £4m). The accumulated fair value loss included within the carrying amount of the hedged item is £nil (2017 £1m).

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	Less than one year £m	Between one and two years £m	More than two years £m
Cash and cash equivalents	3,232	–	–
Loans and overdrafts	(784)	(702)	(702)

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 2018, the Group had a total of \$1.0bn (2017 \$1.0bn) of this type of swap outstanding with a weighted average duration of 5.8 years (2017 5.6 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 8.5 years (2017 9.5 years). Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 5.5% (2017 4.6%) on US dollars. The cost of the fixed rate debt was 4.8% (2017 4.9%).

Sensitivity analysis

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 approximately £7m (2017 £7m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by approximately £20m (2017 £14m).

Liquidity risk

Contractual cash outflows on financial liabilities

The contracted cash outflows on loans and overdrafts, and derivative financial instruments at the reporting date are shown below, classified by maturity. The cash outflows are shown on a gross basis, are not discounted, are translated at the spot rate and include estimated interest payments where applicable. Contracted cash outflows reflects the gross cash outflow on derivative financial instruments and excludes the broadly offsetting cash inflows for the receive leg of derivatives that are settled separately to the pay leg.

	31 December 2018					31 December 2017				
	Contracted cash outflow					Contracted cash outflow				
	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	(4,299)	(971)	(1,742)	(3,301)	(6,014)	(4,083)	(213)	(2,474)	(3,217)	(5,904)
Cash flow hedges – financial assets	204	(3,754)	(2,722)	(376)	(6,852)	224	(2,582)	(2,121)	(118)	(4,821)
Cash flow hedges – financial liabilities	(158)	(3,897)	(3,253)	(345)	(7,495)	(162)	(2,681)	(2,166)	(106)	(4,953)
Other foreign exchange/interest rate contracts – financial assets	42	(756)	–	–	(756)	12	(619)	(1)	–	(620)
Other foreign exchange/interest rate contracts – financial liabilities	(18)	(816)	(154)	(36)	(1,006)	(56)	(1,458)	(102)	(54)	(1,614)
Debt-related derivatives – financial assets	165	(1,109)	(93)	(393)	(1,595)	79	(38)	(793)	(416)	(1,247)
Debt-related derivatives – financial liabilities	(2)	(14)	–	–	(14)	(19)	(399)	(8)	–	(407)
Other financial assets and liabilities	233					78				

Contractual cash outflows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other non-derivative financial liabilities, such as trade payables, are settled within the normal operating cycle of the business (within one year for current liabilities and within two years for the majority of non-current liabilities).

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29. Financial risk management continued

Borrowing facilities

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2018, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2017 £2bn). The RCF was undrawn throughout the year. The RCF also acts as a backstop to Commercial Paper issued by the Group. At 31 December 2018, the Group had no Commercial Paper in issue (2017 £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 instant-access current accounts, short-term deposits and money market funds, choosing instruments with appropriate maturities or sufficient liquidity to provide adequate 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 which is deposited with financial institutions with strong credit ratings for short periods. The cash and cash equivalents balance at 31 December 2018 of £3,232m (2017 £3,271m) was invested with 31 (2017 33) 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 using foreign exchange forward contracts and the Group aims, where possible, to apply cash flow hedge accounting to these transactions.

The currency and notional amount of the designated hedging instruments match the currency and principal amounts of the forecast transactions being hedged, therefore the hedging instruments and hedged items have values which will generally move in opposite directions because of the same hedged risk. As the critical terms of the hedging instruments match those of the hedged items, an economic relationship can be demonstrated on an ongoing basis.

The hedge ratio is 1:1 on the basis that the notional amount of the designated hedging instruments matches the principal amount of the forecast foreign currency sales/purchases designated as the hedged items.

The Group considers the potential sources of hedge ineffectiveness to be:

- valuation adjustments for credit risk made to derivative hedging instruments at each hedge effectiveness measurement date;
- foreign currency basis inherent in the ongoing re-pricing of designated foreign currency derivative hedging instruments which are not present in the ongoing re-pricing of the hedged items;
- changes in the timing of the designated hedged items;
- non-occurrence of the designated hedged items.

The effect of cash flow hedges on the Group's financial position and performance for the year ended 31 December 2018 is as follows:

	Weighted average hedged rate	Change in the value of hedging instruments since 1 January £m	Change in the value of hedged items since 1 January £m	Notional amount £m
Purchase/(sale) contracts:				
Sterling/US dollar	1.37	25	(25)	(872)
Sterling/euro	1.17	6	(6)	(475)
Other		(17)	17	(35)
Cash flow hedges – foreign exchange contracts		14	(14)	(1,382)

The Notional amount is the sterling equivalent of the net currency amount purchased or sold. For example, for designated sterling/US dollar cash flow hedges, the Group has purchased a net \$1,195m at a weighted average rate of 1.37 costing £872m.

The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next five years.

Amounts charged to the hedging reserve in respect of cash flow hedges were £25m (2017 £61m), including a £39m charge (2017 £24m credit) on reclassification to profit and loss, and a £14m credit (2017 £37m credit) on contracts held at 31 December 2018.

Additional information on the Group's derivative financial instruments is provided in note 13.

29. Financial risk management continued

Sensitivity analysis

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.

The estimated impact on foreign exchange gains and losses in net finance costs of a ten cent movement in the closing sterling to US dollar exchange rate on the retranslation of US dollar-denominated bonds held by BAE Systems plc is approximately £56m (2017 £49m).

Credit risk

For trade receivables, contract receivables and amounts due from equity accounted investments, the Group measures a provision for expected credit losses at an amount equal to lifetime expected credit losses, estimated by reference to past experience and relevant forward-looking factors.

The Group's assessment is that credit risk in relation to defence-related sales to government customers or sub-contractors to governments is extremely low as the probability of default is insignificant; therefore the provision for expected credit losses is immaterial in respect of receivables from these customers. For all non-government commercial customers, the Group assesses expected credit losses, however this is not considered material to the financial statements. The Group considers that default has occurred when a receivable is past 180 days overdue, because historical experience indicates that these receivables are generally not recoverable. The Group recognises a provision of 100% against all receivables over 180 days past due unless there is objective evidence that individual receivables in this category are recoverable.

Excluding the UK, US and Saudi Arabian governments where credit risk is not considered an issue, no one counterparty constitutes more than 7% of the trade receivables balance (2017 2%).

The carrying amount of the Group's financial assets represents the maximum exposure to credit risk.

Movements on the provision for expected credit losses are as follows:

	2018 £m	2017 £m
At 1 January	35	40
Net remeasurement of loss allowance	(3)	(3)
Amounts written off	(2)	(1)
Foreign exchange gains and losses	–	(1)
At 31 December	30	35

For contract receivables and amounts due from equity accounted investments the expected credit loss provision is immaterial as the probability of default is insignificant.

The Group writes off a trade receivable when there is objective evidence that the debtor is in significant financial difficulty and there is no realistic prospect of recovery, for example, when a debtor enters bankruptcy or financial reorganisation. None of the trade receivables that were written off during the year are still subject to enforcement activity. The ageing of trade receivables is detailed below:

	2018			2017		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due	873	–	873	1,119	–	1,119
Up to 180 days overdue	304	–	304	369	–	369
Past 180 days overdue	280	(30)	250	211	(35)	176
	1,457	(30)	1,427	1,699	(35)	1,664

Trade receivables past 180 days overdue primarily relate to contracts in Saudi Arabia. The Group has assessed the risk of default and recoverability of these receivables at the balance sheet date and the expected credit losses in respect of these balances are not considered to be material.

Offsetting financial assets and liabilities

		2018					2017				
	Notes	Gross balances ¹ £m	Amounts offset ² £m	Balance sheet ³ £m	Amounts not offset ⁴ £m	Net balances ⁵ £m	Gross balances ¹ £m	Amounts offset ² £m	Balance sheet ³ £m	Amounts not offset ⁴ £m	Net balances ⁵ £m
Assets											
Cash and cash equivalents	17	3,244	(12)	3,232	–	3,232	3,287	(16)	3,271	–	3,271
Other financial assets	13	411	–	411	(172)	239	315	–	315	(204)	111
Liabilities											
Overdrafts	20	(12)	12	–	–	–	(23)	16	(7)	–	(7)
Other financial liabilities	13	(178)	–	(178)	153	(25)	(237)	–	(237)	187	(50)

1. The gross amounts of the recognised financial assets and liabilities.

2. The amounts offset in accordance with paragraph 42 of IAS 32.

3. The net balances presented in the Consolidated balance sheet.

4. The amounts subject to a master netting arrangement not offset in the Consolidated balance sheet in accordance with paragraph 42 of IAS 32. Includes £153m (2017 £187m) in respect of recognised financial instruments and £19m (2017 £17m) in respect of cash collateral.

