



Annual Report
2017

BAE SYSTEMS

Welcome to the BAE Systems Annual Report 2017

Strategic report



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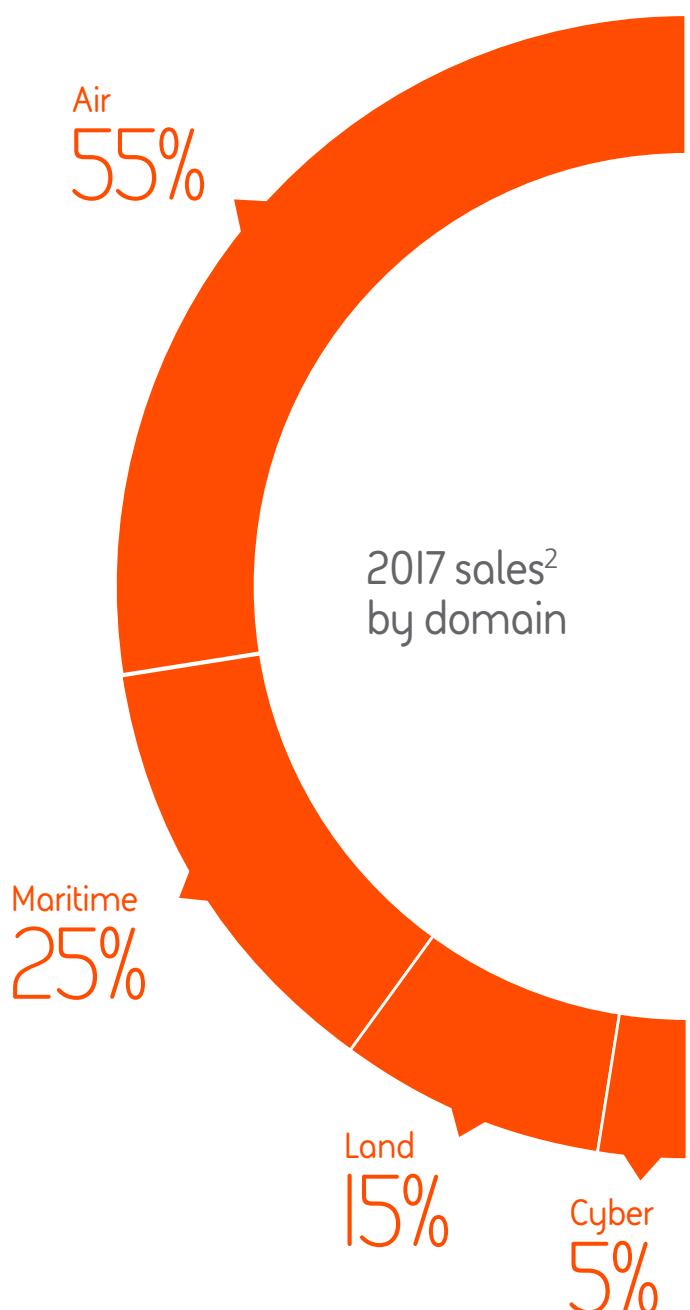
Further information can be found online by visiting baesystems.com

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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. We employ a skilled workforce of 83,200 people¹ in over 40 countries, and work closely with local partners to support economic development by transferring knowledge, skills and technology.



1. Including share of equity accounted investments.

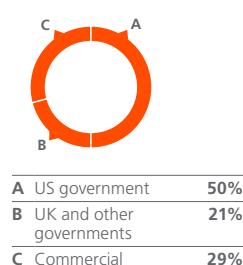
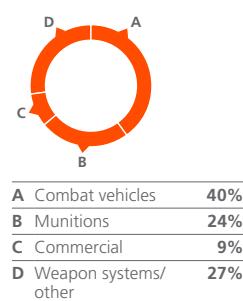
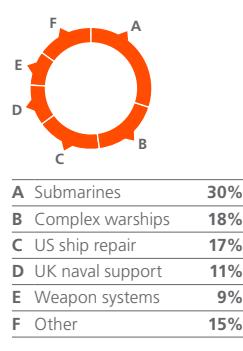
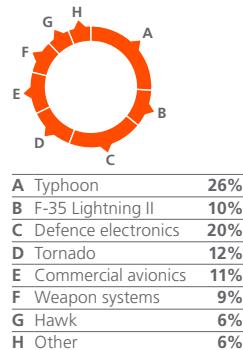
2. Revenue plus the Group's share of revenue of equity accounted investments.

Our business at a glance

 **04** Our key products and services

Sales¹ by domain

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



- 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
- 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
- Manufacture, development, upgrade and in-service support of Hawk trainer aircraft
- Development of next-generation unmanned air systems and defence information systems

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

- 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

- 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

28 Group financial review

2017 sales¹

£19,626m

2017 revenue

£18,322m

Sales¹ by destination

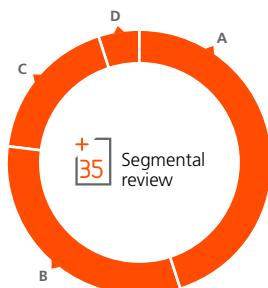
BAE Systems has leading positions in its principal markets – the US, UK, the Kingdom of Saudi Arabia and Australia – as well as established positions in a number of other international markets.



A US	39%
B UK	21%
C Saudi Arabia	16%
D Australia	3%
E Other international markets ³	21%

Sales¹ by activity

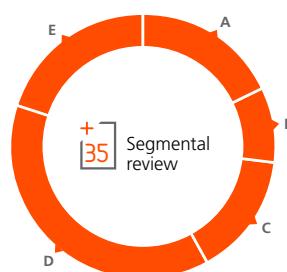
BAE Systems has a diverse portfolio, broadly balanced between an enduring services and support business, long-term platform and product programmes, electronic systems, and activities in cyber and intelligence.



A Military and technical services and support	45%
B Platforms	32%
C Electronic systems	18%
D Cyber	5%

Sales¹ by reporting segment

BAE Systems reports its performance through five principal reporting segments².



A Electronic Systems	18%
B Cyber & Intelligence	9%
C Platforms & Services (US)	15%
D Platforms & Services (UK)	38%
E Platforms & Services (International)	20%

Employees by location

24 Our people

US

29,100

Other

10,600

Employees⁴

83,200

UK

34,300

Australia

3,100

6,100

Saudi Arabia

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

2. Effective 1 January 2018, BAE Systems revised its reporting segments to reflect the organisational changes described on page 17. See page 56 for more information.

3. Includes £0.9bn (4%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

4. Including share of equity accounted investments.

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

Typhoon manufacture and capability development



Manufacture of major Typhoon assemblies for European partner nations and other export customers. Aircraft assembly for the Royal Air Force, Royal Saudi Air Force and Royal Air Force of Oman. 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 a joint unmanned combat air system programme with France.

Air support and training



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

Defence electronics



Design, manufacture and support of avionics equipment across a range of US and other western 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.

Complex warships



Design and manufacture of two 65,000-tonne aircraft carriers, five Offshore Patrol Vessels, and Type 26 frigates for the Royal Navy.

Submarines



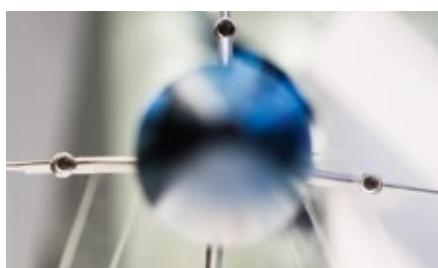
Design and manufacture of seven Astute Class nuclear-powered attack submarines for the Royal Navy. The first three Astute Class submarines are in operational service with the Royal Navy, with the remaining four boats in build. The final boat is expected to enter service in the middle of the next decade. 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.

Ship repair and naval support



Provision of naval and commercial 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 east, west and Gulf coasts, as well as Hawaii, and has invested in new dry dock facilities at its San Diego shipyard to support the US Navy's increased focus on Asia-Pacific operations.

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 complex ammunition plant operations for the US Army to produce insensitive munitions and propellant grains.

Combat vehicles



Products and services include: upgrade of US Army tracked vehicles, including Bradley Fighting Vehicles; design and manufacture of the US Army's M109 self-propelled howitzer and Armored Multi-Purpose Vehicle, as well as amphibious vehicles for the US Marine Corps and international customers; design, manufacture and support of the CV90 and BvS10 combat vehicles for international customers; and vehicle upgrade and support to the British Army.

Cyber security



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

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.

- Sales increased by £0.6bn to £19.6bn largely reflecting currency translation.
- Underlying EBITA increased to £2,034m, a 4% increase on a constant currency basis³.
- Underlying earnings per share increased by 8% to 43.5p.
- Operating business cash flow increased by £748m to £1,752m.
- Net debt reduced by £790m compared with 31 December 2016.
- Order intake⁴ of £20.3bn.
- Order backlog⁴ of £41.2bn was unchanged on a constant currency basis³.

Financial performance measures as defined by the Group

Sales

£19,626m

(2016 £19,020m)

KPI

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.

Underlying EBITA

£2,034m

(2016 £1,905m)

KPI

Definition Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments (EBITA), and non-recurring items⁵.

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

Underlying earnings per share

43.5p

(2016 40.3p)

KPI

Definition Basic earnings per share excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, non-recurring items⁵ and, in 2017, a credit in respect of US tax reform enacted in December 2017.

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

Operating business cash flow

£1,752m

(2016 £1,004m)

KPI

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.

Net debt

£(752)m

(2016 £(1,542)m)

BONUS KPI

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.

Order intake⁴

£20,257m

(2016 £22,443m)

BONUS KPI

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.

Order backlog⁴

£41.2bn

(2016 £42.0bn)

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.

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 101).

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 28 to 34.

- Revenue increased by £0.5bn to £18.3bn largely reflecting currency translation.
- Operating profit decreased to £1,480m, including a £384m non-cash goodwill impairment in Applied Intelligence reflecting lower growth assumptions.
- Basic earnings per share decreased by 7% to 26.8p.
- Net cash flow from operating activities increased by £668m to £1,897m.

Financial performance measures defined in IFRS¹

Revenue

£18,322m
(2016 £17,790m)

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

Operating profit

£1,480m
(2016 £1,742m)

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 share

26.8p
(2016 28.8p)

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

Net cash flow from operating activities

£1,897m
(2016 £1,229m)

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

- Group's share of the pre-tax accounting net pension deficit reduced by £2.2bn compared with 31 December 2016 to £3.9bn.
- Final dividend of 13p per share making a total of 21.8p per share for the year, an increase of 2% over 2016.

Other financial highlights

Group's share of the net pension deficit

£(3.9)bn
(2016 £(6.1)bn)

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

Dividend per share

21.8p
(2016 21.3p)

Definition Interim dividend paid and final dividend proposed per share.

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. Current year compared with prior year translated at current year exchange rates.
4. Including share of equity accounted investments.
5. Items that are not relevant to an understanding of the Group's underlying performance (see page 28).

Operational and strategic highlights

In 2017, we made progress across the Group in achieving our strategic objectives.



We agreed contracts under the Saudi British Defence Co-operation Programme to provide ongoing support services to the Royal Saudi Air Force and Royal Saudi Naval Forces for a further five years to 31 December 2021.

The full £3.7bn production contract for the first batch of three Type 26 frigates was signed in June, with £2.8bn of order intake in the year. Production of the first ship, Glasgow, commenced in July.

Growing demand for our Advanced Precision Kill Weapon System (APKWS™) laser-guided rockets, with awards totalling nearly \$300m (£222m) during the year and over 13,000 units delivered at 31 December.

In November, the 2017 UK triennial pension 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.

We received a \$414m (£306m) contract for the third and final option for Low-Rate Initial Production of 48 M109A7 self-propelled howitzers and ammunition carriers under the Paladin Integrated Management programme. The award contains options for a further 180 vehicle sets over three years of Full-Rate Production.



+18 Group strategic framework

+35 Segmental review



During the year, our US-based Intelligence & Security business secured six task order contracts valued at more than \$180m (£133m), increasing the Full-Motion Video Intelligence, Surveillance and Reconnaissance analysis support we provide to the US intelligence community.



Our US-based Electronic Systems business received orders on the F-35 Lightning II programme worth over \$450m (£333m) for additional hardware production and five years of support.



In December, BAE Systems and the Government of Qatar entered into a contract, valued at approximately £5bn, for the supply of 24 Typhoon aircraft. Alongside supplying the aircraft, the agreement provides for the supply of ground support to the Qatar Armed Forces and delivery of technical and pilot training in Qatar. The contract is subject to financing conditions and receipt by the Group of first payment which are expected to be fulfilled no later than mid-2018.

Under a contract signed in 2012, the first eight Typhoon and all eight Hawk aircraft for Oman were delivered to the Sultanate of Oman in the year. The remaining four Typhoon aircraft are scheduled to be delivered in 2018.

Under the seven-boat Astute Class submarine programme, we received the full £1.4bn contract for the sixth submarine from the Royal Navy and the fourth boat, Audacious, was launched.



Chairman's letter



"There is no doubt that 2017 was a successful year."

Sir Roger Carr Chairman

The year in review

There is no doubt that 2017 was a successful year and, most importantly, a year in which the leadership baton was smoothly and efficiently passed over to Charles Woodburn as Chief Executive of the Group.

The Company's long-term health and growth were further underpinned by contracts successfully secured during the year on major programmes in our principal and international markets. Notably, these included contracts to supply frigates and submarines for the Royal Navy, new and upgraded land vehicles for the US, M777 howitzers for India, and strong global demand for our world-class defence and commercial electronic systems capabilities. In December, we entered into a contract to supply Typhoon aircraft to Qatar, subject to financing conditions, and we remain cautiously optimistic of securing further aircraft sales to international customers.

Our cyber and intelligence capability remains in high demand from government and commercial customers around the world, in a challenging market environment. It is equally critical in ensuring best-in-class cyber protection for our own defence platforms, products and services. In recent years, we have leveraged our capabilities into the commercial sector, where on occasions increased volume has been achieved at the expense of value. This has now been addressed through a change of management and by refocusing the business into markets where specialised skills provide competitive edge and attractive returns.

During the second half of the year, our organisation structure was simplified and aligned with the demands of the business today.

Dividend (pence)



+
06 Alternative performance
measure definitions

These changes acknowledge the increasing requirement for in-country production by our customers, the need to continuously hone our competitive edge in all markets and the emphasis that must be placed on efficient execution of a strong order book.

For my part, as Chairman, I have been pleased to witness the Company's ability to manage structural and leadership change in a turbulent year.

It has been made clear to me by customers, shareholders, employees and partners that all have valued the preservation of seasoned executive experience with the introduction of fresh thinking and renewed energy in the management team at a time of geopolitical turbulence.

Relationships and reputation are, of course, key to the success of any business. In this context, it is pleasing that close liaison with governments in the UK, US, the Gulf, Australia, India and many other key international markets, continues to ensure the strength of our relationships at the highest levels and underline our commitment to contributing to national priorities across the globe. This will be particularly important in 2018 in the pursuit of major business opportunities in air, maritime, land and cyber currently under negotiation.

The year ahead, therefore, remains demanding, both in delivering the order book we have and building an even stronger backlog for the long-term future of the business, but we approach it with confidence and enthusiasm.

Our strategy

Whilst market conditions may fluctuate, our strategy remains clear. We are an international defence company operating in the domains of air, maritime, land and cyber with major business interests in the UK, US, the Kingdom of Saudi Arabia and Australia.

We manage a balanced business of products and services, employing world-class skills in technology and engineering to meet our customers' current and future needs. We use these capabilities primarily in the defence sector but, where appropriate, extend our reach into related and adjacent commercial market areas.

We develop the skills necessary to supply our customers by a commitment to apprenticeships, graduate training and life-long learning.

The cash we generate from the business is used to pay our people, pay our taxes, meet our pension obligations, invest in the business through research and technology and capital expenditure, reward shareholders and make acquisitions, when appropriate.

To deliver this strategy, we have a well-defined operational framework, underpinned by a strong culture which seeks to be trusted, innovative and bold.

Our culture

As a company, we focus not simply on how much money we make but, more importantly, how we make money. The tone is set at the top and cascades throughout the organisation.

We are proud of what we do and committed to serve and equip those that serve and protect us. We aim to inspire and excel in the work we do and the technology we develop.

The management ethos is to work with customers in the spirit of partnership, striving to go the extra mile in the products we make and the service we offer, recognising that we must earn everything and are entitled to nothing.

As Chairman, I believe we should place safety above profit, people above process, and ethics above outcomes, in an environment that promotes merit and values diversity. Our Corporate Responsibility Committee monitors performance in these areas.

Our Remuneration Committee focuses on the importance of rewarding management commensurate with performance and creating a structure that is fair, transparent and inclusive in recruiting, securing and retaining the best talent.