5. The net balances after deducting the amounts in (4) from (3).

Notes to the Group accounts

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30. Share-based payments

The Group has granted equity-settled share options and Long-Term Incentive Plan arrangements which 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.

Details of the terms and conditions of each share-based payment plan are given in the Annual remuneration report on pages 97 to 115.

Expense in year

	2018 £m	2017 £m
Executive Share Option Plan	7	6
Performance Share Plan	13	12
Restricted Share Plan	7	6
	27	24

The Group also incurred a charge of £36m (2017 £37m) in respect of the equity-settled all-employee Free Shares and Matching Partnership Shares elements of the Share Incentive Plan.

Executive Share Option Plan

	2018		2017	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	32,907	5.28	34,315	4.59
Granted during the year	8,971	5.83	9,816	6.48
Exercised during the year	(3,174)	4.74	(7,491)	3.92
Expired during the year	(2,540)	5.60	(3,733)	4.86
Outstanding at the end of the year	36,164	5.44	32,907	5.28
Exercisable at the end of the year	9,482	4.52	5,835	3.81
			2018	2017
Range of exercise price of outstanding options (£)			3.01 – 6.49	3.01 – 6.49
Weighted average remaining contracted life (years)			7	8
Weighted average fair value of options granted (£)			0.86	0.88

Performance Share Plan and Restricted Share Plan

	Performance Share Plan		Restricted Share Plan	
	2018 Number of shares '000	2017 Number of shares '000	2018 Number of shares '000	2017 Number of shares '000
Outstanding at the beginning of the year	20,758	22,992	3,769	3,328
Granted during the year	7,851	6,979	1,540	1,463
Exercised during the year	(965)	(456)	(1,012)	(766)
Expired during the year	(5,264)	(8,757)	(197)	(256)
Outstanding at the end of the year	22,380	20,758	4,100	3,769
Exercisable at the end of the year	250	38	–	–
	2018	2017	2018	2017
Weighted average remaining contracted life (years)	5	5	5	5
Weighted average fair value of awards granted (£)	4.63	5.36	5.83	6.49

The exercise price for the Performance Share Plan and Restricted Share Plan is £nil (2017 £nil).

30. Share-based payments continued

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

Performance Share Plan – Monte Carlo

Restricted Share Plan – Dividend valuation

	2018	2017
Range of share price at date of grant (£)	5.82 – 6.07	6.05 – 6.49
Expected option/award life (years)	3 – 10	3 – 10
Volatility (%)	19	19
Risk free interest rate (%)	0.8	0.2

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £5.89 (2017 £6.11).

31. 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 22).

Transactions with related parties occur in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

Related party	Sales to related parties		Purchases from related parties		Amounts owed by related parties		Amounts owed to related parties ¹		Management recharges ¹	
	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 £m	2018 £m	2017 £m
Advanced Electronics Company Limited	38	86	166	158	18	24	24	5	–	–
CTA International SAS	1	8	–	–	–	3	15	–	–	–
Eurofighter Jagdflugzeug GmbH	1,028	1,004	–	–	37	47	52	49	–	–
FADEC International LLC	101	95	–	–	–	–	–	–	–	–
FAST Training Services Limited	2	2	–	–	–	–	–	–	–	–
MBDA SAS	23	28	199	199	8	9	864	873	18	16
Panavia Aircraft GmbH	32	48	26	51	4	3	–	–	–	–
Reaction Engines Limited	1	–	–	–	–	–	–	–	–	–
BAE Systems Pensions Trust Limited ²	–	–	19	17	4	4	10	11	–	–
	1,226	1,271	410	425	71	90	965	938	18	16

1. Also relates to disclosures under IAS 24 Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2018, £869m (2017 £884m) was owed by BAE Systems plc and £96m (2017 £54m) by other Group subsidiaries.

2. Transactions with BAE Systems Pensions Trust Limited represent lease arrangements for land and buildings leased by the Group.

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 97 to 115. Total emoluments for directors and key management personnel charged to the Consolidated income statement were:

	2018 £'000	2017 £'000
Short-term employee benefits	15,140	16,878
Post-employment benefits	1,127	1,661
Share-based payments	6,578	5,123
	22,845	23,662

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32. Contingent liabilities

Contingent liabilities are potential future cash outflows which are either not probable or cannot be measured reliably.

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. Various Group undertakings are parties to legal actions and claims which arise in the normal course of business. Provision is made for any amounts that the directors consider may become payable (see note 23).

The Group has no individually significant contingent liabilities.

33. Commitments

Operating lease commitments

The Group leases land, buildings, vehicles and equipment 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:

	2018 £m	2017 £m
Payments due:		
Not later than one year	281	251
Later than one year and not later than five years	891	769
Later than five years	534	626
	1,706	1,646
Total of future minimum sublease income under non-cancellable subleases	93	101

Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2018 £m	2017 £m
Property, plant and equipment, and investment property ¹	253	310
Intangible assets	21	18
	274	328

1. Includes £83m (2017 £100m) at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

34. Acquisition of subsidiary

On 14 December 2018, the Group acquired 100% of the issued share capital of ASC Shipbuilding Pty (ASCS) for consideration of A\$1. Following the acquisition, ASCS was awarded the contract for the Australian Hunter Class Future Frigate programme.

The Group has determined that it controls ASCS; therefore the acquisition has been accounted for as a business combination and its results and financial position have been consolidated from the date of acquisition.

The provisionally determined fair values of the assets and liabilities of ASCS at the date of acquisition are as follows:

	£m
Cash and cash equivalents	14
Trade and other receivables	1
Trade and other payables	(15)
Net identifiable assets acquired	—
Goodwill arising	—
Net assets acquired	—

Acquisition-related costs of £1m have been included in operating expenses in the Consolidated income statement in the year ending 31 December 2018.

ASCS contributed £1m to the Group's revenue and £nil to the Group's operating profit between the date of acquisition and the balance sheet date.

If ASCS had been acquired on 1 January 2018, the Group's revenue and operating profit would have been £16,904m and £1,604m, respectively, for the year ending 31 December 2018.

35. 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 2018 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. For companies incorporated outside of the United Kingdom, the country of incorporation is shown in the address. No subsidiary undertakings have been excluded from the consolidation.

Subsidiaries – wholly-owned

4219 Lafayette, LLC ¹ 4219 Lafayette Center Drive, Chantilly VA 20151, United States	BAE Systems 2000 Pension Plan Trustees Limited ²	BAE Systems Australia (Electronic Systems) Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
Aerosystems International Limited Lupin Way, Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom	BAE Systems AB ⁵ Box 5676, SE-114 86 Stockholm, Sweden	BAE Systems Australia (NSW) Holdings Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
Alvis Limited	BAE Systems Al Diriyah Programme Limited ²	BAE Systems Australia (NSW) Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
Alvis Pension Scheme Trustees Limited	BAE Systems Applied Intelligence (Asia Pacific) Pte Limited United Square, 101 Thomson Road, #25-03/04, 307591, Singapore	BAE Systems Australia (Singapore) Pte Limited ⁸ 60 Paya Lebar Road, #08-43 Paya Lebar Square, 409051, Singapore
Alvis Vickers Limited	BAE Systems Applied Intelligence (Australia) Pty Limited Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia	BAE Systems Australia Datagate Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
Armstrong Whitworth Aircraft Limited ²	BAE Systems Applied Intelligence (Belgium) NV Geldenaaksebaan 329, B-3001, Heverlee, Leuven, Belgium	BAE Systems Australia Defence Holdings Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
ASC Shipbuilding Pty Limited Level 2, 80 Flinders Street, Adelaide SA 5000, Australia	BAE Systems Applied Intelligence (Connect) A/S c/o Kromann Reumert, Sundkrogsgade 5, Copenhagen East, 2100, Denmark	BAE Systems Australia Defence Pty Limited ⁹ Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
Australian Marine Engineering Corporation (Finance) Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia	BAE Systems Applied Intelligence (GCS) Limited Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom	BAE Systems Australia Holdings Limited ² Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
Avro International Aerospace Limited ²	BAE Systems Applied Intelligence (Germany) GmbH Mainzer Landstrasse 50, 60325 Frankfurt am Main, Germany	BAE Systems Australia Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
BAE Systems (Al Diriyah C4i) Limited ²	BAE Systems Applied Intelligence (Integration) Limited Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom	BAE Systems Australia Logistics Pty Limited ⁴ Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
BAE Systems (Aviation Services) Limited	BAE Systems Applied Intelligence (Ireland) Limited Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland	BAE Systems Australia Sea Sentinel Project Pty Limited Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia
BAE Systems (Canada) Inc. 220 Laurier Avenue West, Suite 1200, Ottawa ON K1P 5Z9, Canada	BAE Systems Applied Intelligence (Japan) KK 12/F Ark Mori Building, 1-12-32 Akasaka, Minato-ku, Tokyo, Japan 107-6024	BAE Systems Avionics Singapore Pte Limited One Marina Boulevard, #28-00, Singapore 018989, Singapore
BAE Systems (Combat and Radar Systems) Limited 4th Floor, St. Paul's Gate, 22-24 New Street, St. Helier JE1 4TR, Jersey	BAE Systems Applied Intelligence (Luxembourg) SARL 412F Route d'Esch, L-2086, Luxembourg	BAE Systems Bofors AB SE-691 80 Karlskoga, Sweden
BAE Systems (Consultancy Services) Limited	BAE Systems Applied Intelligence (Spain) S.A. Paseo de la Castellana, 141, Cuzco IV, 28046 Madrid, Spain	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 (Corporate Air Travel) Limited	BAE Systems Applied Intelligence (UK) Limited	BAE Systems C-ITS AB Box 5676, SE-114 86 Stockholm, Sweden
BAE Systems (CS&SI – Qatar) Limited ²	BAE Systems Applied Intelligence A/S c/o Kromann Reumert, Sundkrogsgade 5, Copenhagen East, 2100, Denmark	BAE Systems China (Exports) Limited
BAE Systems (Defence Systems) Limited	BAE Systems Applied Intelligence Canada Inc. 1959 Upper Water Street, Suite 900, Halifax NS B3J 2X2, Canada	BAE Systems Communications Limited ²
BAE Systems (Dynamics) Limited	BAE Systems Applied Intelligence France SAS 19 Boulevard Malesherbes, 75008, Paris, France	BAE Systems Communications Solutions, LLC ¹ Knowledge Oasis, Building 4, Second Floor, 0402-Z427, Knowledge Oasis Muscat, PO Box 16, Postal Code 135, Muscat, Oman
BAE Systems (Farnborough 1) Limited	BAE Systems Applied Intelligence GCS Inc. ⁶ 1676 International Drive, 10th Floor, Suite 1000, McLean VA 22102, United States	BAE Systems Controls Inc. ⁷ 1098 Clark Street, Endicott NY 13760, United States
BAE Systems (Farnborough 2) Limited	BAE Systems Applied Intelligence Inc. ⁷ 5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States	BAE Systems Creole Inc. ¹⁰ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
BAE Systems (Farnborough 3) Limited	BAE Systems Applied Intelligence Limited Surrey Research Park, Guildford, Surrey GU2 7YP, United Kingdom	BAE Systems Datagate Holdings Limited
BAE Systems (Finance) Limited	BAE Systems Applied Intelligence LLC ¹ 5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110, United States	BAE Systems Datagate Limited
BAE Systems (Funding Three) Limited	BAE Systems Applied Intelligence Malaysia Sdn Bhd Level 25, Menara Hong Leong, No. 6 Jalan Damanlela, Bukit Damansara, 50490 Kuala Lumpur, Malaysia	BAE Systems Deployed Systems Limited ¹¹
BAE Systems (Funding Two) Limited	BAE Systems Applied Intelligence New Zealand Limited c/o Russell McVeagh, Vero Centre, 48 Shortland Street, Auckland Central, T140, New Zealand	BAE Systems Display Technologies Limited
BAE Systems (Gripen Overseas) Limited	BAE Systems Applied Intelligence Pty Limited Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia	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 (Hawk Synthetic Training) Limited	BAE Systems Applied Intelligence US Corp ⁶ 440 Wheelers Farms Road, Suite 202, Milford CT 06461, United States	BAE Systems Electronic Systems (Overseas) Limited
BAE Systems (Holdings) Limited ²		BAE Systems Electronics Limited
BAE Systems (Insurance) Limited		BAE Systems Enterprises Limited
BAE Systems (International) Limited		BAE Systems Executive Pension Scheme Trustees Limited ²
BAE Systems (Kazakhstan) Limited		
BAE Systems (Land and Sea Systems) Limited ³		
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 (Nominees) Limited ²		
BAE Systems (Oman) Limited		
BAE Systems (Operations) Limited ⁴		
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. Albp. A. Baraniaka 88, 61-131 Poznan, Poland		
BAE Systems (Projects) Limited		
BAE Systems (Property Investments) Limited		
BAE Systems (Vehicles and Equipment) Limited		

Notes to the Group accounts continued

35. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Finance (Ireland) Unlimited Company¹²
Level 5, Block 4, Dundrum Town Centre, Sandymore 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
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Flight Training (Australia) Pty Limited⁴
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh
SA 5111, Australia

BAE Systems Funds Management^{2,12}

BAE Systems Global Combat Systems Bridging Limited

BAE Systems Global Combat Systems Limited

BAE Systems Global Combat Systems Munitions Limited

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 Holding GmbH¹³
Hauptstrasse 48, 82433 Bad Kohlgrub, Germany

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 Inc.⁷
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Holdings International LLC¹
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems IAP Research, Inc.⁶
CT Corporation System, 4400 Easton Commons Way, Ste 125,
Columbus OH 43219, United States

BAE Systems Imaging Solutions Inc.⁷
1841 Zanker Road, Suite 50, San Jose CA 95112, United States

BAE Systems India (Homeland Security) Private Limited¹⁴
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8,
New Delhi – 110037, India

BAE Systems India (Services) Private Limited¹⁴
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8,
New Delhi – 110037, India

BAE Systems India (Technology) Private Limited¹⁴
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8,
New Delhi – 110037, India

BAE Systems India (Ventures) Private Limited¹⁴
#201, 2nd Floor, World Mark 2, Asset No. 8, Aerocity, NH-8,
New Delhi – 110037, India

BAE Systems Information and Electronic Systems
Integration Inc.²
65 Spit Brook Road, Nashua NH 03061, United States

BAE Systems Insurance (Isle of Man) Limited
Tower House, Loch Promenade, Douglas, IM1 2LZ,
Isle of Man, United Kingdom

BAE Systems Integrated System Technologies
(KSA) Limited

BAE Systems Integrated System Technologies
(Overseas) Limited

BAE Systems Integrated System Technologies GmbH¹⁵
Hans-Stießberger-Str. 2b, 85540 Haar, Germany

BAE Systems Integrated System Technologies Limited

BAE Systems International Inc.⁷
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Jacksonville Ship Repair LLC¹
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Land & Armaments Holdings LLC⁶
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.¹
2000 North 15th Street, 11th Floor, Arlington VA 22201,
United States

BAE Systems Land Systems (Finance) Limited

BAE Systems Land Systems (Investments South Africa)
Limited

BAE Systems Land Systems (Investments) Limited

BAE Systems Land Systems (Logistics) Limited

BAE Systems Land Systems (Ranges) Limited

BAE Systems Land Systems (Singapore Investments)
Limited

BAE Systems Land Systems ATF Limited

BAE Systems Land Systems FMTV International Inc.¹⁰
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

BAE Systems Land Systems Pinzgauer (Holdings) Limited

BAE Systems Land Systems Pinzgauer Limited

BAE Systems Logistica Ltda
SCN Quadra 5 Bloco A, Ed. Brasília Shopping, Torre Norte,
Sala 426, Brasília, DF CEP:70715-900, Brazil

BAE Systems MAI Turkey Hava Sistemleri A.Ş
Kizilimak Mahallesi, 1445. Sok No: 2, The Paragon B Blok K: 23,
iç Kapi No: 113 Çukurambar, Çankaya, Ankara, Turkey

BAE Systems Marine (Holdings) Limited

BAE Systems Marine (YSL) Limited

BAE Systems Marine Limited

BAE Systems Norfolk Ship Repair Inc.⁶
750 West Berkley Avenue, Norfolk VA 23523, United States

BAE Systems Oman LLC¹
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 Pension Funds CIF Trustees Limited²

BAE Systems Pension Funds Investment
Management Limited^{2,16}

BAE Systems Pension Funds Trustees Limited²

BAE Systems Project Services Limited

BAE Systems Projects (Canada) Limited

BAE Systems Properties Limited

BAE Systems Quest Limited²

BAE Systems Regional Aircraft (Japan) KK⁶
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.¹⁰
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904,
United States

BAE Systems Rokar International Limited
PO Box 45059, 11 Hartom Street, Mount Hotzvim,
91450 Jerusalem, Israel

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 Saudi America Limited
Business Gate Building 7, Floor 1, Riyadh 11482, 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) Limited²

BAE Systems Saudi Arabia (Vehicles and
Equipment Nominees) Limited²

BAE Systems Saudi Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

BAE Systems Serviços de Avionicos Ltda.
Rua Boa Vista, No. 254, 13th Floor, Suite 15, Centro, São Paulo,
São Paulo 01014-907, Brazil

BAE Systems Share Plans Trustee Limited²

BAE Systems Shared Services (Overseas) Limited

BAE Systems Shared Services Inc.⁶
11215 Rushmore Drive, Charlotte NC 28277, United States

BAE Systems Ship Repair Inc.⁶
750 West Berkley Ave., Norfolk VA 23523, United States

BAE Systems Southeast Shipyards AMHC Inc.^{1,6}
8500 Heckscher Drive, Jacksonville FL 32226, United States