We believe it is only by adopting these principles that we can win the backing of our stakeholders and the support of society at large.

The Audit Committee continues to be the check and balance that we have to ensure we account conservatively, manage prudently and manage risk effectively. In discharging these responsibilities, the Committee works closely with management, internal audit and the external audit team to gather their perspectives and ensure the integrity, accuracy and veracity of our financial reporting to a high standard.

Chairman's letter continued

At the heart of the business are the people we employ and the talent we build from apprentice to boardroom. As an international leader in engineering and technology, we believe we have a responsibility to develop a deep pool of expertise through high-quality training and apprenticeships, with some 2,000 apprentices and 500 graduates currently in training in the UK.

Board and Executive Committee

With effect from 1 July, Charles Woodburn succeeded Ian King as Chief Executive. Ian retired after a career spanning more than 40 years at the Company, including leading BAE Systems as Chief Executive since 2008.

Building a pipeline of talent and managing succession at all levels in the business is, of course, an essential part of strategic planning. Our Nominations Committee consistently reviews membership of the Board and Executive Committee. In this respect, in 2017, we were fortunate to recruit Revathi Advaithi as a non-executive director bringing wide international operational experience with strong engineering and digital credentials, and Karin Hoeing as Group Human Resources Director and member of the Executive Committee. As we look forward, beyond the current year, we will continue to refresh the Board and Executive Committee to ensure our experience and skillset is fit for purpose in a changing world.

To avoid complacency and in the pursuit of excellence, we conduct rigorous annual reviews of the Board with the employment of an external advisor every other year. The key findings of the 2018 Independent Board Evaluation are outlined in the Chairman's Governance letter on page 72 of this report. As a Board, we debate and review our culture each year to ensure we continue to treat everyone respectfully, trade responsibly, act with integrity and govern scrupulously.

Summary

In summary, we have been pleased to deliver another year of good performance with sales of £19.6bn and underlying earnings per share of 43.5p, underpinned by an order backlog of £41.2bn.

Against the background of a strong Board, and a refreshed and committed management team, we are both content with the year's performance and positive about our future prospects.

The Board therefore has recommended a final dividend of 13p for a total of 21.8p per share for the full year. Subject to shareholder approval at the May 2018 Annual General Meeting, the dividend will be paid on 1 June 2018 to holders of ordinary shares registered on 20 April 2018.



Sir Roger Carr Chairman

Chief Executive's review



“BAE Systems delivered a good performance in 2017, consistent with our expectations for the year.”

Charles Woodburn Chief Executive

+
[18] Group strategic framework

+
[19] Our markets

Introduction

BAE Systems delivered a good performance in 2017, consistent with our expectations for the year. We are taking the actions necessary to address costs and to meet our customers' affordability challenges. Despite economic and political uncertainties, governments in our major markets continue to prioritise defence and security, with strong demand for our capabilities. We are investing in our business, our people, and in the technology and skills we need to drive the business forward. With an improving outlook for defence budgets in a number of our markets and a solid foundation for medium-term growth, we are well placed to generate good returns for shareholders.

Since taking on the role of Chief Executive, I have reiterated that we are a strong company, with a number of key advantages, pursuing the right strategy.

We have a broad geographic footprint and diversified market positions. Importantly, our track record of successful partnerships in international markets to develop local industry, employment and skills is now becoming a key requirement to do business in those markets.

We have world-class technologies in the fields of electronic warfare, autonomous systems, advanced manufacturing, robotics and data analytics, and we continue to invest in research and development, often alongside our customers, to identify and develop emerging technologies. The speed of change in technology means that we must continually build on our technological advantage, and attract and retain the right talent in order to stay competitive.

It is important to recognise that in a tough, competitive market, we need to become a stronger, smarter and sharper organisation to win new business and grow, which means increasing our focus and efforts in three priority areas:

Operational excellence

We have a number of major programmes under way on which we are ramping up production, so it is vital that we maintain our focus on operational excellence by delivering for our customers. There is simply no better way to highlight our skills and capabilities and, therefore, win new business.

Chief Executive's review continued

Competitiveness

Good progress has been made in making the organisation more efficient over the last few years, and there are further opportunities with procurement and enhanced collaboration at the forefront.

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.

Driving performance in these three areas will be key for the development of the business as we execute on our strategy in 2018 and beyond.

2017 performance

US

After seven months under a Continuing Resolution that maintained funding at the prior year's level, the fiscal year 2017 defence budget ultimately rose by approximately 4%. Similarly, fiscal year 2018 has begun under multiple Continuing Resolutions. On 9 February 2018, Congress passed, and the President signed, a budget agreement that supports the medium-term planning assumptions for our US businesses. This budget agreement increases the budget caps for two years, and extends the current Continuing Resolution to 23 March 2018 to allow lawmakers to pass a fiscal year 2018 omnibus appropriations bill.

We see continued support for increased defence spending in the President's recently-released fiscal year 2019 budget request. This request maintains positive momentum in funding for military readiness and modernisation, and provides greater near-term certainty. Our US-based portfolio remains well aligned with customer priorities and growth areas, such as the ramp-up of production on a number of our long-term programmes.

Our US electronics business delivered good operational performance across our core franchise positions in the high-technology areas of electronic warfare, precision-guided munitions, Intelligence, Surveillance and Reconnaissance, and electro-optics.

BAE Systems has sustained its leadership position in the US electronic warfare market and production is ramping up to execute orders across a number of programmes, some of which are classified. As the electronic warfare system supplier on the F-35 Lightning II combat aircraft programme, we are increasing production and are well positioned to meet further increases in output rates over the coming years to meet the requirements of both US and international customers. On F-15, upgrade programmes are contracted and progressing for the US Air Force and international customers.

The Group's US-based combat vehicles business is underpinned by programmes for the manufacture of Armored Multi-Purpose Vehicles and M109A7 self-propelled howitzers, and Bradley upgrades which all progressed in the year. In the amphibious vehicle market, 16 prototypes have been delivered to the US Marine Corps under the Amphibious Combat Vehicle 1.1 programme. We are one of two competitors for this programme, with final down-selection expected in 2018.

BAE Systems is a leading supplier of ship repair services to the US Navy and continues to adjust its workforce and facilities to meet evolving demand. Additional dry dock capacity at our San Diego shipyard became operational in February 2017 and accepted its first ship during the year.

Whilst market conditions remain highly competitive and continue to evolve, our US-based Intelligence & Security business is focused on delivering on its contracts and maintaining a high level of bid activity.

UK

Defence and security remains a priority for the UK government. We expect this to be reaffirmed in the National Security Capability Review, and in the Modernising Defence Programme, which was announced in January 2018 by the Defence Secretary.

Transition arrangements after March 2019 will be important to enable companies to prepare for potential changes in the regulatory environment. As there is relatively limited UK-EU trading and movement of EU nationals into and out of BAE Systems' UK businesses, the resulting Brexit impact on the business is likely to be limited, depending on the terms of any transition and final agreements for the UK's future relationship with the European Union.

We will support the 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.

In December, BAE Systems and the Government of Qatar entered into a contract, valued at approximately £5bn, for the supply of 24 Typhoon aircraft. Alongside supplying the aircraft, the agreement provides for the supply of ground support to the Qatar Armed Forces and delivery of technical and pilot training in Qatar. The contract is subject to financing conditions and receipt by the Group of first payment which are expected to be fulfilled no later than mid-2018.

Discussions with current and prospective operators of the Typhoon aircraft continue to support the Group's expectations for additional Typhoon contract awards. However, there can be no certainty as to the timing of these orders.

As a result of reducing production activity on Typhoon and Hawk, and also taking into account the changes to support requirements as the Royal Air Force transitions from Tornado to F-35 Lightning II, the business announced in October a total proposed headcount reduction of up to 1,400 roles over the next three years.

The Typhoon aircraft's progression towards the Royal Air Force Centurion standard will enable transition of capability from Tornado to Typhoon as the UK Tornado fleet is scheduled to come out of service at the end of the decade.

UK-based production of rear fuselage assemblies for the F-35 Lightning II aircraft increased to 82 in the year, with most of the advanced manufacturing investment in place to achieve the planned increase in production volumes. In readiness for the arrival of the UK's first F-35 Lightning II aircraft in 2018, good progress has been made on the support facilities for the stand-up of the operational service at RAF Marham in Norfolk.

In the maritime domain, there remains pressure on the Navy's near-term budgets.

On the aircraft carrier programme, HMS Queen Elizabeth successfully concluded initial sea trials and entered HM Naval Base, Portsmouth, for the first time in August, with operational handover to the Royal Navy in December.

Following contract award for the first batch of three Type 26 frigates, worth £3.7bn, production for the first ship, Glasgow, commenced in July. The National Shipbuilding Strategy announced in September committed to all eight Type 26 frigates to be built in our Scottish manufacturing facilities. In October, we announced a teaming agreement with Cammell Laird for their bid for the UK Ministry of Defence's proposed Type 31e general purpose frigate programme.

Submarine activity is increasing with the Astute and Dreadnought class submarines now both in production and major redevelopment of the Barrow site to deliver the Dreadnought programme under way.



Our strategy in action

iMOTR™, a new product designed to improve radar accuracy

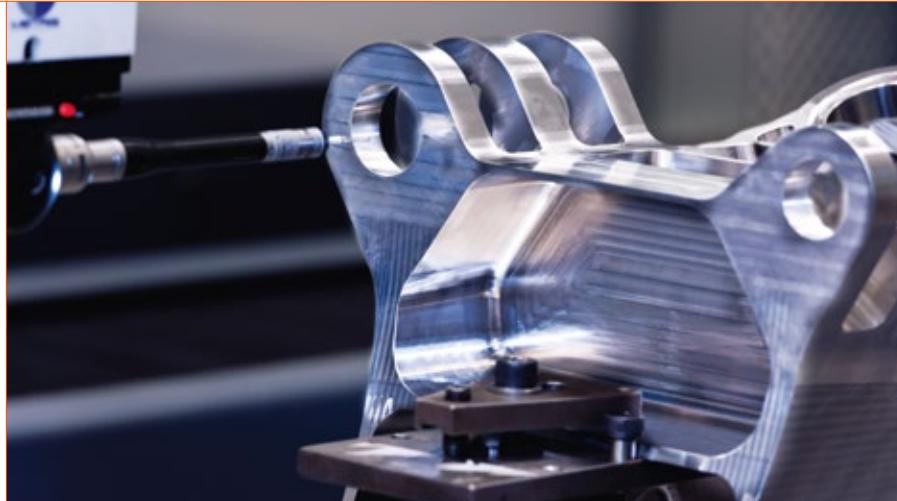
In August, our Intelligence & Security business launched a new product, iMOTR™. This innovative, mobile, multiple-object tracking radar uses commercial off-the-shelf solutions to provide military test and evaluation ranges with a higher degree of accuracy in tracking the time, space and position information for several objects in flight compared with current radars.

The iMOTR™ solution, developed over two years with Group-funded research and development expenditure, features enhanced capabilities that offer more precise flight path tracking for objects travelling close to the ground and allow tracking information to be shared in real time with other radars or data collection sensors. These added capabilities will allow our customers to assess larger, more complex scenarios that are critical to developing the next generation of solutions to address national security threats.

Group strategic framework

More online
baesystems.com

Chief Executive's review continued



Our strategy in action

Advanced manufacturing facilities for F-35 Lightning II

In 2017, we demonstrated our military aircraft manufacturing expertise as we achieved a significant milestone on the F-35 Lightning II programme. With the delivery of the 318th rear section of the aircraft during the year, 10% of the projected global customer aircraft requirement has now been produced. The achievement of this milestone has only been possible through investments made in our advanced manufacturing facilities and our close working relationship with the supply chain. Our focus in these areas will enable us to meet the ramp-up in production on the programme in the coming years.

As a key partner on F-35 Lightning II, a premier defence programme, we are responsible for approximately 15% of the work on each aircraft, excluding propulsion, and we play a major role in the programme across multiple markets, including the US, UK and Australia.

 More online
baesystems.com

 18 Group strategic framework

International

The Saudi Arabian In-Kingdom Industrial Participation programme continues to make good progress and we have commenced discussions with the new Saudi Arabian Military Industries (SAMI) organisation to explore how we can collaborate to deliver further In-Kingdom Industrial Participation. All of these activities are aligned with our long-term industrialisation strategy, as well as the Saudi Arabian government's National Transformation Plan and Vision 2030.

On the Salam Typhoon programme, all contracted 72 aircraft have now been delivered and the Typhoon support contracts are operating well, exceeding the baseline flying programme contracted with the customer.

Discussions with the Saudi Arabian customer through 2017 resulted in contractual agreements under the Saudi British Defence Co-operation Programme being formalised. These provide support services to the Royal Saudi Air Force and Royal Saudi Naval Forces for a further five years to 31 December 2021.

In Australia, the business is underpinned by long-term support contracts, whilst activity progresses on two major bid opportunities.

Firstly, as one of two tenderers for the Land 400 Phase 2 Combat Reconnaissance Vehicle programme, we have completed the Risk Mitigation Activity contract and submitted our final proposal, with final preferred tender selection anticipated in the first half of 2018.

Secondly, our initial tender response for the Commonwealth's nine-ship SEA 5000 Future Frigate programme was submitted in August and we anticipate a preferred tender selection in 2018.

The MBDA joint venture has continued to win orders in both domestic and export markets. The increase in business volumes has resulted in the requirement to expand production capacities in the UK and France.

Cyber security

Applied Intelligence achieved sales growth from the continued delivery of national security solutions for the UK and international governments. In addition, we have deployed anti-fraud, regulatory compliance, and cyber security products and services across a large range of commercial customers.

In 2017, Applied Intelligence reported an underlying loss of £61m, including a £24m restructuring charge. The first half loss of £27m was followed by a reduced second half loss, before the restructuring charge, of £10m as cost reduction actions started to deliver bottom-line benefit. A goodwill impairment of £384m was taken in 2017 reflecting the future level and timing of expected returns from the business.

Effective 1 January 2018, the business changed its operating model to deliver a more targeted portfolio of products and services focused on customers within three core business units: Government; Financial Services; and Technology & Commercial. The restructuring will enable a greater focus on customer needs and higher levels of operational efficiency, in the commercial business, that will accelerate improvements in competitiveness and profitability.

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 deliver on the Group's strategy.

Pension schemes

The 2017 UK triennial pension funding valuations concluded in November, with the aggregate funding deficit as at 31 March 2017 across the UK schemes at £2.1bn. The deficit recovery plan on the Group's largest pension scheme, the BAE Systems Pension Scheme, continues to March 2026, with the other schemes now with reduced repayment periods or fully funded.

The UK funding deficit at 31 March 2017 is some £3bn lower than the accounting deficit, using like-for-like mortality assumptions and asset values at 31 December 2017, largely due to lower liabilities as a result of the discount rate assumption based on the expected returns on the investments held by the schemes.

Research and technology

BAE Systems has developed some of the world's most innovative technologies and invests in research and development to generate future products and capabilities. We embrace disruptive technology, drive innovation and invest appropriately both on a self-funded basis and in conjunction with our customers, universities, and small and medium-sized enterprises. Company-funded research and development contributes, along with customer funding, in driving focused investment in areas such as defence and commercial electronics, military aircraft, precision weapons and cyber security.

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. During 2017, we rolled out further ethics training across the Group to support employees and, in January 2018, launched our revised Code of Conduct.

The safety of our employees, and anybody who works on, or visits, our sites, remains a key priority. Our safety culture and our employees demand high standards for all aspects of health and safety. In 2017, there was a 3% reduction in the Recordable Accident Rate and a 28% reduction in the total number of major injuries recorded as we continued to focus on reducing risk and embedding safety culture to drive improvement.

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.

Organisational changes

In October, we announced a restructure of our operations outside of the US-managed business in support of our three priorities of delivering operational excellence, honing our competitive edge and accelerating our technology innovation. The new operating model, effective 1 January 2018, will simplify our management structure to create strengthened Air and Maritime reporting segments, whilst changes to our UK-based Applied Intelligence cyber security business are focused on meeting customer needs and accelerating improvements in competitiveness and profitability.

Our 2017 results are re-presented on page 56 to reflect the organisational changes and our segmental guidance for 2018 is presented on page 57 on a consistent basis. On pages 58 and 59, we summarise the short- to medium-term prospects for our five principal reporting segments from 1 January 2018.

Summary

Our business benefits from a large order backlog, strong franchises and established positions on long-term programmes in the US, UK, Saudi Arabia and Australia. Our strategy is clear and well defined, with governments in our major markets continuing to prioritise defence and security, with strong demand for our capabilities. Through execution of a consistent strategy, we are well placed to maximise opportunities, deal with the challenges and continue to generate good shareholder returns.



Charles Woodburn Chief Executive

Group strategic framework

Our strategy is comprised of five key long-term areas of focus that will help us to achieve our vision and mission. This strategy remains relevant and consistent. We have updated our Group strategic framework to reflect our renewed focus on becoming a stronger company, able to win and grow in a tougher, competitive market.

The mission statement has evolved and aims to set out more clearly our purpose – why we exist – and the importance of our work. It emphasises that we put our customers first, giving them the critical capabilities and technological edge they rely on to protect security and prosperity around the world.

We have also redefined our strategic objectives to become three strategic priorities from 2018, providing greater alignment between our strategy and the near-term business objectives all our employees work to.

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

Maintain and grow our defence businesses

Continue to grow our business in adjacent markets

Develop and expand our international business

Inspire and develop a diverse workforce to drive success

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 are Trusted, Innovative and Bold

Our strategy in action



+ 15 iMOTR™, a new product designed to improve radar accuracy



+ 16 Advanced manufacturing facilities for F-35 Lightning II



+ 36 First flights of our new Head-Up Display



+ 39 Unmanned air systems adaptability and mission efficiency



+ 40 Providing anti-money laundering protection to one of the UK's largest banks



+ 42 Upgrading and securing communications capabilities on US Army vehicles



+ 44 Nearing Full-Rate Production on the Paladin Integrated Management programme



+ 47 A new concept for full-spectrum air defence



+ 48 First Typhoon and Hawk aircraft delivered to the Royal Air Force of Oman



+ 51 Production of Type 26 frigates for the Royal Navy commences



+ 52 Supporting the operational capabilities of the Royal Saudi Air Force



+ 54 Upgrading Australia's radar defence network

Our 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.



Supporting our customers

Our strategy is focused on providing a vital advantage to our customers across 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, including leading cyber capabilities, provides us with a comprehensive offering for our customers, with cyber now recognised as a defence domain in its own right.

Responding to a changing character of conflict

Our business continues to respond to geopolitical and technology trends that will influence the future character of conflict and shape our customers' requirements. 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.

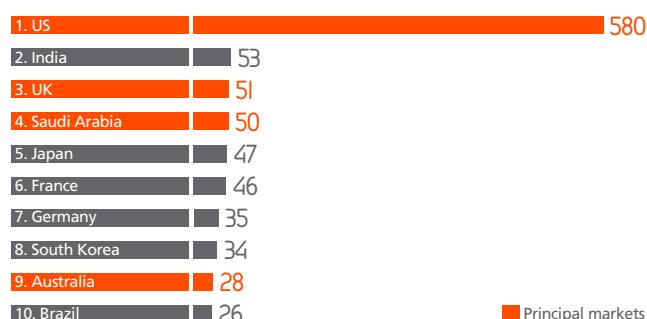
International growth aspirations

Following a number of years of defence spend contraction, global defence markets are stabilising, with a number of nations returning to growth in response to an increasingly uncertain security environment.

We continue to recognise the importance and requirements of our international customers. We have a significant international presence, one of the broadest amongst the defence primes, supported by long-standing customer relationships and diverse capabilities, leveraged across the Group.

Accessible global defence markets¹

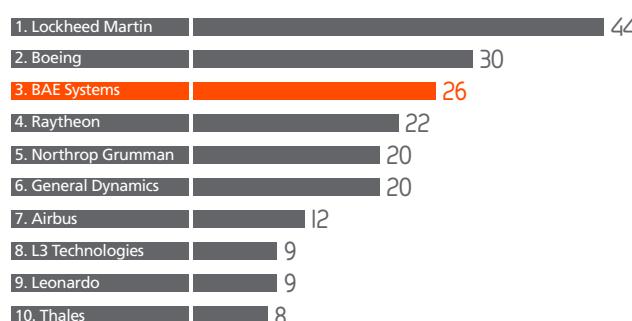
Top ten global defence markets accessible for business by the Group (\$bn)



Source: 2016 US budget as shown in the Department of Defense Fiscal Year 2018 Budget Request and, outside the US, IHS Jane's Defence Budgets (based on 2016 total defence budgets and constant 2017 US dollars).

BAE Systems' global defence market position

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



Source: Defense News Top 100 for 2017 (based on 2016 numbers). Exchange rate applied to BAE Systems is \$1.35/£1.

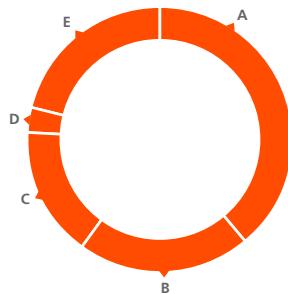
1. Markets inaccessible for business by BAE Systems are excluded.

Our markets continued

US

UK

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.

After seven months under a Continuing Resolution that maintained funding at the prior year's level, the fiscal year 2017 defence budget ultimately rose by approximately 4%. Whilst the fiscal year 2018 budget remains under a Continuing Resolution, the bipartisan budget agreement passed on 9 February 2018 would increase the US defence budget by approximately 10% over current levels, reflecting continued growth in defence spending to \$700bn (£518bn) for the fiscal year ending 30 September 2018. This budget agreement increases the budget caps for two years and extends the Continuing Resolution to 23 March 2018 to allow lawmakers to pass a 2018 spending bill.

The US defence budget is expected to experience continued growth.

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 and Armored Multi-Purpose 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 2017 Spring Budget reinforced previous commitments to increase defence spending, as well as the continued pledge to maintain spending at 2% of GDP. This provides the context for the Modernising Defence Programme announced in January 2018 by the Defence Secretary, the outcome of which is aimed to be announced by the summer of 2018.

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 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 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 £0.9bn (4%) of sales generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

International



The **Kingdom of Saudi Arabia** continues to be a leading 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 indigenous defence industry and capability. Through the restructuring of the Group's portfolio of interests in a number of industrial companies, building on our strong history in Saudi Arabia, we are working in partnership to deliver these priorities and we have commenced discussions with the new 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 expected in the air, maritime and land domains.

In addition to a number of key priorities highlighted in the Australian Defence White Paper, the government 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 Australia's initiative for growing domestic capabilities, 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.

We provide support to the Australian Defence Force through engineering, programme management and sustainment solutions, including Jindalee Operational Radar Network upgrade, Hawk Lead-In Fighter support, F-35 Lightning II sustainment, and Anzac frigate support and upgrade.



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. With high growth in Asia-Pacific and the Middle East, BAE Systems has developed relationships with partners and customers in a number of countries, working directly with local industry.

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.

We have signed a contract to provide Typhoon aircraft to Qatar, subject to financing conditions and receipt by the Group of first payment. We provide support to Typhoon and Hawk aircraft and naval vessels supplied to Oman.

In 2017, we signed a contract to collaborate on the first development phase of an indigenous fifth-generation fighter jet, TF-X, for the Turkish Air Force. Our footprint in Turkey is growing through our armoured combat vehicles joint venture, FNSS.

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

Our US businesses export combat vehicles to international customers, including Brazil and Japan.

In India, we have long-established relationships with local industry partners. We have a strong partnership with Hindustan Aeronautics Limited on Hawk aircraft and, more recently, with Mahindra Defence Services on M777 howitzers.

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 large 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

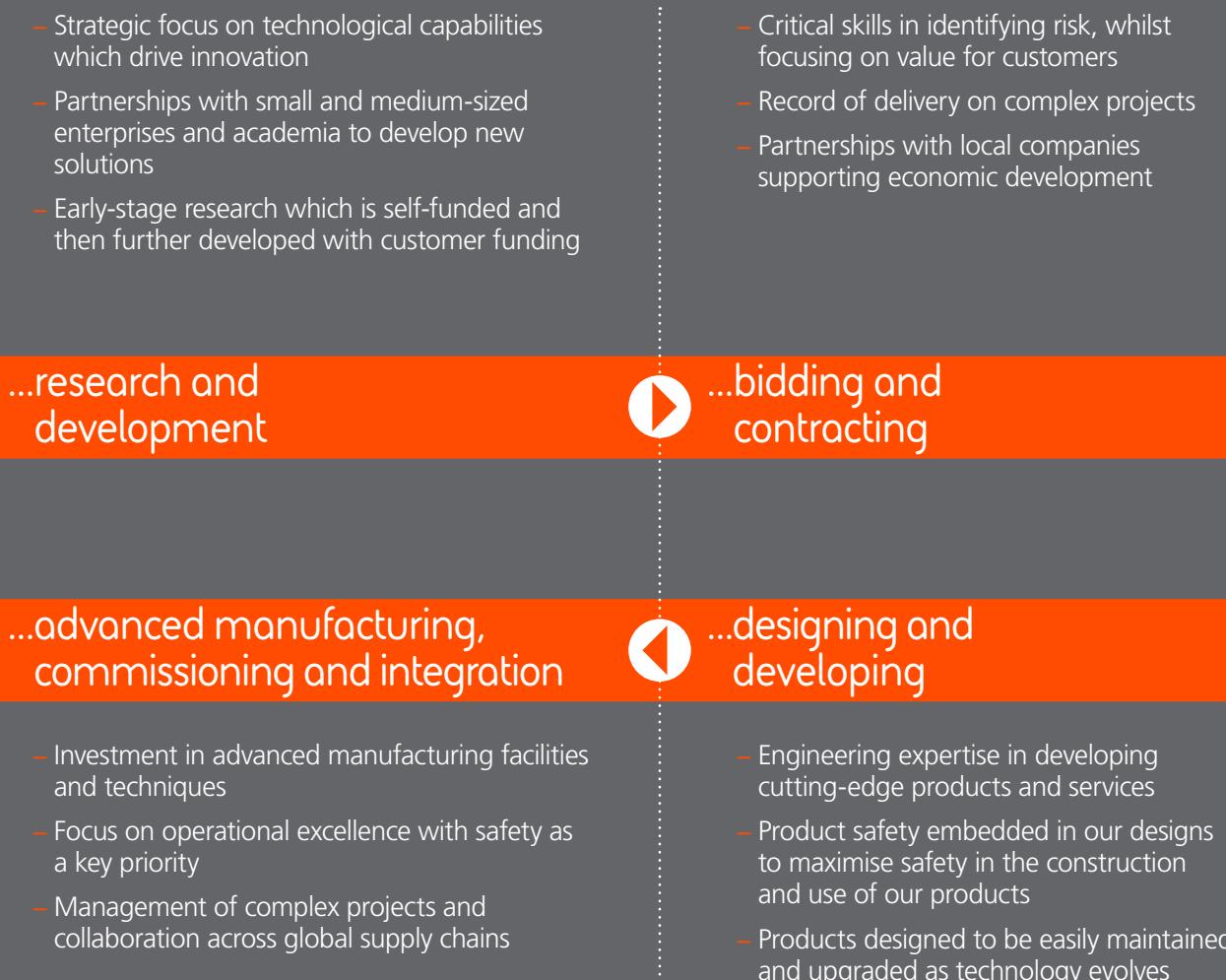
Our values of Trusted, Innovative and Bold are at the heart of everything we do and provide the right focus and framework for the Company to aspire to and live by, now and into the future.

 18 Group strategic framework

...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.

 24 Our people



...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 responsible behaviour

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.

60 Corporate responsibility

...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

How our business works

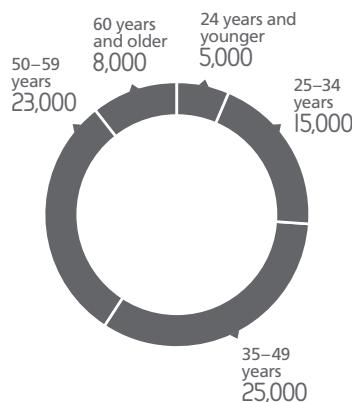
Our people

Recruiting and retaining the best people from the widest possible talent pool is a key priority for BAE Systems.

Gender diversity

	Male	Female
Board ¹	7	4
	64%	36%
Senior managers ^{2,3}	300	50
	86%	14%
Total employees ^{4,5}	60,000	16,000
	79%	21%

Age diversity^{4,5}



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

Our approach

Our human resources strategy prioritises employee welfare and development, empowerment and knowledge transfer. Our Group Human Resources Director reports directly to our Chief Executive and chairs the HR Council to ensure that our strategy supports the Integrated Business Plan and People Policy. The Group's 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 People Policy sets out our people management expectations, including with regard to diversity and inclusion, training and development, reward and employee engagement.

Diversity and inclusion

We are committed to creating an inclusive environment with a diverse workforce, which reflects the communities in which we work.

Our Chief Executive leads the Enterprise Diversity and Inclusion Council which has three key priorities:

- build a culture of inclusion and inclusive leadership globally;
- drive a heightened awareness and education of diversity and inclusion across the organisation; and
- foster diversity and inclusion throughout the organisation.

Our businesses are tasked with developing strategies and programmes that support these priorities and we are implementing measures to track progress.

We are determined to bridge the historical gender gap in our industry by encouraging more women to join the Company and promoting development so that we ultimately increase the number of women in senior executive positions.

We have employee-led networks supporting Lesbian, Gay, Bisexual, Transgender and Allies called OutLink in the UK and US. In the UK,

this has resulted in a jointly developed Transgender Policy being established in 2017.

Identifying and recruiting talent

We need to recruit a diverse range of professionals to help solve our customers' challenges, including engineers, designers, software developers and project managers. We look to draw people from a wide range of backgrounds and cultures.

We have been focusing our recruitment on the next generation to replace the skills and experience we are losing as our workforce retires, to mitigate Science, Technology, Engineering and Mathematics (STEM) skills shortages, and to accelerate diversity within our leadership. For example, we have partnered with Cranfield University to provide the UK's first-ever Masters-level post-graduate engineering apprenticeship scheme, with 76 BAE Systems engineers starting the programme in January 2018.

Training and development

We want every employee to reach their full potential and feel rewarded for what they do. We support this through our comprehensive career frameworks, development programmes and the breadth of our operations. Continual improvement of competence and skills transfer helps us to continue to develop world-leading technologies that give our customers a critical advantage.

Our focus on professional development throughout our employees' careers supports their personal and professional growth, and ensures that we have the skills to meet our customers' current and future requirements.

Supporting STEM workshops in Oman

In 2017, our UK and Omani engineering graduates ran STEM workshops at schools in Adam and Nizwa, close to the Adam air base, home to Typhoon aircraft in Oman. The students participated in hands-on exercises introducing them to engineering, and listened to our graduates' experiences of their time abroad and with BAE Systems in Oman.

Engineering and technological disciplines are core to the future plans for Oman's national economy. The workshops undertaken by BAE Systems in Oman continue to have the full backing of the Omani Ministry of Education.

1. At 1 January 2018. At 31 December 2017, the Board comprised seven male (70%) and three female (30%) directors.

2. 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.

3. Excludes executive directors.

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

5. See summary of Deloitte LLP assurance on page 65.



Reward

We provide our employees with competitive reward packages which include a range of benefits, and we recognise individual and team successes.

The UK government has introduced gender pay gap reporting regulations for companies with more than 250 employees. For 2017, the average gender pay gap for our UK workforce was 11.2%, which is lower than the current UK national average of 18.1%. We have a gender pay gap because we employ around four times more men than women and a greater proportion of our senior leadership team is male. This trend is not unusual for companies like ours which employ large numbers of people with qualifications in STEM-related fields. With the number of women who study and work in these fields significantly less than the number of men, we recruit from a much smaller pool of female talent. We continue to work hard to increase the number of females we employ to improve our gender balance and become a more diverse organisation.

Engagement

Effective engagement enables our employees to contribute to improving business performance and helps us to gauge our success in creating an environment in which everyone can fulfil their potential.

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

We keep employees informed about what is happening across the business, including Company results, major business decisions and other matters which affect them, using a variety of media, including our intranet and e-mail, through podcasts, newsletters and leadership blogs, and also through team briefs and team meetings where we seek to listen to employees' views and opinions. Employees have the opportunity to share their views through our employee surveys.

We seek to maintain constructive relationships with our trade unions in the UK and Australia, and our labour unions in the US. We have structures in place to work with trade union representatives in our local markets, where it is appropriate and legally acceptable.

Recruiting the next generation

Our apprenticeship programme is one of the biggest and most progressive in the UK, and is rated 'outstanding' by the Office for Standards in Education (Ofsted). In 2017, we recruited 576 apprentices and trainees, 190 graduates and 79 interns. By the end of 2017, we had approximately 2,000 apprentices and 500 graduates in training across our UK business, approximately 6% of the workforce.

Our 2017 apprentice intake figures provided our best ever diversity and inclusion statistics, with 27% female and 5% black, Asian and minority ethnic. From a social mobility perspective, in 2016, 18% of our apprentices were recruited from the top 20 most deprived wards in England.

Social and community matters

It is important to us and our employees that we give back to the communities where we have a presence and can make a positive difference.

Globally, during 2017, we contributed more than £11m⁵ to local, national and international charities and not-for-profit organisations through our Community Investment programme.