BAE Systems Surface Ships (Holdings) Limited

BAE Systems Surface Ships (Overseas) Limited

BAE Systems Surface Ships (Projects) Limited

BAE Systems Surface Ships Integrated Support Limited

BAE Systems Surface Ships Intermediate Holdings
Limited

BAE Systems Surface Ships International Limited⁵

BAE Systems Surface Ships Limited

BAE Systems Surface Ships Maritime Limited

BAE Systems Surface Ships Portsmouth Limited⁵

BAE Systems Surface Ships Projects (Malaysia) Sdn Bhd
Level 14, West Block, Wisma Golden Eagle Realty, 142-C,
Jalan Ampang, 50450 Kuala Lumpur, Malaysia

BAE Systems Surface Ships Property Services Limited

BAE Systems Surface Ships Support Limited⁴

BAE Systems SWS Defence AB
SE-691 80 Karlskoga, Sweden

BAE Systems Tactical Vehicle Systems LP¹
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904,
United States

BAE Systems Technology Solutions & Services Inc.⁶
520 Gaither Road, Rockville, MD 20850, 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 LLC¹
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904,
United States

BAE Systems TVS Inc.¹⁰
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904,
United States

BAE Systems Zephyr Corporation⁷
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 Corporation⁷
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 Corporation⁷
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 Corporation⁷
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 Corporation⁷
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, Inc.⁶
1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States

35. Information about related undertakings continued

Subsidiaries – wholly-owned continued

Brabazon Limited

British Aerospace (Far East) Limited¹⁷

Level 54, Hopewell Centre, 183 Queen's Road East, Hong Kong

British Aerospace (Malaysia) Sdn Bhd¹⁷

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)
Limited²

British Aircraft Corporation Limited²

Buckfield Properties Limited

Cashhold Limited^{2,4}

CPS International, Inc.¹⁰

c/o Benedetti & Benedetti, Comosa Building, 21st Floor,
Ave. Samuel Lewis, PO Box 850120, Panama 5, Panama

Creole (Nigeria) Limited⁴

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 Ireland Limited⁵

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.

5th Floor, Suite 1920, 256 Franklin Street, Boston MA 02110,
United States

ETI Engineering, Inc.⁶

1676 International Drive, 10th Floor, Suite 1000,
McLean VA 22102, United States

Gloster Aircraft Limited²

Granada Enterprises Limited

PO Box 1732, Riyadh 11441, Saudi Arabia

H-B Utveckling, H-B Development AB

Nybrogatan 7, SE-114 34 Stockholm, Sweden

Hadrian Holdings, Inc.¹⁴

521 Fifth Avenue, New York NY 101075, United States

Hadrian Trustees Limited^{2,14}

Hägglunds Vehicle GmbH

Ernst-Grote Strasse 13, 30916 Isernhagen, Germany

Hawker Siddeley Aviation Limited²

Hawker Siddeley Dynamics Limited²

Hertfordshire Estates Limited⁴

HSA/HSD Pension Fund Trustees Limited²

Hunter Aerospace Corporation Pty Limited

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh
SA 5111, Australia

International Military Sales Limited

Jetstream Aircraft Limited²

Prestwick International Airport, Prestwick, Ayrshire KA9 2RW,
United Kingdom

Kalamind Limited¹⁸

Lemacrown Limited¹⁹

MES Holdco Limited

4th Floor, St. Paul's Gate, 22-24 New Street, St. Helier JE1 4TR,
Jersey

MES Interco¹²

Meslink Limited

Newcombe Properties Limited

Piper Group plc

Pitch Technologies AB

Repslagaregatan 25, SE-582 22 Linköping, Sweden

Pitch Technologies Limited

Sweden House, 5 Upper Montagu Street, London W1H 2AG,
United Kingdom

Port Solent Limited

Port Solent Marina Limited

PT. BAE Systems Services⁶

Wisma 46, Kota BNI, 34th Floor, Suite 34.01.A,
Jl. Jenderal Sudirman Kavling 71, Jakarta 10220, Indonesia

Representaciones SSTs, CA¹⁰

Ave Francisco de Miranda, Centro Lido El Rosal Oficina 71B,
Caracas, Venezuela

Royal Ordnance (Crown Service) Pension Scheme
Trustees Limited

Royal Ordnance B.V.

c/o SGG Netherlands N.V., Hoogoorddreef 15,
1101 BA Amsterdam, Netherlands

Royal Ordnance Senior Staff Pension Scheme
Trustees Limited

Royal Ordnance Speciality Metals Limited²

RWT Limited²

Salford Electrical Instruments Limited

Scentcivil Limited

Scottish Aviation Limited²

Prestwick International Airport, Prestwick, Ayrshire KA9 2RW,
United Kingdom

Sepia, LLC¹

4219 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 Limited¹⁸

Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Stewart & Stevenson Operations (Nigeria) Limited¹⁰

Tapa House (2nd Floor), 45, Imman Dauda St (Abosede Kuboye
Crescent Entrance), Surulere, Lagos, Nigeria

Stewart & Stevenson TVS UK Limited

Stratsec.net Sdn Bhd

Unit F-3-1, Blok F, Third Floor, CBD Perdana 3, Jalan Perdana,
Cyber 12, 63000 Cyberjaya, Selangor Darul Ehsan, Malaysia

Support Solutions General Services and Contracting
Company/Limited Liability company^{1,13}

House No. 145, Street No. 1, Qtr. 611, Al Andalous Area,
Al Mansour, Baghdad, Iraq

TDS International Holdings Pty Limited²⁰

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh
SA 5111, Australia

TDS International Pty Limited

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh
SA 5111, Australia

The Blackburn Aeroplane & Motor Co Limited²

The Bristol Aviation Company Limited²

The British & Colonial Aeroplane Co. Limited²

The Leeds Partnership Limited⁴

The Supermarine Aviation Works Limited^{2,3}

Thomas Sopwith Aviation Company Limited²

VSEL Birkenhead Limited

Warship Design Services Limited

Westover Controls Incorporated⁶

1098 Clark Street, Endicott NY 13760, United States

35. Information about related undertakings continued

Subsidiaries – not wholly-owned

Advanced National Company for Aircraft Maintenance Limited (88.1%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Aircraft Accessories & Components Co Limited (75.6%)
PO Box 13532, Jeddah 21434, Saudi Arabia

Aircraft Research Association Limited (87.1%)²
Manton Lane, Bedford MK41 7PF, United Kingdom

ARA Pension Fund Trustees Limited (87.1%)
Manton Lane, Bedford MK41 7PF, United Kingdom

BAE Systems Saudi Development and Training Company Limited (87.3%)²¹
PO Box 67775, Riyadh 11517, Saudi Arabia

BAE Systems SDT (UK) Limited (87.3%)

Flight Control System Management GmbH (66.6%)²²
PO Box 801109, 81663 Munich, Germany

Hadrian Properties, Inc. (95%)¹⁴
521 Fifth Avenue, New York NY 101075, United States

International Systems Engineering Company Limited (79.9%)
PO Box 54002, Riyadh 11514, Saudi Arabia

Overhaul and Maintenance Company Holding (88.1%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Saudi Maintenance & Supply Chain Management Company Limited (51%)
PO Box 1732, Riyadh 11441, Saudi Arabia

Saudi Technology & Logistics Services Limited (65%)²
PO Box 1732, Riyadh 11441, Saudi Arabia

SMSCMC (UK) Limited (51%)

Equity accounted investments

Abercromby Property International (20.42%)
521 Fifth Avenue, New York NY 101075, United States

Advanced Electronics Company Limited (44%)
PO Box 90916, Riyadh 11623, Saudi Arabia

Air Astana (49%)⁷
Zakarpatskaya Str 4A, 050039 Almaty, Kazakhstan

AMSH B.V. (50%)²³
Weena 210-212, 3012 NJ Rotterdam, Netherlands

BAeHAL Software Limited (40%)^{2,14}
Airport Lane, HAL Estate, Bangalore 560010, India

BHIC Bofors Defense Asia Sdn Bhd (49%)
Level 21, Suite 21.01, The Gardens South Tower, Mid Valley City, Lingkaran Syed Putra, 59200 Kuala Lumpur, Malaysia

Canadian Naval Support Limited (50%)²⁴
3099 Barrington Street, Halifax NS B3K 5M7, Canada

CTA International SAS (50%)
13 Route De La Miniere, 78034 Versailles Cedex, France

Data Link Solutions L.L.C. (50%)^{1,17}
400 Collins Ave, Cedar Rapids IA 52498, United States

Eurofighter Aircraft Management GmbH (33%)^{2,13}
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Eurofighter Jagdflugzeug GmbH (33%)²
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

European Aerosystems Limited (50%)^{14,20}

FADEC International LLC (50%)¹
1098 Clark Street, Endicott NY 13760, United States