Community investment management

Our Community Investment Policy requires us to develop and maintain a Global Community Investment Strategy which outlines how we support our primary focus areas, where a measurable impact to the community can be demonstrated.

Our primary focus areas are:

- **Customer** – supporting active service personnel, veterans and their families;
- **Education** – inspiring young people to consider STEM subjects and careers; and
- **Local community** – working to support the communities in which we operate.

An outcome of our Community Investment Policy is that each market develops its own programme in support of the Global Community Investment Strategy and which is relevant to their lines of business, charitable needs and culture.

Community investment funding is not paid to third-party fundraisers or directly to individuals. As part of our due diligence procedures, prior to a charitable sponsorship or charitable 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.

The impact of the work we do

We have strong ties with armed forces charities and organisations that assist serving personnel, veterans and their families. In the UK, we are proud to be a founder donor (£5m over five years) to the Defence and National Rehabilitation Centre due to open in 2018.

Volunteering is important to us and our employees, so we enable and encourage it to be identified as a personal development goal.

In the US, during the 2017 Military Appreciation Month integrated campaign, 'Remember. Honor. Support.', employee donations to selected organisations were double-matched by the Company (up to \$5,000 per employee) for a total of nearly \$180,000 (£133,000).

How our business works

Our technology

We leverage our technology and engineering capabilities and invest in research and development to deliver competitive solutions for our customers now and in the future.

Research and development expenditure¹

£1.7bn

(2016 £1.5bn)

Our approach

Technology and innovation are central to our business; they underpin our strategy and the development of our products and services.

We scan emerging technologies from around the world to assess their potential for application in defence and security. We develop embryonic technology before selecting technologies to mature for use in our products and services. To do this, we work across our business and we work with our customers, academia and other industry partners. In some cases, we will acquire other organisations to secure exclusive access to technologies that are critical for our future.

We also work with potential overseas partners as part of our international campaigns and this can be a major discriminator in some markets. An example of this is our participation, for the first time, in a technology symposium with Singapore's Defence Science and Technology Agency (DSTA) in 2017. Our hope is that this will be the first step in working with DSTA to identify and prioritise areas of technology that we can jointly explore for future collaboration.

Our people are encouraged to innovate and embrace disruptive technologies focused on those which will ensure our customers are equipped to face present and future threats. We look for ways that technology can give our customers a competitive edge.

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

Our investment

Our strategic thinking informs where we invest our research and development (R&D) funding and resource. This in turn helps us to secure customer funding from organisations such as the UK Ministry of Defence, the Defense Advanced Research Projects Agency (DARPA) and the US military service laboratories to take the development of the technology to the next level.

We target investment in customer priority areas and in programmes that will give us a competitive advantage. Our R&D programmes are designed to improve the capability and performance of our products and services, reduce the cost of production, and provide customers with efficiency savings and lower through-life costs.

In 2017, we spent £1.6bn (2016 £1.4bn) on R&D, of which £238m (2016 £206m) was funded by the Group. In addition, the Group's share of the R&D expenditure of its equity accounted investments in 2017 was £0.1bn (2016 £0.1bn).

Protecting our investment in new technologies is important and we have a portfolio of patents and patent applications covering approximately 2,000 inventions internationally.

We look to make value-adding acquisitions in emergent new technologies or in technologies that will accelerate our R&D programmes and, in 2017, we completed the acquisition of IAP Research, Inc., a US engineering company focused on the development and production of electromagnetic launchers, power electronics and advanced materials.

Laser Directed Energy Weapons – changing the nature of warfare

Recognising the potential for Laser Directed Energy Weapons (LDEWs) to change the nature of warfare, we are leveraging our engineering expertise across our UK and US businesses to accelerate the development and introduction of laser capabilities.

Using focused light energy, LDEWs could be used in a range of operations across the air, maritime and land domains, and our aim is to show our customers the potential capabilities of these weapons, whilst prioritising safety and affordability.

We are collaborating with the university community to consider how to protect our platforms from LDEWs and how we can shape our future platform designs to ensure protection is built in to their development.

1. Including share of equity accounted investments.



Cobotics – delivering manufacturing advantage

Traditional manufacturing processes separate the complex tasks performed by humans from the simple, repeatable tasks performed by robots. In contrast, cobotic systems are designed for humans to work collaboratively with robots, allowing us to merge the efficiency and repeatability from the robot with the skill and dexterity from the human operator.

Our ongoing development of cobotic technology is focused on how we can provide more agility in the manufacturing environment, increase productivity, reduce costs and deliver improvements in safety. Advances in sensor technology, robotics design and machine learning will increasingly enable humans to work safely alongside machines without stopping the production line. Our aim is to produce a system with the ability to adapt to the user interfacing with it, thereby becoming the ultimate manufacturing assistant.

Our areas of focus

Today, there are BAE Systems technologies operating from the depths of the ocean to the far reaches of space. However, the technologies that have brought us to where we are today will not see us through the next decades. This is why we are investing in key technologies that will be important for our customers in the future and which will bring value to our business over the coming years.

Areas of focus include:

- **Big data** – developing technologies and capabilities that allow us to analyse and deduce relevant information from vast amounts of data. This is of growing importance for both the defence and commercial sectors.
- **Stealth** – continuing to invest in the development of materials, design approaches, manufacturing techniques and support processes that minimise the observability of our military products.
- **Electronic warfare** – developing this advanced technology to help pilots identify, monitor, analyse and respond to potential threats. We are also investing to improve our efficiency and capacity in defence electronics production.

- **Autonomy** – investing in the development and integration of autonomous systems technologies. They will play an increasingly important role in future conflict by removing armed forces personnel from dull, dirty and dangerous tasks while ensuring humans remain in control, continuing to make critical military decisions.

- **Laser Directed Energy Weapons** – commencement of a programme to develop a laser weapon integration capability and accelerate its introduction into operational service.

- **Advanced manufacturing** – positioning our manufacturing capability to meet future product and platform demands through the development and exploitation of novel materials and advanced manufacturing technologies.

Chief Technology Officer

Technology is a key priority for our business and a new Chief Technology Officer (CTO) was appointed at the start of 2018 to focus on our investment in, and development and exploitation of, technologies across our products, services and operations.

Nigel Whitehead, a member of the Executive Committee, assumed the role of CTO and, working with the BAE Systems, Inc. business, he will also oversee functional collaboration across the Group on technology, IT and digital strategy; manufacturing; engineering; support; and project management.

Group financial review

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.

Peter Lynas Group Finance Director



Financial performance

Measures as defined by the Group

Sales □ 28

£19,626m (2016 £19,020m)

Measures defined in IFRS¹

Revenue □ 28

£18,322m (2016 £17,790m)

Underlying EBITA

□ 28

£2,034m (2016 £1,905m)

Operating profit

□ 28

£1,480m (2016 £1,742m)

Underlying earnings per share

□ 30 KPI

43.5p (2016 40.3p)

Basic earnings per share

□ 30

26.8p (2016 28.8p)

Operating business cash flow

□ 31 KPI

£1,752m (2016 £1,004m)

Net cash flow from operating activities

□ 31

£1,897m (2016 £1,229m)

Net debt

□ 32 KPI

£(752)m (2016 £(1,542)m)

BONUS

Order intake³

□ 30 KPI

£20,257m (2016 £22,443m)

BONUS

Order backlog³

□ 30 KPI

£41.2bn (2016 £42.0bn)

BONUS

Income statement

Sales increased by £0.6bn to £19.6bn (2016 £19.0bn) largely reflecting currency translation.

Underlying EBITA increased by £129m to £2,034m (2016 £1,905m), giving a return on sales of 10.4% (2016 10.0%). There was an exchange translation benefit of £50m. Growth on a constant currency basis⁴ was at 4%.

Revenue increased by £0.5bn to £18.3bn (2016 £17.8bn) largely reflecting currency translation.

Operating profit decreased by £262m to £1,480m (2016 £1,742m). 2017 includes a £384m impairment in respect of the Applied Intelligence business, which is excluded from underlying EBITA. There was an exchange translation benefit of £39m.

Non-recurring items in 2017 of £13m represents a loss on the disposal of the BAE Systems San Francisco Ship Repair business. Non-recurring items in 2016 of £12m represented an impairment taken in respect of that business.

Amortisation of intangible assets is in line with the prior year at £86m (2016 £87m).

Impairment of goodwill in 2017 represents the impairment of goodwill in Applied Intelligence reflecting the future level and timing of expected returns from the business.

80% of the UK executive directors' bonuses are based on the achievement of financial KPIs (see page 101).

06 Alternative performance measure definitions

Net finance costs, including equity accounted investments, were £380m (2016 £619m). The underlying interest charge, excluding pension accounting, and fair value and foreign exchange adjustments on financial instruments and investments decreased marginally to £245m (2016 £257m). Net interest expense on the Group's pension deficit was £173m (2016 £177m). There was a credit in respect of fair value and foreign exchange adjustments of £38m (2016 £185m charge) on exchange translation of US dollar-denominated bonds.

Taxation expense, including equity accounted investments, of £287m (2016 £249m) reflects the Group's underlying effective tax rate for the year of 21%, partially offset by a £40m credit in respect of US tax reform enacted in December 2017. The US federal tax rate has been reduced from 35% to 21% with effect from 1 January 2018, while the estimated state tax rate has increased from 5% to 6%. In line with this change, the rate applying to US deferred tax assets and liabilities at 31 December 2017 has been reduced from 40% to 27%, creating a rate adjustment in 2017, which is partly reflected in the income statement.

The calculation of the underlying effective tax rate is shown in note 6 to the Group accounts on page 155.

The underlying effective tax rate for 2018 is expected to reduce from 21% to around 18% benefiting from US tax reform, with the final rate dependent on the geographical mix of profits.

Looking beyond 2018, the effective tax rate will depend principally on whether there are any changes in tax legislation in the Group's most significant countries of operation, the geographical mix of profits and the resolution of open issues.

Income statement

Financial performance measures as defined by the Group	2017 £m	2016 £m
Sales	KPI 19,626	19,020
Underlying EBITA	KPI 2,034	1,905
Return on sales	10.4%	10.0%
Financial performance measures defined in IFRS ¹	£m	£m
Revenue	18,322	17,790
Operating profit	1,480	1,742
Return on revenue	8.1%	9.8%
Reconciliation of sales to revenue	£m	£m
Sales	KPI 19,626	19,020
Deduct Share of sales by equity accounted investments	(2,575)	(2,427)
Add Sales to equity accounted investments	1,271	1,197
Revenue	18,322	17,790
Reconciliation of underlying EBITA to operating profit	£m	£m
Underlying EBITA	KPI 2,034	1,905
Non-recurring items	(13)	(12)
Amortisation of intangible assets	(86)	(87)
Impairment of goodwill	(384)	–
Financial expense of equity accounted investments	(34)	(28)
Taxation expense of equity accounted investments	(37)	(36)
Operating profit	1,480	1,742
Net finance costs	(346)	(591)
Taxation expense	(250)	(213)
Profit for the year	884	938
Underlying interest expense	(245)	(257)
Net interest expense on retirement benefit obligations	(173)	(177)
Fair value and foreign exchange adjustments on financial instruments and investments	38	(185)
Net finance costs (including equity accounted investments)	(380)	(619)

Exchange rates

Average	2017	2016
£/\$	1.289	1.354
£/€	1.141	1.223
£/A\$	1.681	1.823

Sensitivity analysis

Estimated impact on sales of a ten cent movement in the average exchange rate	£m
\$	550
€	75
A\$	35

1. International Financial Reporting Standards.
2. Generally Accepted Accounting Principles.
3. Including share of equity accounted investments.
4. Current year compared with prior year translated at current year exchange rates.

Group financial review continued

Earnings per share

Underlying earnings per share for the year increased by 8% to 43.5p (2016 40.3p). The in-year loss at Applied Intelligence was offset by good performance across the rest of the Group.

Basic earnings per share was 26.8p (2016 28.8p). Basic earnings per share is lower than underlying earnings per share mainly reflecting the £384m goodwill impairment charge taken in 2017 which is excluded from underlying earnings per share.

Orders

Order intake² decreased by £2.2bn to £20,257m (2016 £22,443m). The most significant award was the production contract for the first batch of three Type 26 frigates, with £2.8bn of order intake in the year.

Order backlog² decreased by £0.8bn to £41.2bn (2016 £42.0bn) reflecting currency translation.

Earnings per share

Financial performance measures as defined by the Group	2017	2016
Underlying earnings	£1,383m	£1,277m
Underlying earnings per share	KPI 43.5p	40.3p
Financial performance measures defined in IFRS ¹		
Profit for the year attributable to equity shareholders	£854m	£913m
Basic earnings per share	26.8p	28.8p
Reconciliation of underlying EBITA to underlying earnings	£m	£m
Underlying EBITA	2,034	1,905
Underlying interest expense (including equity accounted investments)	(245)	(257)
	1,789	1,648
Taxation expense (at the underlying effective tax rate)	(376)	(346)
Non-controlling interests	(30)	(25)
Underlying earnings	1,383	1,277
Reconciliation of underlying earnings to profit for the year attributable to equity shareholders	£m	£m
Underlying earnings	1,383	1,277
Impact of US tax reform enacted in December 2017	40	–
Non-recurring items, post tax	(10)	(9)
Amortisation and impairment of intangible assets, post tax	(68)	(69)
Impairment of goodwill	(384)	–
Net interest expense on retirement benefit obligations, post tax	(137)	(140)
Fair value and foreign exchange adjustments on financial instruments and investments, post tax	30	(146)
Profit for the year attributable to equity shareholders	854	913
Non-controlling interests	30	25
Profit for the year	884	938

Orders

Financial performance measures as defined by the Group	2017	2016
Order intake ²	KPI £20,257m	£22,443m
Order backlog ²	£41.2bn	£42.0bn

1. International Financial Reporting Standards.

2. Including share of equity accounted investments.

Cash flow

Operating business cash flow was £1,752m (2016 £1,004m), which includes cash contributions in respect of pension deficit funding, over and above service costs, for the UK and US schemes totalling £271m on a funding basis.

The remainder of the advances received in 2012 on the Omani Typhoon and Hawk order, as well as European Typhoon

production, are almost all now consumed. On the Saudi support contracts renewal, some £300m of cash was received in 2017 representing advance funding to be utilised in 2018 and 2019. Costs have been incurred against provisions created in previous years as the US commercial shipbuilding programmes are closed out. Approximately £100m of VAT payments rolled from December 2017 into January 2018.

Taxation payments increased to £227m (2016 £187m) in line with the increase in adjusted profit before taxation as calculated in note 6 to the Group accounts on page 155.

Net capital expenditure and financial investment was £444m (2016 £450m). As planned, capital investment was made in support of the production ramp-up in our US Electronic Systems and Combat Vehicles businesses.

Dividends received from equity accounted investments of £72m (2016 £38m) is primarily receipts from MBDA, FNSS and Advanced Electronics Company. There was a higher dividend from MBDA in 2017.

Interest received was £23m (2016 £10m).

The cash outflow in respect of **acquisitions and disposals** in 2017 of £11m reflects costs incurred in respect of the disposal of BAE Systems San Francisco Ship Repair and the acquisition of IAP Research, Inc. The cash inflow in 2016 of £6m reflected the sale of a 4.1% shareholding in a subsidiary company in Saudi Arabia.

Interest paid was £204m (2016 £210m).

Equity dividends paid in 2017 represents the 2016 final (£404m) and 2017 interim (£280m) dividends.

Dividends paid to non-controlling interests decreased to £8m (2016 £24m) reflecting a lower payment by Saudi Maintenance & Supply Chain Management Company in which the Group has a 51% shareholding.

There was a **cash outflow from matured derivative financial instruments** of £83m (2016 £480m inflow) from rolling hedges relating to balances with the Group's subsidiaries and equity accounted investments. The cash flow partially offsets the foreign exchange translation on the Group's external US dollar-denominated borrowing (see below).

Net cash flow from loans in 2016 represented repayment of a \$350m (£286m) 3.5% bond at maturity.

Foreign exchange translation primarily arises in respect of the Group's US dollar-denominated borrowing. In 2016, this was materially offset by the cash flow from matured derivative financial instruments (see above).

Cash flow

Financial performance measures as defined by the Group	2017 £m	2016 ¹ £m
Operating business cash flow	KPI 1,752	1,004
Financial performance measures defined in IFRS ¹	£m	£m
Net cash flow from operating activities	1,897	1,229
Reconciliation from operating business cash flow to net cash flow from operating activities	£m	£m
Operating business cash flow	KPI 1,752	1,004
Add back Net capital expenditure and financial investment	444	450
Deduct Dividends received from equity accounted investments	(72)	(38)
Deduct Taxation	(227)	(187)
Net cash flow from operating activities	1,897	1,229
Net capital expenditure and financial investment	(444)	(450)
Dividends received from equity accounted investments	72	38
Interest received	23	10
Acquisitions and disposals	(11)	6
Net cash flow from investing activities	(360)	(396)
Interest paid	(204)	(210)
Net (purchase)/sale of own shares	(1)	3
Equity dividends paid	(684)	(670)
Dividends paid to non-controlling interests	(8)	(24)
Cash flow from matured derivative financial instruments	(83)	480
Movement in cash collateral	(15)	32
Net cash flow from loans	–	(286)
Net cash flow from financing activities	(995)	(675)
Net increase in cash and cash equivalents	542	158
Add back Net cash flow from loans	–	286
Add back/(deduct) Cash classified as held for sale	2	(2)
Foreign exchange translation	301	(621)
Other non-cash movements	(55)	59
Decrease/(increase) in net debt	790	(120)
Opening net debt	(1,542)	(1,422)
Net debt	KPI (752)	(1,542)

¹ I87 and I88 Notes 24 and 26 to the Group accounts

1. International Financial Reporting Standards.

2. Re-presented to reclassify interest paid from investing to financing activities.

Group financial review continued

Balance sheet

The £0.9bn decrease in **intangible assets** to £10.4bn (2016 £11.3bn) mainly reflects exchange translation (£0.5bn) and the Applied Intelligence goodwill impairment (£0.4bn).

Property, plant and equipment, and investment property is £2.0bn (2016 £2.0bn).

Equity accounted investments and other investments increased to £390m (2016 £305m) reflecting the Group's share of profit for the year (£116m) and reduced pension allocation from the lower deficit (£66m), less dividends received (£72m).

The **Group's share of the net IAS 19 pension deficit** reduced to £3.9bn (2016 £6.1bn) mainly reflecting asset returns, updated mortality tables and allowances for future mortality improvements. The major movements in the net pension deficit are shown in the bridge chart below.

In November, the 2017 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. The UK accounting deficit, using like-for-like mortality assumptions and asset values at 31 December 2017, is approximately £3bn higher than the funding deficit. The discount rate applied to liabilities for accounting purposes reflects the yield on high-quality corporate bonds. The discount

Balance sheet

	2017 £m	2016 £m
Summarised balance sheet		
Intangible assets	10,378	11,264
Property, plant and equipment, and investment property ¹	1,977	1,999
Equity accounted investments and other investments	390	305
Working capital ¹	(3,752)	(3,564)
Group's share of the net IAS 19 pension deficit (see below)	(3,920)	(6,054)
Net tax assets and liabilities	435	935
Net other financial assets and liabilities	18	121
Net debt	KPI (752)	(1,542)
Net assets held for sale	10	–
Net assets	4,784	3,464

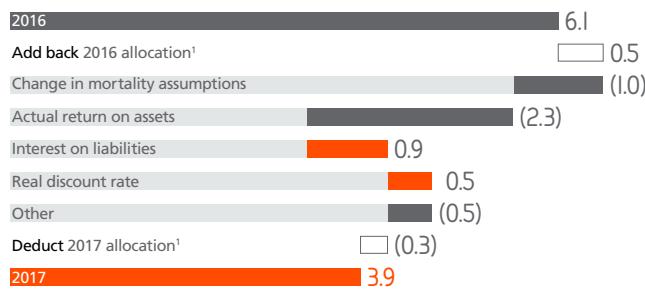
1. Funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme included in working capital in the Consolidated balance sheet is presented here in property, plant and equipment, and investment property.

	£m	£m
Components of net debt		
Cash and cash equivalents	3,271	2,769
Debt-related derivative financial instrument assets	60	114
Loans – non-current	(4,069)	(4,425)
Loans and overdrafts – current	(14)	–
Net debt	KPI (752)	(1,542)

Exchange rates

	2017	2016
Year end		
£/\$	1.353	1.236
£/€	1.126	1.172
£/A\$	1.730	1.707

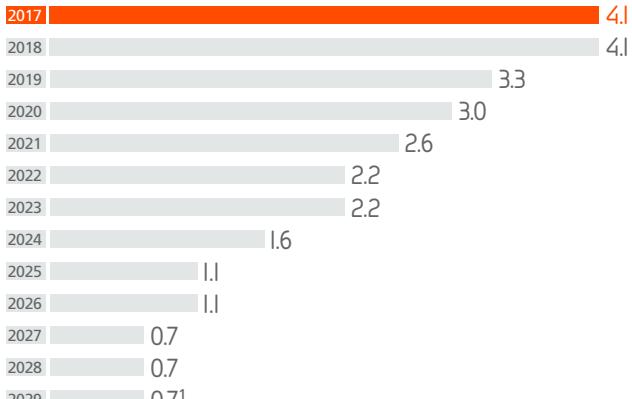
Accounting net pension deficit – bridge (£bn)



¹ 174 Note 21 to the Group accounts

1. Amounts allocated to equity accounted investments.

Maturity of the Group's borrowings (£bn)



¹ 172 Note 19 to the Group accounts

1. Repayable in 2041 (£292m) and 2044 (£395m).

rate for funding purposes reflects a prudent assessment of expected returns on the investments held by the schemes. Based on the new funding valuations, the Group will increase current annual deficit recovery payments to the UK schemes to £220m a year from 1 April 2018.

Details of the Group's pension schemes are provided in note 21 to the Group accounts on page 174.

A net deferred tax asset of £0.7bn (2016 £1.2bn) relating to the Group's pension deficit is included within **net tax assets and liabilities**.

In aggregate, there was a £0.2bn decrease in **working capital** largely reflecting advance funding on support contracts in Saudi Arabia and timing of VAT payments, partly offset by previous advances now largely utilised.

The Group's **net debt** at 31 December 2017 is £752m, a net decrease of £790m from the net debt position of £1,542m at the start of the year. There are no material debt maturities before 2019. The maturity of the Group's borrowings is shown in the chart opposite.

Cash and cash equivalents of £3,271m (2016 £2,769m) are held primarily for the repayment of debt securities, pension deficit funding, payment of the 2017 final dividend and management of working capital.

Net assets held for sale represents the Aircraft Accessories and Components Company expected to be sold in 2018.

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 £18.3bn (year ended 31 December 2017)
See note 1 to the Group accounts

Carrying value of goodwill

Goodwill £10.0bn (at 31 December 2017)
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 2017)
See note 14 to the Group accounts

Tax provisions

Tax provisions £351m (at 31 December 2017)
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 2017)
See note 21 to the Group accounts

□ 142 For more information

Changes in accounting policies

Effective 1 January 2018, BAE Systems adopted IFRS 15, Revenue from Contracts with Customers. The Group's results announcement for the half year ending 30 June 2018 will be the first to be prepared under IFRS 15.

The new Standard does not change the way in which we manage our contracts under Lifecycle Management, our mandated project management process, or the lifetime profitability and cash flow.

Revenue on the majority of contracts, currently being recognised based on the completion of milestones or deliveries, will cumulatively be recognised earlier.

The provisional impact of restating our results for the adoption of IFRS 15 is a reduction in underlying earnings per share of 1.4p to 42.1p for the year ended 31 December 2017 and an increase in net assets of £57m at 31 December 2017. The restated results will be used as the comparatives for the Group's financial statements for the year ending 31 December 2018. The earnings impact on 2018 and beyond is not expected to be material.

Details of the impact of IFRS 15 are provided in note 34 to the Group accounts on page 199.

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

□ 185 Note 23 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 13p per share making a total of 21.8p per share for the year, an increase of 2% over 2016. At this level, the annual dividend is covered two times. Subject to shareholder approval at the 2018 Annual General Meeting, the dividend will be paid on 1 June 2018 to holders of ordinary shares registered on 20 April 2018. The ex-dividend date is 19 April 2018.

At 31 December 2017, the Company had retained earnings of £2.6bn (2016 £2.1bn), the non-distributable portion of which is £649m (2016 £604m) (see page 202). Total external dividends relating to 2017 are £694m (2016 £677m), including the interim dividend paid during the year of £280m (2016 £273m) and the final dividend proposed of approximately £414m (2016 £404m). 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 page 81).

Group financial review continued

Treasury

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

Objectives/policies

Net debt

Maintain a balance between the continuity, flexibility and cost of debt funding through the use of borrowings from a range of markets with a range of maturities, currencies and interest rates, reflecting the Group's risk profile.

- Material borrowings are arranged by the central treasury department and funds raised are lent onward to operating subsidiaries as required.

Interest rates

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

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

Liquidity

Maintain adequate undrawn committed borrowing facilities.

- An undrawn committed Revolving Credit Facility of £2bn contracted to December 2018 and £1.9bn contracted from December 2018 to December 2020 is available to meet expected general corporate funding requirements.

Monitor and control counterparty credit risk and credit limit utilisation.

- The Group adopts a conservative approach to the investment of its surplus cash. It is deposited with financial institutions with 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 the income statements or balance sheets of foreign subsidiaries and equity accounted investments it regards as long-term investments.

 190 Note 28 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).

 154 Note 6 to the Group accounts

Segmental review

We report our performance through five principal reporting segments¹.

+
06 Alternative performance measure definitions

				
Electronic Systems + 36	Cyber & Intelligence + 40	Platforms & Services (US) + 44	Platforms & Services (UK) + 48	Platforms & Services (International) + 52
Employees ² 14,400	Employees ² 10,900	Employees ² 11,400	Employees ² 30,100	Employees ² 13,800

Financial performance measures

	As defined by the Group						Defined in IFRS ³			
	KPI	KPI	KPI	KPI	Revenue £m	Operating profit/(loss) £m	Return on revenue %	Net cash flow from operating activities £m		
	Sales £m	Underlying EBITA £m	Return on sales %	Operating business cash flow £m	Order intake ² £m	Order backlog ² £bn				
Year ended 31 December 2017										
Electronic Systems	3,635	562	15.5	450	4,175	5.4	3,635	542	14.9	569
Cyber & Intelligence	1,820	52	2.9	116	1,859	2.1	1,820	(367)	(20.2)	127
Platforms & Services (US)	2,928	242	8.3	222	3,542	4.6	2,825	218	7.7	286
Platforms & Services (UK)	7,682	794	10.3	427	6,817	16.8	7,624	774	10.2	607
Platforms & Services (International)	4,138	472	11.4	671	4,365	13.3	3,136	427	13.6	669
HQ ⁴	287	(88)		(134)	288	–	–	(114)		(134)
Deduct Intra-group	(864)				(789)	(1.0)	(718)			(227)
Deduct Taxation ⁵										
Total	19,626	2,034	10.4	1,752	20,257	41.2	18,322	1,480	8.1	1,897

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 IFRS³ are provided in the Group financial review on pages 28 to 34. 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 24 to the Group accounts (see page 187).

1. Effective 1 January 2018, BAE Systems revised its reporting segments to reflect the organisational changes described on page 17. See page 56 for more information.

2. Including share of equity accounted investments.

3. International Financial Reporting Standards.

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

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

Segmental review

Electronic Systems

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.



Our strategy in action

First flights of our new Head-Up Display

Our LiteHUD® Head-Up Display (HUD) took to the skies for its first flights in 2017, marking a significant milestone for both the technology and the programme.

A HUD is a see-through display that seamlessly presents flight-critical information directly in a pilot's line of sight without obstructing views of the outside world. We began funding the development of LiteHUD® more than two years ago and we are confident that customers will benefit from its next-generation display capability at an off-the-shelf price.

Designed using our patented optical waveguide technology, LiteHUD® is 60% smaller and up to 50% lighter than conventional head-up displays. The system enhances situational awareness in day and night conditions, significantly improving flight safety and reducing pilot fatigue.

Electronic Combat includes the Integrated Electronic Warfare, Low Observable Tactical Aircraft Electronic Warfare and Tactical Aircraft Electronic Warfare product lines. The business provides a depth of capability in integrated electronic warfare systems 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 products.

Controls & Avionics addresses the commercial and military aircraft electronics markets, 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.

06 Alternative performance measure definitions

Operational and strategic highlights

- Orders worth over \$450m (£333m) received for F-35 Lightning II hardware production and support
- Invested more than \$100m (£74m) in our 'Ramp to Rate' initiative to prepare the business for future Electronic Warfare growth
- Received a \$311m (£230m) contract to provide the Digital Electronic Warfare System (DEWS) to support the sale of new aircraft to an international customer
- Growing demand for APKWS™ laser-guided rockets, with awards totalling approximately \$300m (£222m) during the year
- LiteHUD® Head-Up Display selected by critical launch customers, with first flights in 2017
- The FADEC Alliance joint venture transitioned to Full-Rate Production of the full authority digital engine control for the LEAP commercial aircraft engine
- Major milestone achieved with the delivery of our 8,000th hybrid-electric system

Financial performance

Financial performance measures as defined by the Group

	2017	2016
Sales	KPI £3,635m	£3,282m
Underlying EBITA	KPI £562m	£494m
Return on sales	15.5%	15.1%
Operating business cash flow	KPI £450m	£469m
Order intake ¹	KPI £4,175m	£3,322m
Order backlog ¹	KPI £5.4bn	£5.2bn

Financial performance measures defined in IFRS²

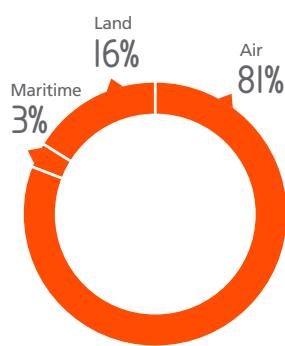
	2017	2016
Revenue	£3,635m	£3,282m
Operating profit	£542m	£474m
Return on revenue	14.9%	14.4%
Cash flow from operating activities	£569m	£568m

- Sales compared with 2016 were up 5% at \$4.7bn (£3.6bn). The growth came in the electronic warfare business from the F-35 Lightning II and DEWS programmes, as well as increasing classified activity. Volumes of the APKWS™ product almost doubled over the year and now represent one of the top five sales lines.
- The return on sales achieved of 15.5% (2016 15.1%) reflects continued strong programme execution and risk retirement.

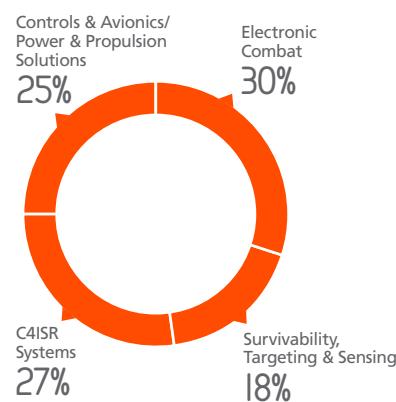
- Cash conversion of underlying EBITA for the full year was at 85% (2016 97%), excluding pension deficit funding.
- Order backlog was at a record high of \$7.3bn (£5.4bn) following further awards for F-35 Lightning II systems, classified Electronic Warfare activity and APKWS™ product.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

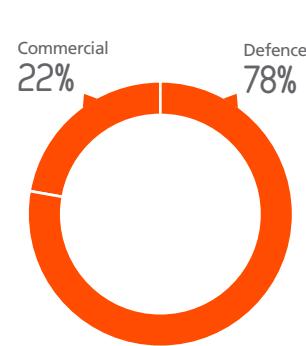
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Defence and commercial (%)



Segmental review Electronic Systems

Operational performance

Electronic Combat

BAE Systems has sustained its leadership position in the US electronic warfare market and production is ramping up across a number of programmes, some of which are classified.

Low-Rate Initial Production (LRIP) hardware deliveries for the F-35 Lightning II programme continue with Lot 10 and 11 deliveries. We have received initial Lot 12 funding, with an anticipated final award value in excess of \$300m (£222m), and a Request for Proposal for a potential block buy encompassing multiple lots.

BAE Systems reached a price agreement with Lockheed Martin on a \$155m (£115m) Electronic Warfare Performance Based Logistics contract. The award provides Electronic Warfare material availability and support for the F-35 Lightning II aircraft over a five-year period.

The business is under contracts from Boeing and Warner Robins Air Logistics Complex, totalling more than \$1.0bn (£0.7bn), to install the Digital Electronic Warfare System on select new F-15 aircraft, upgrade existing F-15 aircraft, and to provide spare units and modules for an international customer. The programme remains on schedule. BAE Systems has also received a \$311m (£230m) contract to provide the Digital Electronic Warfare System to support the sale of new F-15 aircraft to another international customer.

Following our selection by Boeing in 2015 to develop and manufacture the next-generation digital electronic warfare system for the US Air Force's Eagle Passive Active Warning Survivability System programme to upgrade up to 400 F-15 aircraft, we are currently executing the \$161m (£119m) engineering and manufacturing development contract. The programme could be worth more than \$1.0bn (£0.7bn) over its life.