FAST Holdings Limited (50%)^{14,20}

FAST Training Services Limited (50%)¹⁴

FNSS Savunma Sistemleri A.S (49%)²⁰
PK 37, Golbasi 06830, Ankara, Turkey

Gripen International KB (50%)^{1,13}
SE-581 88 Linköping, Sweden

MBDA Holdings SAS (25%)
1 Avenue Réaumur, 92350 Le Plessis-Robinson, France

Nobel Business Support AB (34%)
SE-691 80 Karlskoga, Sweden

Nurol BAE Systems Hava Sistemleri Anonim Şirketi (49%)²³
Universiteler Mah, 1605.Cad, No:3/1-3, 06800, Ankara, Turkey

Panavia Aircraft GmbH (42.5%)²
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Reaction Engines Limited (18%)²³
Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom

Saab Bofors Test Center AB (30%)
SE-691 80 Karlskoga, Sweden

Saab-BAE Systems Gripen AB (50%)²
SE-581 88 Linköping, Sweden

Sealand Support Services Limited (33.3%)⁹
MoD Sealand, Welsh Road, Sealand, Deeside, Flintshire

CH5 2LS, United Kingdom

Seele-Alvis Fenestration Limited (43.5%)^{8,20}
Unit A44, Jack's Place, 6 Corbett Place, London E1 6NN, United Kingdom

SIKA International Limited (50%)^{15,20}

Spectrum Technologies Limited (20%)^{2,14}
Western Avenue, Bridgend Industrial Estate, Bridgend, Mid Glamorgan CF31 3RT, United Kingdom

Winner Developments Limited (33.3%)

Notes

1. Unincorporated entity for which the address given is the principal place of business.
2. Directly owned by BAE Systems plc.
3. Ownership held in class of A shares, B shares and preference shares.
4. Ownership held in class of A shares and B shares.
5. Ownership held in ordinary shares and preference shares.
6. Ownership held in common shares.
7. Ownership held in common stock.
8. Year end 30 June.
9. Ownership held in ordinary shares and redeemable preference shares.
10. Ownership held in authorized shares.
11. 40% owned by BAE Systems plc.
12. Unlimited company.
13. In liquidation.
14. Year end 31 March.
15. In members' voluntary liquidation.
16. Year end 5 April.
17. Year end 30 September.
18. In strike off.
19. Ownership held in ordinary shares and class of A shares.
20. Ownership held in class of A shares.
21. 1% owned by BAE Systems plc.
22. 33.3% owned by BAE Systems plc.
23. Ownership held in class of B shares.
24. Ownership held in common shares and B Preferred shares.

36. Events after the reporting period

In January 2019, the Group announced an agreement with Rheinmetall to create a joint UK-based military land vehicle design, manufacturing and support business. Rheinmetall will purchase a 55% stake in the existing BAE Systems UK-based combat vehicles business, with BAE Systems retaining 45%. The establishment of the new joint venture is subject to regulatory approvals which are anticipated to be completed in the first half of 2019. Once the approvals have been completed, the joint venture will be known as Rheinmetall BAE Systems Land (RBSL). The UK-based combat vehicles business is presented as held for sale at 31 December 2018 (see note 18).

As a part of a planned reorganisation of the Group's portfolio of interests in a number of industrial companies in Saudi Arabia, the Group completed the disposal of its 75.6% shareholding in Aircraft Accessories and Components Company (AACC) in January 2019. AACC is presented as held for sale at 31 December 2018 (see note 18).

37. Changes in accounting policies and restatements

This note explains the impact of changes in accounting policies and the correction of a prior year error on the Group's financial statements.

Impact on financial statements

As a result of changes in the Group's accounting policies, prior year comparative information has been restated for the adoption of IFRS 15 Revenue from Contracts with Customers. As explained below, IFRS 9 Financial Instruments was adopted without restating comparative information.

Following an internal review of the third-party accounting valuation of a longevity swap held by one of the Group's pension schemes, the Group became aware of an error in respect of the treatment of experience collateral in the accounting valuation. This resulted in a material error in the value of pension scheme assets included in the financial statements for the years ended 31 December 2017 and 31 December 2016. This error has been corrected retrospectively by restating the comparative amounts presented in these financial statements.

The following tables show the adjustments recognised for each individual line item. Line items that are not affected by the changes have not been included. As a result, the sub-totals and totals disclosed cannot be recalculated from the numbers provided.

Consolidated balance sheet (extract)

	As at 31 December 2017			
	As previously reported £m	Impact of IFRS 15 £m	Valuation of longevity swap £m	Restated £m
Non-current assets				
Equity accounted investments	384	(60)	(2)	322
Deferred tax assets	724	(40)	18	702
	14,738	(100)	16	14,654
Current assets				
Inventories	723	10	–	733
Trade and other receivables including amounts due from customers for contract work	3,586	(3,586)	–	–
Trade, other and contract receivables	–	4,244	–	4,244
	7,715	668	–	8,383
Total assets	22,453	568	16	23,037
Non-current liabilities				
Trade and other payables	(1,722)	(1)	–	(1,723)
Retirement benefit obligations	(4,222)	–	(102)	(4,324)
Provisions	(413)	(22)	–	(435)
	(10,563)	(23)	(102)	(10,688)
Current liabilities				
Trade and other payables	(6,322)	(433)	–	(6,755)
Provisions	(345)	(55)	–	(400)
	(7,106)	(488)	–	(7,594)
Total liabilities	(17,669)	(511)	(102)	(18,282)
Net assets	4,784	57	(86)	4,755
Capital and reserves				
Other reserves	6,098	(8)	–	6,090
Retained earnings	(2,693)	65	(86)	(2,714)
Total equity attributable to equity holders of BAE Systems plc	4,741	57	(86)	4,712
Non-controlling interests	43	–	–	43
Total equity	4,784	57	(86)	4,755

Notes to the Group accounts

continued

37. Changes in accounting policies and restatements continued

Consolidated balance sheet (extract)

	As at 31 December 2016			
	As previously reported £m	Impact of IFRS 15 £m	Valuation of longevity swap £m	Restated £m
Non-current assets				
Equity accounted investments	299	(48)	(1)	250
Deferred tax assets	1,251	(79)	9	1,181
	15,947	(127)	8	15,828
Current assets				
Inventories	744	32	–	776
Trade and other receivables including amounts due from customers for contract work	3,305	(3,305)	–	–
Trade, other and contract receivables	–	3,959	–	3,959
	7,029	686	–	7,715
Total assets	22,976	559	8	23,543
Non-current liabilities				
Trade and other payables	(1,027)	(13)	–	(1,040)
Retirement benefit obligations	(6,277)	–	(53)	(6,330)
Provisions	(372)	(20)	–	(392)
	(12,213)	(33)	(53)	(12,299)
Current liabilities				
Trade and other payables	(6,540)	(377)	–	(6,917)
Provisions	(234)	(57)	–	(291)
	(7,299)	(434)	–	(7,733)
Total liabilities	(19,512)	(467)	(53)	(20,032)
Net assets	3,464	92	(45)	3,511
Capital and reserves				
Retained earnings	(4,583)	92	(45)	(4,536)
Total equity attributable to equity holders of BAE Systems plc	3,438	92	(45)	3,485
Non-controlling interests	26	–	–	26
Total equity	3,464	92	(45)	3,511

37. Changes in accounting policies and restatements continued

Consolidated income statement

	Year ended 31 December 2017		
	As previously reported £m	Impact of IFRS 15 £m	Restated on adoption of IFRS 15 £m
Continuing operations			
Sales	19,626	(1,139)	18,487
Deduct Share of sales by equity accounted investments	(2,575)	41	(2,534)
Add Sales to equity accounted investments	1,271	–	1,271
Revenue	18,322	(1,098)	17,224
Operating costs	(17,089)	1,046	(16,043)
Other income	131	–	131
Group operating profit	1,364	(52)	1,312
Share of results of equity accounted investments	116	(9)	107
<i>Underlying EBITA</i>	2,034	(60)	1,974
<i>Non-recurring items</i>	(13)	–	(13)
<i>EBITA</i>	2,021	(60)	1,961
<i>Amortisation of intangible assets</i>	(86)	–	(86)
<i>Impairment of intangible assets</i>	(384)	–	(384)
<i>Financial expense of equity accounted investments</i>	(34)	–	(34)
<i>Taxation expense of equity accounted investments</i>	(37)	(1)	(38)
Operating profit	1,480	(61)	1,419
<i>Financial income</i>	416	–	416
<i>Financial expense</i>	(762)	–	(762)
Net finance costs	(346)	–	(346)
Profit before taxation	1,134	(61)	1,073
Taxation expense	(250)	34	(216)
Profit for the year	884	(27)	857
Attributable to:			
Equity shareholders	854	(27)	827
Non-controlling interests	30	–	30
	884	(27)	857
Earnings per share			
Basic earnings per share	26.8p	(0.8)p	26.0p
Diluted earnings per share	26.7p	(0.8)p	25.9p
Underlying earnings per share ¹	43.5p	(1.4)p	42.1p

1. Restated underlying earnings per share excludes an additional £18m benefit in respect of the impact of US tax reform enacted in December 2017 included in the restated taxation expense above.