We have been awarded \$87m (£64m) worth of modifications to a competitively awarded contract for an electronic warfare system for the US Air Force Special Operations Command's fleet of C-130J aircraft. The total value of the contract, including all options, could exceed \$300m (£222m). This award extends our position to include our electronic warfare capabilities on large, fixed-wing aircraft.

Production of our sensor technology for the Long Range Anti-Ship Missile has commenced following a \$40m (£30m) order from prime contractor Lockheed Martin. We provided the sensor technology that supported a successful launch of the missile, demonstrating its ability to address the US Navy's requirement for versatile, multi-platform precision munitions that enable distributed operations.

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. We are under contract to cross-deck the mission electronics onto a new Gulfstream G550 business jet for the US Air Force. BAE Systems will continue to sustain the existing EC-130H electronics as we develop, manufacture, procure, integrate and sustain the electronics. The programme could be worth more than \$2.0bn (£1.5bn) over the next decade.

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 13,000 units delivered as at 31 December 2017. In addition to expanding its use in the US military, the system is generating strong international attention, with 19 nations expressing interest. The programme received awards totalling approximately \$300m (£222m) during the year.

We continue to execute on the Terminal High-Altitude Area Defence programme. We have received a \$30m (£22m) production contract for long-lead material on Lots 9 and 10, and anticipate that additional units will be added in response to increasing demand.

On the \$236m (£174m) Common Missile Warning System programme, we continue to deliver to schedule.

Under the five-year, \$434m (£321m) Enhanced Night Vision Goggle III and Family of Weapon Sights – Individual Indefinite Delivery, Indefinite Quantity contract, we continued to progress the production qualification testing.

The US Army's Family of Weapon Sights – Crew Served programme completed its System Critical Design Review during the year. This seven-year contract awarded in 2016 has a potential value of up to \$384m (£284m).

The LiteHUD® Head-Up Display has been selected by critical launch customers for integration on multiple platforms. In 2017, it had its first flights on a C-130J aircraft, a Textron Scorpion jet and our advanced Hawk demonstrator aircraft.

In December, the US Department of Defense announced that we were awarded a contract by the US Army for the Limited Interim Missile Warning System programme.

C4ISR Systems

In September, the Communications & Navigation Solutions product line joined the Intelligence, Surveillance & Reconnaissance business to form a new C4ISR Systems business that spans the entire mission lifecycle (sensing, processing, exploitation and dissemination).

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 have been awarded an \$81m (£60m) contract for 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 with a system to be fielded on various surface ship types.

Since winning the Geospatial Data Services Foundational GEOINT Content Management programme in 2014, we have been awarded orders valued at \$214m (£158m). The business is meeting all 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, we are executing the \$132m (£98m) Tactical Signals Intelligence Payloads programme for the US Army's Gray Eagle unmanned aircraft.

56 Re-presentation
of 2017 results

Work continues on the US Navy's P-8A Poseidon maritime surveillance aircraft programme to provide state-of-the-art processing capabilities. The programme is expected to be worth \$1.2bn (£0.9bn) over its life.

Controls & Avionics

BAE Systems is a major supplier of engine controls, flight controls, 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 remains on schedule, with all hardware in qualification and systems integration testing progressing to plan.

On the Boeing 737 MAX aircraft, a successful first flight was completed on the MAX 9 with our spoiler controls, flight deck systems and utilities electronics.

The development of our civil active interceptors is progressing, with Gulfstream G500 and Embraer KC390 aircraft continuing flight tests with positive pilot feedback. A derivative of the civil interceptors for the Boeing CH-47 Chinook helicopter, LinkEdge™ (Active Parallel Actuation Subsystem), has successfully completed its Preliminary Design Review.

FADEC Alliance, a joint venture between FADEC International (our joint venture with Safran Electronics & Defense) and GE Aviation, has transitioned the full authority digital engine control (FADEC) for the LEAP engine to Full-Rate Production. The LEAP engine powers the Airbus A320neo, the Boeing 737 MAX and the Comac C919. The development of the FADEC for the GE9x engine for the Boeing 777X is on schedule, with certification planned for 2018.

On the F-35 Lightning II programme, LRIP Lot 11 is ongoing for the current vehicle management computer and active interceptor system equipment. Orders for Lot 12 are expected in 2018.

BAE Systems has been awarded a multi-million dollar contract to provide flight control computers, active interceptors, accelerometers and integrated colour display systems for new Taiwanese Air Force training aircraft. The award establishes our footprint on a new platform.

Looking forward

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

58 Segmental
looking forward



Our strategy in action

Unmanned air systems adaptability and mission efficiency

We are developing technology for the US Defense Advanced Research Projects Agency (DARPA) that will enable unmanned air systems to conduct multiple missions. The CONverged Collaborative Elements for RF Task Operations – or CONCERTO – programme is creating single, multi-function payloads that adapt to changing battlefield situations and mission needs in real time.

These compact units will allow operators to converge multiple radio frequency systems on one payload that will efficiently switch between intelligence, surveillance and reconnaissance; command and control; networking; and combat operations support missions without having to make physical changes.

18 Group strategic framework

More online
baesystems.com

Power & Propulsion Solutions

With the transit bus market continuing its shift towards more electric bus systems to meet emission targets and to satisfy an environmentally-conscious public, BAE Systems achieved a major milestone with the delivery of its 8,000th hybrid-electric system. Transit operators around the world are looking for reliable, low-emission technologies and major cities, such as Seattle, Boston, Quebec, London and Paris, are adopting our advanced hybrid solutions, which are capable of emission-free driving up to half of the time.

Segmental review

Cyber & Intelligence

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.



Our strategy in action

Providing anti-money laundering protection to one of the UK's largest banks

BAE Systems Applied Intelligence has been selected by one of the UK's largest banks as its preferred strategic vendor for anti-money laundering protection.

With laundered money now estimated to represent between 2% and 5% of global Gross Domestic Product – equivalent to the fifth largest economy in the world – money laundering schemes are becoming ever more complex, with commercial, retail and investment banks all becoming targets for fraudsters.

The contract means this bank can use our latest cutting-edge technology to ensure criminals and money launderers are accurately detected.

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

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

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

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

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. Its solutions are delivered as licensed technologies, software-as-a-service subscriptions, through outsourced managed services, and via consulting and systems integration projects.

UK Services delivers cyber security, data analytics, and digital transformation consulting and systems integration services to national security, government and large enterprises in the UK.

International Services & Solutions provides cyber intelligence and defence solutions to international government agencies and communications service providers.

Commercial Solutions provides cyber defence, counter-fraud and financial compliance products to commercial organisations globally.

06 Alternative performance measure definitions

Operational and strategic highlights

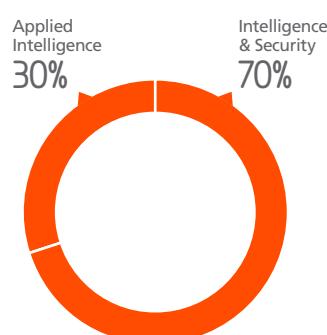
Intelligence & Security

- Six task orders secured valued at more than \$180m (£133m) for Full-Motion Video Intelligence, Surveillance and Reconnaissance analysis support
- Won a position on a US Department of Treasury programme to support the Office of Terrorism and Financial Intelligence, with a maximum lifecycle value of \$135m (£100m)
- Awarded three US Navy contracts with an estimated lifecycle value of approximately \$180m (£133m) to provide engineering and integration support for critical mission systems
- Selected by the US Navy to pursue orders to provide equipment and support services for Space and Naval Warfare Systems Center Atlantic

Applied Intelligence

- Contracts won with UK government and commercial customers for secure IT transformation and cyber defence
- Restructuring activities under way, including headcount and facility reductions and a move to a revised operating model, effective 1 January 2018, to drive profitable growth

Sales by business (%)



Financial performance

Financial performance measures as defined by the Group

	2017	2016
Sales	KPI £1,820m	£1,778m
Underlying EBITA	KPI £52m	£90m
Return on sales	2.9%	5.1%
Operating business cash flow	KPI £116m	£83m
Order intake ¹	KPI £1,859m	£1,885m
Order backlog ¹	KPI £2.1bn	£2.4bn

Financial performance measures defined in IFRS²

	2017	2016
Revenue	£1,820m	£1,778m
Operating (loss)/profit	£(367)m	£59m
Return on revenue	(20.2)%	3.3%
Cash flow from operating activities	£127m	£106m

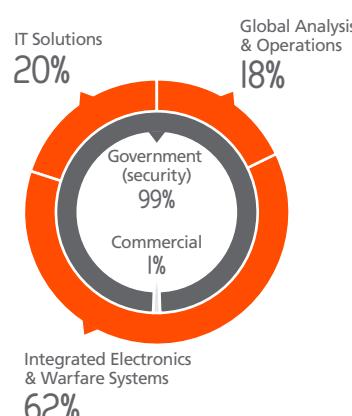
- In aggregate, sales were marginally lower at \$2.3bn (£1.8bn). The Intelligence & Security business saw a 4% decrease largely in the highly competitive area of IT support services to the intelligence community. Growth in Applied Intelligence was at 6%, benefiting from increases in the UK Services and International Services & Solutions divisions.
- Return on sales was 2.9% (2016 5.1%), after a restructuring charge taken in the Applied Intelligence business. Return on sales in the Intelligence & Security business was similar to last year at 8.8%. In Applied Intelligence, the underlying loss for the year was £61m, including £24m for the restructuring charge. The first half loss

of £27m was followed by a reduced second half loss, before the restructuring charge, of £10m as the cost-reduction actions under the ongoing restructuring started to deliver bottom-line benefit.

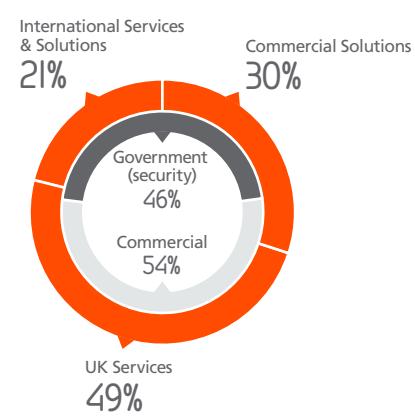
- There was an operating loss of £367m (2016 profit £59m), which includes a £384m goodwill impairment in Applied Intelligence reflecting the future level and timing of expected returns from the business.
- Cash conversion of underlying EBITA for the year was in excess of 100%.
- Order backlog reduced marginally to \$2.9bn (£2.1bn).

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

Sales analysis: Intelligence & Security (%)



Sales analysis: Applied Intelligence (%)



Segmental review Cyber & Intelligence



Our strategy in action

Upgrading and securing communications capabilities on US Army vehicles

In October, our engineers achieved a significant milestone, successfully upgrading the C4¹ capabilities of the 5,000th mine-resistant tactical vehicle for US and allied forces.

The upgrades, which are performed at our state-of-the-art facility in Summerville, South Carolina, US, enhance vehicle communications systems, intercom systems, mobile network systems and soldier protective systems on a variety of Mine-Resistant Ambush Protected (MRAP) vehicles, including the MRAP All-Terrain Vehicle (M-ATV), MaxxPro Dash and RG-31 platforms.

This important milestone comes as the US Army seeks to improve the mission capabilities of its tactical vehicle fleet and enhance situational awareness for soldiers.

 More online
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 18 Group strategic framework

Operational performance

Intelligence & Security Global Analysis & Operations

We are pursuing task orders under a new Indefinite Delivery, Indefinite Quantity contract with an estimated value of more than \$400m (£296m) to expand our work in motion-imagery analysis, analytic training, multi-media support and research for the US intelligence community. During the year, the business secured six task order contracts valued at more than \$180m (£133m).

We won a position on a US Department of Treasury programme to support the Office of Terrorism and Financial Intelligence. The maximum lifecycle value of all task orders to be awarded under the programme is estimated at \$135m (£100m).

Integrated Electronics & Warfare Systems

The business is executing on the second year of a five-year, sole-source contract worth up to \$368m (£272m) to provide systems engineering services to the US Navy's Strategic Systems Programs office. The programme provides support for weapons systems on board US Ohio and UK Vanguard Class submarines, as well as future Ohio Class replacement and UK Dreadnought Class submarines.

US Navy contract awards in the year include: a new five-year, \$42m (£31m) multiple-award contract with the Naval Undersea Warfare Center Division to install submarine multi-mission trainer systems at bases in the US, Guam and Australia; a 22-month, \$76m (£56m) contract to support the rapid design, development, fabrication, customisation and lifecycle maintenance of new and existing communication and electronic platforms for the Naval Warfare Center Aircraft Division; and a five-year, \$64m (£47m) contract to provide lifecycle systems engineering and technical support for a variety of deployed systems that ensure operational readiness of the fleet.

In addition, the US Navy awarded BAE Systems a position on a five-year Indefinite Delivery, Indefinite Quantity contract to provide research, development, test and evaluation services support for the Naval Warfare Center Aircraft Division's Aircraft Prototype Systems Division. The potential lifecycle value of all task orders under this contract across the eight awardees could reach \$487m (£360m).

+ 56 Re-presentation of 2017 results

The US Navy has also selected BAE Systems to provide equipment and support services for Space and Naval Warfare Systems Center Atlantic. As one of several companies involved, we will pursue future orders as part of this five-year, Indefinite Delivery, Indefinite Quantity contract. The total value of all orders to be awarded over the life of the contract is estimated at \$180m (£133m).

On the US Air Force Intercontinental Ballistic Missile Integration Support Contractor programme, we were awarded over \$29m (£21m) of additional engineering change proposals in 2017, raising the total lifecycle value of the contract to \$922m (£682m). Our work includes programme management, systems sustainment, and cyber security assessment and defence.

We continue to pursue task orders on a nine-year Indefinite Delivery, Indefinite Quantity contract to support the US Army in developing next-generation technologies for space, high-altitude and missile defence.

IT Solutions

Our contract to connect a number of US agencies under one shared IT environment passed significant security testing and was authorised for adoption into the government IT infrastructure. Although we executed on our task orders and provided IT services to foster greater systems integration and information sharing for the intelligence community, we have been advised that future contract options will not be exercised as the government reassesses its acquisition strategy in favour of a more federated desktop approach. We therefore do not anticipate any future awards beyond the \$164m (£121m) of funding to date.

Our business was awarded a contract increase of \$160m (£118m) to extend the period of performance of a major software development and IT support contract for a US intelligence community customer.

We received a five-year, \$41m (£30m) contract with the US Department of Homeland Security, National Protection and Programs Directorate to provide data analytics, risk scoring and systems engineering support, as well as cyber security assessment, governance and training to ensure all federal civilian agencies are in compliance with government cyber security regulations.

Looking forward

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

+ 58 Segmental looking forward

Organisational changes

Effective 12 February 2018, the business moved to a revised operating model to position for growth through three customer-focused business areas: Integrated Defence Solutions; Intelligence Solutions; and Air Force Solutions.

Applied Intelligence

The business has delivered revenue growth from the continued delivery of national security solutions for the UK and international governments, as well as deployment of anti-fraud, regulatory compliance, and cyber security products and services to commercial customers.

UK Services

The business continues to invest in engineering disciplines and specialist expertise in the cyber, digital and data domains to support our customers in national security intelligence, national-scale cyber defence, commercial cyber security and regulatory compliance.

We have won a number of contracts with both UK government and commercial enterprises, helping our customers to maximise the benefits of secure IT transformation and cyber defence.

International Services & Solutions

The business was underpinned by significant demand for our national-scale cyber defence capabilities. We continue to work with key national security customers in Asia-Pacific and the Middle East. Our technical capability in multi-source intelligence analytics has advanced significantly. In order to improve the cost competitiveness of our engineering, we are continuing to expand our off-shore service operations and delivery centres.

Commercial Solutions

We have a focused set of cyber security, anti-fraud and regulatory compliance solutions.

We continue to see demand for our NetReveal™ anti-fraud and compliance suite, with solutions being deployed to an increasing number of prominent multi-national customers in the financial services sector. Customers are increasingly consuming these solutions as multi-year managed services.

We are continuing to renew existing long-term customer contracts where we deploy a comprehensive portfolio of products. Provision of our anti-fraud and anti-money laundering capabilities continues to see demand with financial services customers.

Organisational changes

In the second half of the year, the business commenced a restructuring that resulted in a headcount reduction and, effective 1 January 2018, the business moved to a revised operating model to deliver a more targeted portfolio of products and services focused on customers within three core business units: Government; Financial Services; and Technology & Commercial. The restructuring will enable a greater focus on customer needs and higher levels of operational efficiency, in the commercial business, that will accelerate improvements in competitiveness and profitability.

Segmental review

Platforms & Services (US)

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 of government-owned munitions facilities.



Our strategy in action

Nearing Full-Rate Production on the Paladin Integrated Management programme

In December, the US Army awarded us a \$414m (£306m) contract for the third and final Low-Rate Initial Production option for the M109A7 self-propelled howitzer. The award includes options to initiate Full-Rate Production which, if exercised, would bring the full value to \$1.7bn (£1.3bn).

The M109A7 consists of a new chassis design for improved performance and upgraded survivability, as well as state-of-the-art digital backbone and power generation capability. These enhancements reduce overall programme cost and logistical footprint, and provide improved mobility and system survivability.

We will produce 48 vehicle sets, including M992A3 ammunition carriers, with options for 60 vehicle sets per year for approximately three years thereafter during Full-Rate Production.

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 for 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 five operational sites in the US on the Atlantic, Gulf of Mexico and Pacific coasts, as well as in Hawaii.

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

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

06 Alternative performance measure definitions

Operational and strategic highlights

- Vehicle deliveries nearing completion under the engineering and manufacturing development phase of the Armored Multi-Purpose Vehicle programme
- Awarded a \$414m (£306m) contract for the third and final option for Low-Rate Initial Production under the Paladin Integrated Management programme
- Completed deliveries of the 16 Amphibious Combat Vehicle prototypes to the US Marine Corps
- First two M777 lightweight howitzers shipped to India for testing under the \$542m (£401m) contract awarded in January 2017
- \$140m (£104m) contract awarded for the modernisation of USS Tortuga
- Construction of the final commercial ship is nearing completion and the ship is expected to be delivered in the first half of 2018
- FNSS received a €155m (£138m) contract to provide 27 amphibious assault vehicles to the Turkish Ministry of National Defence

Financial performance

Financial performance measures as defined by the Group

	2017	2016
Sales	KPI £2,928m	£2,874m
Underlying EBITA	KPI £242m	£211m
Return on sales	8.3%	7.3%
Operating business cash flow	KPI £222m	£58m
Order intake ¹	KPI £3,542m	£3,308m
Order backlog ¹	KPI £4.6bn	£4.6bn

Financial performance measures defined in IFRS²

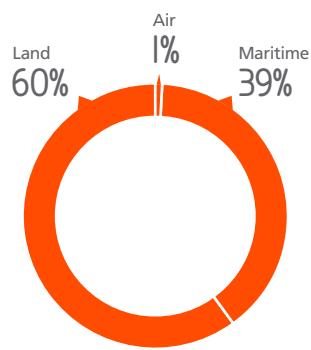
	2017	2016
Revenue	£2,825m	£2,783m
Operating profit	£218m	£182m
Return on revenue	7.7%	6.5%
Cash flow from operating activities	£286m	£129m

- Sales reduced by 3% to \$3.8bn (£2.9bn) as deliveries of land vehicles to Brazil and Japan slipped into the first half of 2018.
- The business delivered an improved return on sales of 8.3% (2016 7.3%). Charges taken in the year on the commercial shipbuilding programmes amounted to \$16m (£12m), with just one contract now remaining for completion.
- Cash conversion of underlying EBITA was significantly improved despite the impact from the use of provisions on the commercial shipbuilding programmes.

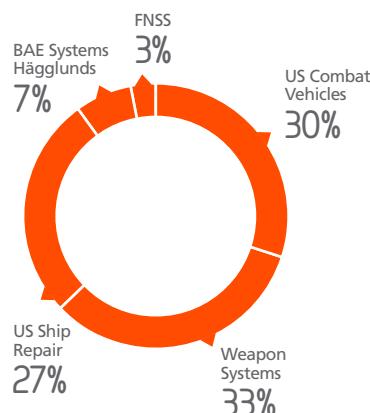
- Order backlog was increased to \$6.3bn (£4.6bn), supportive of future growth expectations. Key awards in the year included the \$0.5bn (£0.4bn) Indian order for M777 howitzers, \$0.4bn (£0.3bn) for Paladin production and a total of \$1.3bn (£1.0bn) in the Ship Repair business.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

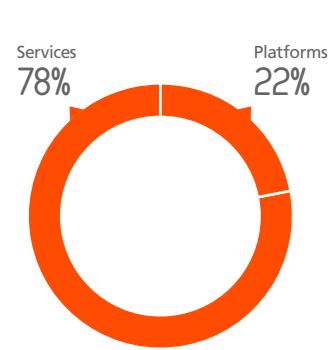
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



Segmental review Platforms & Services (US)

Operational performance

US Combat Vehicles

The business continues to perform on a number of key franchise combat vehicle programmes across both domestic and international markets.

On the US Army's Armored Multi-Purpose Vehicle programme, we have nearly concluded deliveries of the first 29 vehicles under the engineering and manufacturing development phase. The contract, which has a potential value of \$1.2bn (£0.9bn), including options for 289 vehicles in Low-Rate Initial Production, brings the US Army closer to achieving its objective to replace its legacy M113 armoured personnel carriers.

In December, we received a \$414m (£306m) contract for the third and final option for Low-Rate Initial Production of 48 M109A7 self-propelled howitzers and M992A3 ammunition carriers under the Paladin Integrated Management programme. With options for Full-Rate Production of a further 180 vehicle sets over three years, the award is worth approximately \$1.7bn (£1.3bn).

The business is executing a \$286m (£211m) 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. The US customer's production decision regarding the upgrade of approximately 500 vehicles over a three-year period is expected in 2018.

In September, we received a contract from the US Army worth up to \$69m (£51m) for the conversion of the next 20 M88A1 recovery vehicles to the more capable Heavy Equipment Recovery Combat Utility Lift Evacuation Systems (HERCULES) configuration. In March, we received a contract from the US Army worth up to \$112m (£83m) for technical support and sustainment of M88 recovery vehicles.

Teamed with Iveco Defence, we completed deliveries of the 16 Amphibious Combat Vehicle (ACV) 1.1 prototypes to the US Marine Corps for testing under the \$158m (£117m) engineering and manufacturing development phase of the programme. We are one of two competitors for this programme, with final down-selection expected in 2018.

Whilst we have encountered some production challenges, work continues on multiple contracts totalling \$165m (£122m) for Assault Amphibious Vehicles (AAVs) for the Japanese Ministry of Defence, including a contract for 30 new AAVs, and an \$82m (£61m) contract with Brazil to provide 23 upgraded AAVs.

Weapon Systems

BAE Systems remains a leading provider of gun systems and precision strike capabilities. In February 2017, we completed the acquisition of IAP Research, Inc., a US engineering company focused on the development and production of electromagnetic launchers, power electronics and advanced materials.

We continue to execute on a £183m contract to provide the gun system known as the Maritime Indirect Fire System for the Royal Navy's Type 26 frigate.

Following the contract modification received in 2016 from the Swedish government formalising its purchase of an additional 24 Archer systems, production work continues with deliveries expected to begin in 2018. In October, we received a contract to deliver additional Bofors 155mm BONUS smart anti-armour munitions to the Swedish Army in 2019.

In January 2017, we received a \$542m (£401m) Foreign Military Sale contract from the US government to provide 145 M777 lightweight howitzers to the Indian Army. We will build the first 25 guns in our facilities, with the remaining systems assembled in India by Mahindra Defence Services, our selected supplier to establish an assembly, integration and test facility in India. The first two guns were shipped during the year and are progressing through in-country testing.

In July, we received a \$47m (£35m) contract for the continued development of the precision-guided Hypervelocity Projectile, a next-generation, low-drag projectile capable of executing multiple missions from a number of gun systems.

In the complex ordnance manufacturing business, we continue to manage the US Army's Radford and Holston munitions facilities, operating near capacity. In 2017, we received additional funding of \$177m (£131m) to continue construction of a new nitrocellulose facility in Radford. At Holston, we are performing on modernisation contracts totalling \$135m (£100m) for waste water management and a \$146m (£108m) contract for the construction of a nitric acid recovery facility to produce larger quantities of insensitive munitions.

US Ship Repair

As a leading provider of US Navy ship repair and modernisation services, we secured firm orders across our US shipyards totalling approximately \$1.3bn (£1.0bn) in 2017, including a \$140m (£104m) contract for the modernisation of the USS Tortuga at our Norfolk shipyard.

We continue to adjust our workforce and facilities to meet evolving customer demand, including the new dry dock in our San Diego shipyard, which completed operational certification in February and welcomed the USS New Orleans as its first vessel for servicing.

One of the final two commercial ships is complete and awaiting acceptance sea trials pending identification of a buyer following the original customer's decision not to take delivery of the vessel. Construction of the final ship is nearing completion and the ship is expected to be delivered in the first half of 2018.

+ 56 Re-presentation
of 2017 results

BAE Systems Hägglunds

Series production of CV90 Infantry Fighting Vehicles for Norway was completed during the year under the \$865m (£640m) contract.

We have received contracts from the Estonian government for a sustainment programme for 44 CV90s. We are performing to schedule on the refurbishment of Swedish CV90 vehicles, and the sustainment and upgrade of Danish CV90s. We are integrating Mjölnir mortar systems on 40 Swedish CV90s, and testing and verification of Active Protection Systems on Dutch CV90s is under way, together with significant vehicle upgrades.

We continue to perform on a contract to produce 32 BvS10 military vehicles for Austria.

FNSS

FNSS, our land systems joint venture based in Turkey, continues to perform under its \$524m (£387m) programme to produce 259 8x8 wheeled armoured vehicles for the Royal Malaysian Army.

Production has completed on a contract to upgrade M113 tracked armoured personnel carriers for the Royal Saudi Land Forces. The next phase of the contract is expected in 2018.

In support of an export contract to Oman awarded in 2015 for the PARS Wheeled Armoured Vehicle, work continues to deliver 8x8 and 6x6 vehicles in a number of configurations. Deliveries of the first 8x8 and 6x6 vehicles have been accepted, with the first production batch of 8x8 vehicles delivered in December.

Work has begun under two Turkish Land Forces contracts, a €278m (£247m) contract signed in June 2016 to supply 260 Anti-Tank Vehicles and an €84m (£75m) contract signed in December 2016 for air defence vehicles.

In March, FNSS received a €155m (£138m) contract to provide 27 amphibious assault vehicles to the Turkish Ministry of National Defence.



Our strategy in action

A new concept for full-spectrum air defence

Looking forward

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

+ 58 Segmental
looking forward

We take pride in working closely with our customers to understand and develop the capabilities they require to complete their missions. During the 2017 AUSA (Association of the United States Army) exhibition in October, BAE Systems unveiled its Manoeuvre-Short Range Air Defence (M-SHORAD) concept vehicle based on a Bradley Infantry Fighting Vehicle designed to address the US Army's short-range air defence requirements.

The integration of M-SHORAD on an existing Bradley vehicle demonstrates our ability to bring innovative solutions to existing, adaptable platforms. M-SHORAD, a multi-spectral solution consisting of detection, identification, tracking and engagement capabilities to defeat air threats, such as unmanned air vehicles, integrated on the Bradley would provide a full-spectrum air defence solution to the US Army.

+ 18 Group strategic
framework

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Segmental review

Platforms & Services (UK)

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



Our strategy in action

First Typhoon and Hawk aircraft delivered to the Royal Air Force of Oman

The arrival of the first Typhoon and Hawk aircraft, part of a batch of 12 combat and eight trainer jets scheduled to be delivered to the Sultanate of Oman, was marked with a ceremony in June in the presence of the Commander of the Royal Air Force of Oman at Adam Air Base, Oman.

The Sultanate of Oman announced its decision to purchase Typhoon and Hawk aircraft in December 2012, and this first delivery signifies important progress in helping the Sultanate to upgrade the capability of its air force.

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

Maritime programmes include the construction of two Queen Elizabeth Class aircraft carriers, five River Class Offshore Patrol Vessels and seven Astute Class submarines for the Royal Navy, the design and production of the Dreadnought Class submarine and Type 26 frigate, and in-service support, including the delivery of services at HM Naval Base, Portsmouth.

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.

Organisational changes
Effective 1 January 2018, BAE Systems revised its reporting segments to reflect the organisational changes described on page 17. The Platforms & Services (UK) and Platforms & Services (International) management structures have been removed with the organisation streamlined, and strengthened Air and Maritime reporting segments created.

06 Alternative performance measure definitions

Operational and strategic highlights

- Contract valued at approximately £5bn signed in December to supply 24 Typhoon aircraft and support to Qatar, subject to financing conditions and receipt by the Group of first payment
- First eight Typhoon and all eight Hawk aircraft for Oman delivered to the Sultanate of Oman
- Signed the full £3.7bn production contract for the initial batch of three Type 26 frigates
- Received the full £1.4bn contract for the sixth Astute Class submarine from the Royal Navy in March, and the fourth Astute boat, Audacious, was launched in April
- Rationalisation activities announced, including potential headcount reductions in the Military Air & Information and Maritime Services businesses

Financial performance

Financial performance measures as defined by the Group

	2017	2016
Sales	KPI £7,682m	£7,806m
Underlying EBITA	KPI £794m	£810m
Return on sales	10.3%	10.4%
Operating business cash flow	KPI £427m	£199m
Order intake ¹	KPI £6,817m	£8,024m
Order backlog ¹	£16.8bn	£17.8bn

Financial performance measures defined in IFRS²

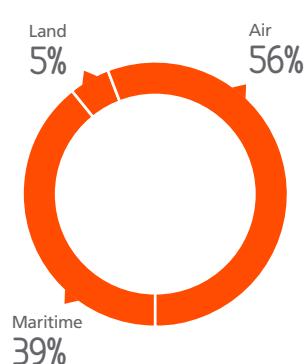
	2017	2016
Revenue	£7,624m	£7,699m
Operating profit	£774m	£780m
Return on revenue	10.2%	10.1%
Cash flow from operating activities	£607m	£385m

- Sales of £7.7bn (2016 £7.8bn) were marginally lower than 2016. Activity levels on the submarine programmes were ahead of plan.
- Return on sales was at 10.3% (2016 10.4%).
- There was a cash inflow of £427m (2016 £199m), which includes a £106m temporary benefit relating to VAT. Consumption of customer advances on the Omani, Saudi Arabian and European Typhoon contracts has now largely completed.

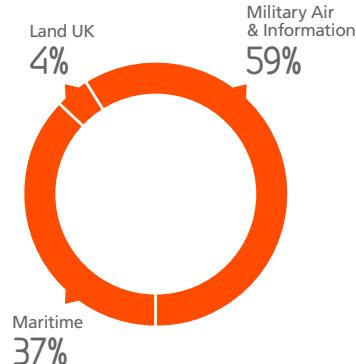
- Order backlog reduced to £16.8bn (2016 £17.8bn). The £5bn order received from Qatar in December for 24 Typhoon aircraft and support has not yet been taken into order backlog, pending completion of the financing package which we expect in the coming months.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

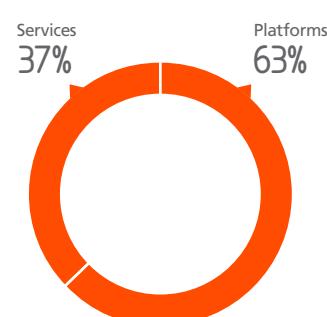
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



Segmental review

Platforms & Services (UK)

Operational performance

Military Air & Information

In December, BAE Systems and the Government of Qatar entered into a contract, valued at approximately £5bn, for the supply of 24 Typhoon aircraft. Alongside supplying the aircraft, the agreement provides for the supply of ground support to the Qatar Armed Forces and delivery of technical and pilot training in Qatar. The contract is subject to financing conditions and receipt by the Group of first payment which are expected to be fulfilled no later than mid-2018.

In the year, 20 Typhoon aircraft were delivered from the UK final assembly facility, of which four were delivered to Saudi Arabia, completing the contract for 72 aircraft. All 236 Tranche 2 aircraft have been delivered to the UK, Germany, Italy and Spain, together with 51 of the 88 contracted Tranche 3 aircraft.

There were eight Typhoon and eight Hawk aircraft deliveries to the Oman customer in the year, with the remaining four Typhoon aircraft scheduled to be delivered in 2018.

Good progress continues to be made on airframe manufacture for the contract to supply 28 Typhoon aircraft to Kuwait secured by Italian Eurofighter partner, Leonardo, in 2016, with fuselage deliveries due to commence in 2018.

Development towards the Royal Air Force Centurion standard continues, which will enable transition of air capabilities from Tornado to Typhoon. Flight testing for Storm Shadow and Meteor weapons capability enhancements was completed during the year. Integration of the Captor E-Scan radar continues.

We have continued to support our UK and European customers' Typhoon and Tornado aircraft and their operational commitments. The ten-year partnership arrangement with the Ministry of Defence to support the UK Typhoon fleet continues as planned, with availability of aircraft being sustained at contractual levels.

The initial support package has been substantially delivered as part of the contract to commence operations at a new operating air base at Adam in Oman.