Notes to the Group accounts

continued

37. Changes in accounting policies and restatements continued

Consolidated statement of comprehensive income

	Year ended 31 December 2017			
	As previously reported £m	Impact of IFRS 15 £m	Valuation of longevity swap £m	Restated £m
Profit for the year	884	(27)	–	857
Other comprehensive income				
Items that will not be reclassified to the income statement:				
Subsidiaries:				
Remeasurements on retirement benefit schemes	2,105	–	(49)	2,056
Tax on items that will not be reclassified to the income statement	(490)	–	9	(481)
Equity accounted investments (net of tax)	53	–	(1)	52
Items that may be reclassified to the income statement:				
Subsidiaries:				
Currency translation on foreign currency net investments	(625)	(5)	–	(630)
Amounts credited to hedging reserve	59	–	–	59
Tax on items that may be reclassified to the income statement	(11)	–	–	(11)
Equity accounted investments (net of tax)	(15)	(3)	–	(18)
Other comprehensive income for the year (net of tax)	1,076	(8)	(41)	1,027
Total comprehensive income for the year	1,960	(35)	(41)	1,884
Attributable to:				
Equity shareholders	1,935	(35)	(41)	1,859
Non-controlling interests	25	–	–	25
	1,960	(35)	(41)	1,884

IFRS 9 Financial instruments – impact of adoption

IFRS 9 replaces the provisions of IAS 39 that relate to recognition, classification and measurement of financial assets and financial liabilities, de-recognition of financial instruments, impairment of financial assets and hedge accounting. The adoption of IFRS 9 Financial Instruments from 1 January 2018 resulted in changes in accounting policies; however, no adjustments were required to the amounts recognised in the financial statements in previous periods. The accounting policies applied from 1 January 2018 are set out in the relevant notes.

Classification and measurement

On 1 January 2018, the Group has classified its financial instruments in the appropriate IFRS 9 categories.

The derivative financial instruments designated as cash flow hedges and fair values hedges under IAS 39 at 31 December 2017 continue to qualify for hedge accounting under IFRS 9 at 1 January 2018 and are therefore treated as continuing hedges.

Derivative financial instruments that were not designated as hedges under IAS 39 were classified in the fair value through profit or loss category and gains and losses were recognised in the income statement in the period. There is no change to the classification of these financial instruments under IFRS 9 as they fail the contractual cash flow characteristics test in IFRS 9 (4.1.2(b)) and (4.1.2A(b)).

Trade receivables and amounts owed by equity accounted investments, previously classified in the loans and receivables category and measured at amortised cost under IAS 39, continue to be classified in the amortised cost category under IFRS 9 as they are held within a business model to collect contracted cash flows and these cash flows consist solely of payments of principal and interest.

Money market funds previously classified in the available for sale category under IAS 39 were previously measured at fair value with any change in fair value recognised in other comprehensive income. Under IFRS 9, money market funds are measured at fair value through profit

and loss. However, fair value approximates to amortised cost for these financial assets; therefore the impact on transition to IFRS 9 is immaterial. Money market funds continue to be presented within cash and cash equivalents in the Consolidated balance sheet.

Equity investments previously classified in the available for sale category under IAS 39 were previously measured at fair value with any change in fair value recognised in other comprehensive income. Under IFRS 9, equity investments are measured at fair value through profit and loss.

Impairment of financial assets

The Group has three types of financial asset that are subject to IFRS 9's new expected credit loss model: trade receivables; contract receivables; and amounts owed by equity accounted investments.

Trade receivables and contract receivables do not contain a significant financing element and therefore expected credit losses are measured using the simplified approach permitted by IFRS 9, which requires expected lifetime losses to be recognised from the initial recognition of the receivables.

The Group has assessed credit risk in relation to defence-related sales to government customers or sub-contractors to governments and believes it to be extremely low as the probability of default is insignificant; therefore the provision for expected credit losses is immaterial in respect of receivables from these customers. The Group considers expected credit losses for non-government commercial customers, however this risk is not material to the financial statements.

Amounts due from equity accounted investments primarily relate to trading balances with no significant financing element, in accordance with IFRS 15. The simplified approach is therefore used for these balances. The identified impairment loss was immaterial.

While cash and cash equivalents are also subject to the impairment requirements of IFRS 9, the identified impairment loss was immaterial.

There was minimal IFRS 9 impact on retained earnings at 1 January 2018 and therefore no restatement was required.

37. Changes in accounting policies and restatements continued

IFRS 15 Revenue from Contracts with Customers – impact of adoption

The Group has adopted IFRS 15 fully retrospectively in accordance with paragraph C3(a). Comparatives for the year ended 31 December 2017 have been restated. The following expedients have been used in accordance with paragraph C5:

- revenue in respect of completed contracts that begin and end in the same accounting period has not been restated;
- revenue in respect of completed contracts with variable consideration reflects the transaction price at the date the contracts were completed; and
- the transaction price allocated to unsatisfied and partially unsatisfied performance obligations as at 31 December 2017 is not disclosed.

The accounting policy in respect of revenue applied from 1 January 2018 is set out in note 1.

As a result of the adoption of IFRS 15 Revenue from Contracts with Customers from 1 January 2018, the following adjustments were made to restate the amounts recognised in the balance sheet at 31 December 2017:

	As at 31 December 2017			Restated on adoption of IFRS 15 £m
	As previously reported £m	Reclassification £m	Remeasurement £m	
Equity accounted investments	384	–	(60)	324
Deferred tax assets	724	–	(40)	684
Inventories	723	10	–	733
Trade and other receivables including amounts due from customers for contract work	3,586	(3,586)	–	–
Trade, other and contract receivables	–	4,055	189	4,244
Non-current other payables	(1,722)	22	(23)	(1,723)
Current trade and other payables	(6,322)	(424)	(9)	(6,755)
Non-current provisions	(413)	(22)	–	(435)
Current provisions	(345)	(55)	–	(400)

The impact of adoption on the Group's retained earnings at 31 December 2017 and 31 December 2016 is as follows:

	2017 £m	2016 £m
Retained earnings – as previously reported	(2,693)	(4,583)
Recognition of revenue for over time contracts based on costs incurred and including attributable margin	201	259
Equity accounted investments – separation of development and production margin, net of tax	(59)	(48)
Licence revenue – deferral of revenue over the licence term	(32)	(39)
Deferred tax	(45)	(80)
Adjustment to retained earnings upon adoption of IFRS 15	65	92
Retained earnings – IFRS 15 (restated)	(2,628)	(4,491)

38. Adoption of IFRS 16 Leases

IFRS 16 is effective from 1 January 2019 and replaces IAS 17 Leases and related interpretations. It will result in almost all leases being recognised on the balance sheet by lessees, as the distinction between operating and finance leases is removed. Under the new standard, a right-of-use asset and a financial liability for future lease payments are recognised. The only exceptions are short-term leases, low-value leases and leases of intangible assets.

The Group will apply the Standard from 1 January 2019. The Group has applied the modified retrospective transition approach and will not restate comparative amounts for the year ended 31 December 2018. In the majority of cases the Group has elected to measure right-of-use assets at the amount of the lease liability on adoption (adjusted for any lease prepayments or accrued lease expenses, onerous lease provisions, and leased assets which have subsequently been sub-leased). For a number of property leases the Group has elected to measure the right-of-use asset as if IFRS 16 had been applied since the start of the lease, but using the incremental borrowing rate at 1 January 2019, with the difference between the right-of-use asset and the lease liability taken to retained earnings.

The Group has elected to adopt the following practical expedients on transition:

- not to capitalise a right-of-use lease asset or related lease liability where the lease expires before 31 December 2019;
- not to reassess contracts to determine if the contract contains a lease and not to separate lease and non-lease elements;
- where an onerous lease provision is in existence, to utilise this provision to reduce the right-of-use asset value rather than undertaking an impairment review;
- to use hindsight in determining the lease term;
- to exclude initial direct costs from the measurement of the right-of-use asset; and
- to apply the portfolio approach where a group of leases has similar characteristics.

Impact of adoption of IFRS 16 Leases

Balance sheet

Upon transition on 1 January 2019, the Group will recognise a right-of-use lease asset of £1,300m (after adjustments for onerous lease provisions, lease prepayments and accrued lease expenses at 31 December 2018), and lease liabilities of £1,486m (non-current £1,270m; current £216m), along with a deferred tax asset of £2m. A sub-lease finance receivable of £70m will also be recognised. A transition adjustment of £92m will be recognised as a debit to retained earnings. The Group will not capitalise low-value leases on transition, or those which expire before 31 December 2019, and has opted not to apply IFRS 16 to leases relating to intangible assets. The right-of-use lease asset principally consists of property.

Income statement

Under IFRS 16 the Group will see a different pattern of expense within the income statement, as the IAS 17 operating lease expense is replaced by depreciation and interest charges. In 2019, the Group's EBITA metric will improve by an estimated £50m under IFRS 16 as the new depreciation expense is expected to be lower than the IAS 17 operating lease charge; however the new finance costs are expected to broadly offset this, such that net profit after tax and the underlying earnings metric are not expected to be materially different compared to the previous IAS 17 reporting basis.

Cash flow statement

The change in presentation as a result of the adoption of IFRS 16 will see an improvement in 2019 of an estimated £46m in cash flow generated from operating activities, offset by a corresponding decline in cash flow from financing activities. There is no overall cash flow impact from the adoption of the new Standard.

Lessor accounting under IFRS 16 is largely unchanged from IAS 17.

Estimated 2019 IFRS 16 Leases impact on underlying EBITA by segment

	£m
Electronic Systems	4
Cyber & Intelligence	3
Platforms & Services (US)	3
Air	19
Maritime	2
HQ	19
Group	50

38. Adoption of IFRS 16 Leases continued

Impact on Consolidated balance sheet at 1 January 2019 (extract)

The following table shows the effect of adopting IFRS 16 on the Consolidated balance sheet at 1 January 2019.

	£m
Non-current assets	
Right-of-use assets	1,255
Investment property	45
Equity accounted investments	(11)
Finance lease receivable	61
Deferred tax assets	2
	1,352
Current assets	
Finance lease receivable	9
Trade, other and contract receivables	(26)
	(17)
Total assets	1,335
Non-current liabilities	
Lease liabilities	(1,270)
Provisions	24
	(1,246)
Current liabilities	
Lease liabilities	(216)
Trade and other payables	28
Provisions	7
	(181)
Total liabilities	(1,427)
Net assets	(92)
Capital and reserves	
Retained earnings	(92)
Total equity attributable to equity holders of BAE Systems plc	(92)
Non-controlling interests	–
Total equity	(92)

The weighted average incremental borrowing rate applied to lease liabilities was 3.43%.

Reconciliation between operating lease commitments and lease liability

The following table explains the difference between the operating lease commitments disclosed applying IAS 17 at 31 December 2018 and the lease liability recognised on adoption of IFRS 16 at 1 January 2019.

	£m
Total minimum lease payments reported at 31 December 2018 under IAS 17 (note 33)	1,706
Change in assessment of lease term under IFRS 16	107
Leases outside the scope of IFRS 16	(81)
Impact of discounting lease liability under IFRS 16	(246)
Lease liability recognised on transition to IFRS 16 at 1 January 2019	1,486

Company statement of comprehensive income for the year ended 31 December

	2018 £m	2017 £m
Profit for the year	890	962
Other comprehensive income		
Items that will not be reclassified to the income statement:		
Remeasurements on retirement benefit schemes ¹	(27)	142
Items that may be reclassified to the income statement:		
Amounts credited/(charged) to hedging reserve	2	(2)
Total other comprehensive income for the year (net of tax)	(25)	140
Total comprehensive income for the year	865	1,102

1. 2018 includes a charge of £7m to correct a prior year error in respect of the accounting valuation of a longevity swap held by one of the Company's defined benefit pension schemes (see note 37 to the Group accounts). This error has not been corrected retrospectively because it is not material to the Company financial statements.

Company statement of changes in equity for the year ended 31 December

	Notes	Issued share capital £m	Share premium £m	Other reserves £m	Retained earnings ¹ £m	Total equity £m
At 1 January 2017		87	1,249	205	2,126	3,667
<i>Profit for the year</i>		—	—	—	962	962
<i>Total other comprehensive income for the year</i>		—	—	(2)	142	140
Total comprehensive income for the year		—	—	(2)	1,104	1,102
Share-based payments	10	—	—	—	55	55
Net purchase of own shares		—	—	—	(1)	(1)
Ordinary share dividends ²		—	—	—	(684)	(684)
At 31 December 2017		87	1,249	203	2,600	4,139
<i>Profit for the year</i>		—	—	—	890	890
<i>Total other comprehensive income for the year</i>		—	—	2	(27)	(25)
Total other comprehensive income for the year		—	—	2	863	865
Share-based payments	10	—	—	—	69	69
Net sale of own shares		—	—	—	1	1
Ordinary share dividends ²		—	—	—	(703)	(703)
At 31 December 2018		87	1,249	205	2,830	4,371

1. The non-distributable portion of retained earnings is £707m (2017 £649m).

2. Details of ordinary share dividends are provided in note 24 to the Group accounts.

Company balance sheet as at 31 December

	Notes	2018 £m	2017 £m
Non-current assets			
Intangible assets		62	38
Property, plant and equipment		13	29
Investments in subsidiary undertakings and participating interests	2	8,497	8,439
Other receivables		3	3
Retirement benefit surpluses	8	44	27
Other financial assets	4	278	280
		8,897	8,816
Current assets			
Trade and other receivables	3	3,102	2,653
Current tax		14	14
Other financial assets	4	207	145
Cash and cash equivalents		2,563	2,707
		5,886	5,519
Total assets		14,783	14,335
Non-current liabilities			
Loans	5	(1,102)	(1,059)
Other payables		(22)	(19)
Retirement benefit obligations	8	(228)	(186)
Other financial liabilities	4	(164)	(216)
Provisions	7	(105)	(101)
		(1,621)	(1,581)
Current liabilities			
Loans and overdrafts		–	(7)
Trade and other payables	6	(8,645)	(8,416)
Other financial liabilities	4	(126)	(172)
Provisions	7	(20)	(20)
		(8,791)	(8,615)
Total liabilities		(10,412)	(10,196)
Net assets		4,371	4,139
Capital and reserves			
Issued share capital		87	87
Share premium		1,249	1,249
Other reserves	9	205	203
Retained earnings ¹		2,830	2,600
Total equity		4,371	4,139

1. The Company's profit for the year is £890m (2017 £962m).

Approved by the Board on 20 February 2019 and signed on its behalf by:

C N Woodburn
Chief Executive

P J Lynas
Group Finance Director

Registered number: 1470151

1. Preparation

Basis of preparation

The financial statements of BAE Systems plc have been prepared on a going concern basis, as discussed in the Directors' report on page 82, and in accordance with Financial Reporting Standard (FRS) 101, Reduced Disclosure Framework, issued in September 2015. The amendments to FRS 101 (2015/16 cycle), issued in July 2016, and FRS 101 (2016/17 cycle), issued in July 2017, have no impact on the Company.

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 requirements of the second sentence of paragraph 110 and paragraphs 113(a), 114, 115, 118, 119(a) to (c), 120 to 127 and 129 of IFRS 15 Revenue from Contracts with Customers;
- 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.

The Company intends to continue to prepare its financial statements in accordance with FRS 101.

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 and Company balance sheet.

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.

The Company recognises an increase in its investments in subsidiary undertakings in respect of the cost of share-based payment awards issued by the Company to employees of the Company's operating subsidiaries, with a corresponding entry to equity.

Amounts owed by subsidiary undertakings

Amounts owed by subsidiary undertakings are stated at amortised cost including a provision for expected credit losses. The Company measures the provision at an amount equal to lifetime expected credit losses, but this is not material to the financial statements as the probability of default is insignificant.

Other significant accounting policies

Other significant accounting policies are consistent with the Group accounts.

Changes in accounting policies

IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers became effective on 1 January 2018.

The impact of the adoption of IFRS 9 is set out in note 37 to the Group accounts. In addition to the information presented in note 37, the Company has receivables from subsidiary undertakings that are within the scope of IFRS 9. These were previously classified in the loans and receivables category and measured at amortised cost under IAS 39 and continue to be classified in the amortised cost category under IFRS 9 as they are held within a business model to collect contracted cash flows and these cash flows consist solely of payments of principal and interest. While receivables from subsidiary undertakings are subject to the impairment requirements of IFRS 9, the identified impairment loss was immaterial as the probability of default is insignificant.

The adoption of IFRS 15 did not have any impact on the Company because the Company does not have any revenue from contracts with customers.

2. Investments in subsidiary undertakings and participating interests

	£m
Cost	
At 1 January 2018	8,458
Additions	58
At 31 December 2018	8,516
Impairment provisions	
At 1 January and 31 December 2018	19
Net carrying value	
At 31 December 2018	8,497
At 31 December 2017	8,439

3. Trade and other receivables

	2018 £m	2017 £m
Current		
Amounts owed by subsidiary undertakings	3,026	2,571
Amounts owed by Group joint ventures	7	5
Prepayments and accrued income	56	62
Other receivables	13	15
	3,102	2,653

4. Other financial assets and liabilities

	2018		2017	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	–	–	–	(1)
Other foreign exchange/interest rate contracts	191	(164)	201	(215)
Debt-related derivative financial instruments – assets	87	–	79	–
	278	(164)	280	(216)
Current				
Cash flow hedges – foreign exchange contracts	–	–	–	(1)
Other foreign exchange/interest rate contracts	129	(126)	145	(152)
Debt-related derivative financial instruments – assets/(liabilities)	78	–	–	(19)
	207	(126)	145	(172)

Notes to the Company accounts

continued

5. Loans

	2018 £m	2017 £m
Non-current		
US\$500m 4.75% bond, repayable 2021	392	369
£400m 4.125% bond, repayable 2022	399	398
US\$400m 5.8% bond, repayable 2041	311	292
	1,102	1,059

6. Trade and other payables

	2018 £m	2017 £m
Current		
Amounts owed to subsidiary undertakings	7,555	7,299
Amounts owed to Group joint ventures	869	884
Accruals and deferred income	140	120
Other payables	81	113
	8,645	8,416

7. Provisions

	Contractual and other £m
Non-current	101
Current	20
At 1 January 2018	121
Created	4
Utilised	(6)
Released	(1)
Net present value adjustments	7
At 31 December 2018	125
Represented by:	
Non-current	105
Current	20
	125

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, but the amount of the outflows could differ significantly from the amount provided and the timing of the outflows cannot be estimated reliably.

8. Retirement benefits

The Company participates in all of the Group's UK pension schemes. Regular contributions to the schemes are made in line with the schedule of contributions and a share of deficit funding is allocated to participating employers. The deficit allocation methodology is based on the relative payroll contributions of active members. Full disclosures relating to these schemes are given in note 22 to the Group accounts.

Amounts recognised on the balance sheet

The table below shows the Company's share of the Group's UK pension schemes after allocation to other participating employers.

	2018 £m	2017 £m
Present value of unfunded obligations	(62)	(33)
Present value of funded obligations	(1,292)	(1,326)
Fair value of scheme assets	1,170	1,200
Company's share of net IAS 19 deficit	(184)	(159)
Represented by:		
Retirement benefit surpluses	44	27
Retirement benefit obligations	(228)	(186)
	(184)	(159)

9. Share capital and other reserves

Share capital

Disclosures in respect of the Company's share capital are provided in note 24 to the Group accounts.

Other reserves

	Statutory reserve £m	Capital redemption reserve £m	Hedging reserve £m	Total £m
At 1 January 2017	202	3	–	205
Amounts charged to hedging reserve	–	–	(2)	(2)
At 31 December 2017	202	3	(2)	203
Amounts credited to hedging reserve	–	–	2	2
At 31 December 2018	202	3	–	205

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.

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 97 to 115.

	2018		2017	
	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 – 6.49	8	3.01 – 6.49	8
Performance Share Plan	–	5	–	5

The average share price in the year was £5.89 (2017 £6.11).

11. Employees

The total number of employees of the Company at 31 December 2018 was 1,509 (2017 1,134). All of the Company's employees work within the Group's HQ segment.

Total staff costs, excluding charges for share-based payments, were as follows:

	2018 £m	2017 £m
Wages and salaries	103	86
Social security costs	11	9
Pension costs – defined contribution plans	3	2
Pension costs – defined benefit plans	21	11
	138	108

12. Commitments

Operating lease commitments

The Company leases land, buildings and vehicles under non-cancellable operating lease agreements. The leases have varying terms, and 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:

	2018 £m	2017 £m
Payments due:		
Not later than one year	15	14
Later than one year and not later than five years	62	56
Later than five years	19	13
	96	83
Total of future minimum sublease income under non-cancellable subleases	6	8

13. Other information

Company audit fee

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £2,000,000 (2017 £2,034,000). Fees payable to Deloitte LLP and its associates for non-audit services to the Company are not required to be disclosed because the Group accounts disclose such fees on a consolidated basis (see note 2 to the Group accounts).

Related party transactions

Disclosures in respect of related party transactions are provided in note 31 to the Group accounts.

The Company also has amounts receivable from Aircraft Accessories and Components Co Limited of £9m (2017 £7m) and Aircraft Research Association Limited of £4m (2017 £4m) which are not wholly-owned subsidiaries.

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 £6,997,880 (2017 £8,748,961); 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 2018 as at the date of exercise was £113,745 (2017 £1,002,325) and the net aggregate value of assets received by directors in 2018 from Long-Term Incentive Plans as calculated at the date of vesting was £908,911 (2017 £1,016,511); 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 one director in respect of defined benefit schemes and to two directors in respect of defined contribution schemes.

Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £3,197m (2017 £3,010m), 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 35 to the Group accounts.

Shareholder information

Registered office

6 Carlton Gardens
London
SW1Y 5AD
United Kingdom
Telephone: +44 (0)1252 373232
Company website: baesystems.com
Registered in England and Wales, No. 1470151

Registrars

Equiniti Limited (0140)
Aspect House
Spencer Road
Lancing
West Sussex
BN99 6DA
United Kingdom

If you have any queries regarding your shareholding or need to notify any changes to your personal details, please contact Equiniti.

Equiniti's website (help.shareview.co.uk) includes a comprehensive set of answers to many frequently asked questions relating to managing a shareholding. If you cannot find the answer to your question, there is an online email form, which will help to ensure your question is directed to the most appropriate team for a response. Alternatively, you can call the BAE Systems Helpline on 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.

JP Morgan Chase Bank N.A. is the depositary. If you should have any queries please contact:

JP Morgan Chase Bank N.A.
PO Box 64504
St Paul
MN 55164-0504, USA

Email: jpmorgan.adr@eq-us.com

Telephone (toll free from within US and Canada): +1 800 990 1135

Telephone from outside US and Canada: +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 email: help@sharegift.org

Share price information

The middle market price of the Company's ordinary shares on 31 December 2018 was 589.2p and the range during the year was 445.5p to 676.4p.

For more information

Visit the Shareholder information section of our website: investors.baesystems.com

FINANCIAL CALENDAR

Financial year end	31 December
Annual General Meeting	9 May 2019
2018 final ordinary dividend payable	3 June 2019
2019 half-yearly results announcement	31 July 2019
2019 interim ordinary dividend payable	2 December 2019
2019 full-year results:	
– preliminary announcement	February 2020
– Annual Report	March 2020
2019 final ordinary dividend payable	June 2020

Beware of share fraud

Investment scams are often sophisticated and difficult to spot.

Spot the warning signs

Fraudsters will often:

- contact you out of the blue;
- apply pressure to invest quickly;
- downplay the risks to your money;
- promise tempting returns that sound too good to be true;
- say that they're only making the offer available to you or even ask you to not tell anyone else about it.

If you're suspicious, report it

You can report the firm or scam to the FCA by contacting their **Consumer Helpline** on **0800 111 6768** or using the reporting form using the link shown here.

If you've lost money in a scam, contact **Action Fraud** on **0300 123 2040** or www.actionfraud.police.uk

How to avoid investment scams

1 Reject unexpected offers

Scammers usually cold call, but contact can also come by email, post, word of mouth or at a seminar. If you've been offered an investment out of the blue, chances are it's a high risk investment or a scam.

2 Check the FCA Warning List

Use the FCA Warning List to check the risks of a potential investment – you can also search to see if the firm is known to be operating without our authorisation.

3 Get impartial advice

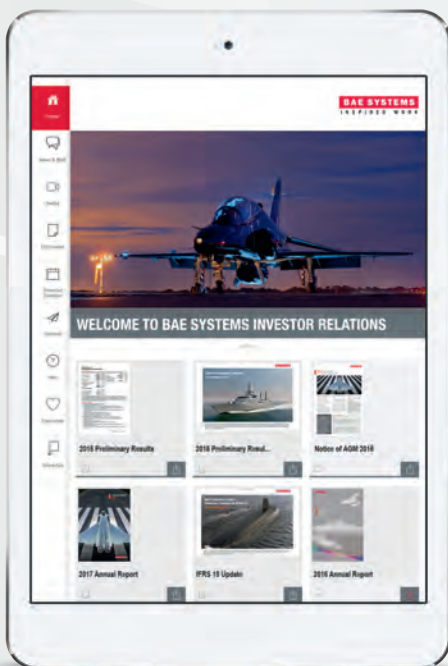
Get impartial advice before investing – don't use an adviser from the firm that contacted you.



Be ScamSmart and visit
www.fca.org.uk/scamsmart

Connect with BAE Systems

baesystems.com



Download the BAE Systems iPad Investors' App

BAE Systems' Investor Relations App gives you all the latest investor and financial media information you need in an iPad-optimised App.



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Designed and produced by Radley Yeldar.



For more information
baesystems.com

BAE Systems plc
6 Carlton Gardens
London
SW1Y 5AD
United Kingdom
Telephone: +44 (0)1252 373232
baesystems.com

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