On the F-35 Lightning II programme, full contract award was secured on Lot 10 and 82 rear fuselage assemblies were manufactured for the Low-Rate Initial Production Lot 10 and 11 contracts. Negotiations continued on Lot 11, with additional order intake received in the year of £248m. Lot 11 negotiations are expected to conclude during the first quarter of 2018, with the balance of the order intake also expected in this timeframe.

At RAF Marham in Norfolk, good progress has been made on construction of the engineering and training facilities and the stand-up of the operational service in readiness for the arrival of the UK's first F-35 Lightning II aircraft in 2018.

Following the announcement that the UK had been chosen as a major European repair hub for the maintenance, repair, overhaul and upgrade of F-35 Lightning II avionics and components, we have established a joint venture with the UK Ministry of Defence and Northrop Grumman, and progress on establishing the repair facility and capability continues to plan.

Support continues to be provided to users of Hawk trainer aircraft around the world. The long-term support contract for the Royal Air Force's UK fleet of Hawk fast jet trainer aircraft continues to deliver against all contractual milestones.

Discussions continue with the Government of India and Hindustan Aeronautics Limited (HAL) for the supply of additional kit sets which will result in aircraft built under licence by HAL for the Indian Air Force and Indian Navy.

Following an extensive review with our partner, Northrop Grumman, of the requirements and conditions of the US Air Force future trainer programme, both companies decided not to proceed with the competitive bid.

An initial contract for the Anglo-French unmanned combat air system feasibility and definition phase of £16m was received during the year. It is anticipated that an Anglo-French follow-on programme will be agreed in 2018.

A £119m contract was secured for collaboration on the first design and development phase of an indigenous fifth-generation fighter jet for the Turkish Air Force.

As a result of reducing production activity on Typhoon and Hawk, and also taking into account the changes to support requirements as the Royal Air Force transitions from Tornado to F-35 Lightning II, the business announced in October a total proposed headcount reduction of up to 1,400 roles over the next three years.

Maritime

On the aircraft carrier programme, HMS Queen Elizabeth successfully concluded initial sea trials and entered HM Naval Base, Portsmouth, for the first time in August. Operational handover and acceptance by the Royal Navy took place in December. HMS Prince of Wales floated out of the dock at Rosyth in December. Large volume installation activities continue to progress, with commissioning of systems planned to commence in 2018 and sea trials beginning in 2019.

The full £3.7bn production contract was signed in June for the first batch of three Type 26 frigates, with £2.8bn of order intake in the year, following funding in previous years for long-lead items. Production of the first ship, Glasgow, commenced in July. The programme currently employs over 1,000 people and production activities will progressively build up during 2018 as more of the ship transitions from completion of the detailed design through to production readiness.

The first Offshore Patrol Vessel (OPV), HMS Forth, completed sea trials in December and was accepted by the Ministry of Defence in January 2018. Construction of the remaining four OPVs on the Clyde continues.

Under the Maritime Support Delivery Framework contract, which the Ministry of Defence has agreed in principle to extend until 31 March 2020, we provide services at HM Naval Base, Portsmouth, and support to half of the Royal Navy's surface fleet. We remain on track to achieve target cost. The business was unsuccessful on a competitive bid to provide equipment procurement and equipment management services for the Queen Elizabeth Class aircraft carriers and Type 45 destroyers.

56 Re-presentation
of 2017 results



Our strategy in action

Production of Type 26 frigates for the Royal Navy commences

18 Group strategic framework

BAE Systems provides significant support and maintenance to the Royal Navy's fleet of Type 45 destroyers, and has responded to a Ministry of Defence competitive proposal on its power improvement project, with the award decision expected in 2018.

Progress continues on the £270m Spearfish torpedo upgrade demonstration and manufacture phases, with the demonstration phase forecast to complete in 2020.

The UK programme to manufacture the Type 26 frigate for the Royal Navy is under way following the receipt of the full £3.7bn production contract for the initial batch of three frigates. Progress on the programme was highlighted by the cutting of steel on Glasgow, the first of the new ships, in July.

Highly-advanced and adaptable, the Type 26 frigate will be able to fulfil multiple missions around the world, from submarine hunting to humanitarian assistance. Designed for a service life of at least 25 years, the Type 26 frigates will be a critical part of the future Royal Navy surface fleet.

More online
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Evolving customer requirements and a focus on improved efficiency and removing cost in the Maritime Services business have led to the announcement in October of a proposed headcount reduction of around 375 roles. The proposed rationalisation will more closely align capacity with workload and improve competitiveness to retain and grow our position on key programmes, while retaining critical skills.

Looking forward

Forward-looking information reflecting the organisational changes described on page 48 is provided later in this report.

58 Segmental looking forward

The first three Astute Class submarines are in operational service with the Royal Navy. Progress continues on the manufacture of the remaining four boats, with launch of the fourth boat, Audacious, achieved in April. A full contract award for the sixth boat, Agamemnon, was secured in March for £1.4bn, with £0.6bn of order intake in the year after order intake in previous years for long-lead items. Further funding of £80m was received for the seventh boat.

Functional and spatial design, and the production of the first of class continues to advance on the Dreadnought Class submarine, the replacement for the Royal Navy's Vanguard Class submarine. The next phase of the contract is scheduled to commence in April 2018.

The major programme of building works at the Barrow site continues, with contracts in place totalling more than £500m, with two further major buildings being completed during the year.

The detailed arrangements for the Dreadnought Alliance, including the organisational, governance and commercial arrangements between the three parties, the Ministry of Defence, BAE Systems and Rolls-Royce, continue to be developed.

Land UK

The business continues to provide UK and international customers with a full range of light and heavy munitions, with orders totalling £133m received in the year.

During the year, 131 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 160 of 515. This is the first entirely new medium calibre cannon and ammunition system qualified by the British Army since the late 1960s.

The business has continued to provide support to previously supplied armoured vehicles and bridging systems, with orders of £48m received in the year. 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.

Segmental review

Platforms & Services (International)

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



Our strategy in action

Supporting the operational capabilities of the Royal Saudi Air Force

Throughout 2017, we have continued to provide support to the Royal Saudi Air Force Typhoon and Tornado fleets. We have delivered against our contractual requirements ensuring that, as part of our commitment to support the defence needs of the Kingdom, an efficient and affordable support service is always available.

Building on our success in reducing through-life costs for the UK Royal Air Force, we have met our commitments in supporting Saudi Arabian aircraft across maintenance, training, logistics and servicing, as well as identifying cost savings and process efficiencies. We have done this without compromising the effectiveness of the aircraft, enabling the Royal Saudi Air Force to continue to conduct its vital role in the defence of the Kingdom.

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 delivers production, upgrade and support programmes for customers in the defence and commercial sectors across the air, maritime and land domains. Services contracts include the provision of sustainment, training solutions and upgrades.

In **Oman**, the business is developing its position building on a long history of relationships with the Omani armed forces through the provision, support and upgrade of defence platforms and cyber security services. Business generated in Oman is executed through our relevant reporting segments.

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

Organisational changes

Effective 1 January 2018, BAE Systems revised its reporting segments to reflect the organisational changes described on page 17. The Platforms & Services (UK) and Platforms & Services (International) management structures have been removed with the organisation streamlined, and strengthened Air and Maritime reporting segments created.

06 Alternative performance measure definitions

Operational and strategic highlights

- Final four of 72 Typhoon aircraft delivered to Saudi Arabia on the Salam Typhoon programme
- The Typhoon support contracts are operating well and a contract for support to additional flying hours was agreed in April
- Contracts agreed to provide ongoing support services to the Royal Saudi Air Force and Royal Saudi Naval Forces for a further five years
- The first major units of the second batch of Hawk aircraft delivered on schedule to Saudi Arabia allowing final assembly to commence
- Assigned the role of F-35 Regional Warehouse provider for the Asia-Pacific region
- Selected as the preferred tenderer for the Jindalee Operational Radar Network upgrade programme
- MBDA signed a contract in December to supply Brimstone and Meteor missiles to Qatar, subject to financing conditions and receipt of first payment
- MBDA contracts for naval fleet air defence and coastal defence in Qatar became effective in July

Financial performance

Financial performance measures as defined by the Group

	2017	2016
Sales	KPI £4,138m	£3,943m
Underlying EBITA	KPI £472m	£400m
Return on sales	11.4%	10.1%
Operating business cash flow	KPI £671m	£435m
Order intake ¹	KPI £4,365m	£6,175m
Order backlog ¹	KPI £13.3bn	£13.1bn

Financial performance measures defined in IFRS²

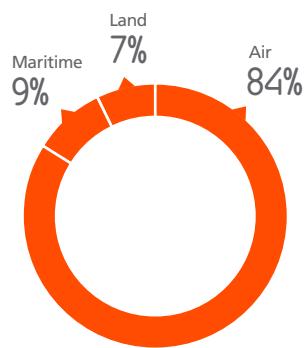
	2017	2016
Revenue	£3,136m	£3,037m
Operating profit	£427m	£365m
Return on revenue	13.6%	12.0%
Cash flow from operating activities	£669m	£473m

- Order backlog was marginally higher at £13.3bn (2016 £13.1bn) as further order intake was booked under the renewal of the five-year support contract in Saudi Arabia and Qatari naval orders became effective within MBDA.

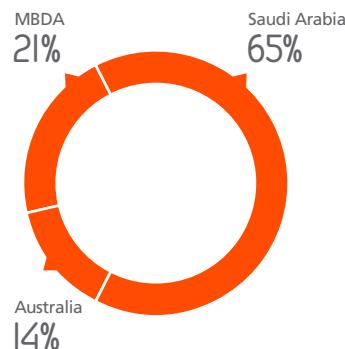
- Sales of £4.1bn (2016 £3.9bn) were 5% up over 2016. With all 72 Salam Typhoon aircraft now in service, we have seen higher levels of support. In addition, we have seen the expected ramp-up from MBDA's strong order backlog.
- Underlying EBITA of £472m (2016 £400m) and the return on sales of 11.4% (2016 10.1%) benefited from improving performance from our Saudi partner companies and stronger performance at MBDA.
- Operating cash inflow was £671m (2016 £435m), although approximately £300m of this was for an advance payment on the Saudi support programme.

1. Including share of equity accounted investments.
2. International Financial Reporting Standards.

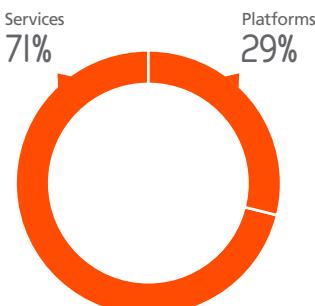
Sales by domain (%)



Sales by line of business (%)



Sales analysis: Platforms and services (%)



Segmental review Platforms & Services (International)

Operational performance

Saudi Arabia

On the Salam Typhoon programme, with four deliveries in the year, all 72 contracted aircraft have been delivered to the customer. Typhoon capability development programmes continue to progress.

The Typhoon support contracts are operating well and a contract for support to additional flying hours was agreed in April.

Discussions have continued with the Saudi Arabian customer through 2017, resulting in contractual agreements under the Saudi British Defence Co-operation Programme to provide ongoing support services to the Royal Saudi Air Force and Royal Saudi Naval Forces for a further five years to 31 December 2021.

Final aircraft deliveries for the first batch of 22 Hawk aircraft were completed in the second half of the year. The first major units of the second batch of 22 aircraft, contracted in 2015, have been delivered on schedule to Saudi Arabia allowing final assembly to commence.

Under the Royal Saudi Naval Forces' Minehunter mid-life update programme, acceptance of the third and final ship is expected in the first half of 2018.

Under the planned reorganisation of our portfolio of interests in a number of industrial companies in Saudi Arabia, Riyadh Wings Aviation Academy LLC acquired a 4.1% shareholding in a Group subsidiary, Overhaul and Maintenance Company, during 2016 and is expected to acquire a further interest up to a maximum of 49%. The reorganisation supports our strategy to expand the customer base of our In-Kingdom Industrial Participation programme, promoting training, development and employment opportunities in line with the Kingdom's National Transformation Plan and Vision 2030.



Our strategy in action

Upgrading Australia's radar defence network

In June, we were advised that we have been selected as the preferred tenderer to help sustain Australia's radar defence network beyond 2042. The Jindalee Operational Radar Network (JORN), a network of three remote over-the-horizon radars, provides wide-area surveillance and the upgrade programme will see us carry out important work to insert new technologies and extend the operational life of the network.

The JORN programme offers further opportunities for Australian suppliers as our 100% Australian approach will see us developing Australian small and medium-sized enterprises in the supply chain. This also ensures that Australia retains control of its strategically important sovereign asset which plays a vital role in supporting the Australian Defence Force's air and maritime operations, border protection, disaster relief, and search and rescue operations.



Group strategic
framework



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The Saudi Arabian In-Kingdom Industrial Participation programme continues to make good progress. During 2017, there has been further capability and knowledge transfer on the Typhoon and Hawk platforms. The first Hawk aircraft assembled in Saudi Arabia will come off the production line in 2018 for delivery to the Royal Saudi Air Force.

We have commenced discussions with the new Saudi Arabian Military Industries (SAMI) organisation to explore how we can collaborate to deliver further In-Kingdom Industrial Participation. All of these activities are aligned with our long-term industrialisation strategy, as well as the Saudi Arabian government's National Transformation Plan and Vision 2030.

Australia

We have continued to provide in-service support to the Navy's two Landing Helicopter Docks under a four-year support contract awarded in 2014. Final acceptance of these vessels is expected in 2018.

HMAS Stuart, the final Anzac Class frigate to be modernised under the Anti-Ship Missile Defence programme, has been accepted into service by the Commonwealth.

The scope of activities for the next five years of sustainment and upgrade of the Anzac fleet under the Warship Asset Management Alliance has been agreed and contracts totalling A\$561m (£324m) have been awarded to BAE Systems.

The next upgrade cycle for the Anzac frigate fleet, the Mid-Life Capability Assurance Programme, has commenced, with the first ship, HMAS Arunta, being docked at our Henderson shipyard during the second half of the year. The upgrade programme is planned to run through to 2023.

The delayed JP 2008 Phase 3F programme to provide enhanced defence satellite communications services was formally accepted by the Commonwealth in November. We will continue to provide in-service support to the system under a five-year support contract.

Mobilisation activities for sustainment of the Regional F-35 Lightning II fleet continues to progress at our Williamstown facility, with an increased scope following the announcement in August that BAE Systems was assigned the role of F-35 Regional Warehouse provider for the Asia-Pacific region.

Our existing Hawk Mk127 Lead-in Fighter sustainment contracts continue to perform strongly.

The Capability Assurance Programme to upgrade the Hawk fleet to meet the training requirements of the fifth-generation F-35 Lightning II is progressing ahead of schedule, with 20 of the 33 aircraft modified at the end of 2017. During 2017, the Australian Air Force customer declared achievement of initial operating capability and has commenced training with the aircraft.

In June, the Commonwealth announced that we have been selected as the preferred tenderer for the Jindalee Operational Radar Network upgrade programme. If successful, the expected value of the contract over the initial award term of ten years is approximately A\$1.0bn (£0.6bn).

Following down-select in 2016 as one of two tenderers for the Land 400 Phase 2 Combat Reconnaissance Vehicle programme, we have completed the Risk Mitigation Activity contract and submitted our final proposal to the Commonwealth in August. Customer evaluation is ongoing, with final preferred tender selection anticipated in the first half of 2018.

Our tender response for the Commonwealth's nine-ship SEA 5000 Future Frigate programme was submitted in August. The Commonwealth continues to fund Schedule Protection Activity to support its evaluation timetable and we anticipate a preferred tender selection in the first half of 2018.

Oman

The Oman Typhoon and Hawk aircraft programme, being undertaken by Platforms & Services (UK), completed delivery of the first eight Typhoon aircraft and all eight Hawk trainer aircraft in 2017. The remaining four Typhoon aircraft are scheduled to be delivered in 2018.

Separately, we continue to fulfil our legacy industrial participation obligations in Oman through delivery of an agreed training and knowledge transfer programme.

Looking forward

Forward-looking information reflecting the organisational changes described on page 52 is provided later in this report.

+ 58 Segmental looking forward

MBDA

In March, MBDA secured a contract from the UK and French governments for a three-year concept phase of the Future Cruise/Anti-Ship Weapon, which will prepare for the replacement of the existing missiles deployed by the UK and French armed forces. This contract follows on from the joint UK-France 2016 programme for the mid-life refurbishment of their current inventory of missiles.

In July, MBDA finalised the financing package to secure effectiveness of the Qatari contracts signed in 2016, which will supply air defence systems and anti-ship missiles for the naval surface fleet along with coastal defence systems.

The German Ministry of Defence and MBDA have entered into a formal negotiation process for the German ground-based air defence system, TLVS, a key element of the German defence strategy. Lockheed Martin will be the joint venture partner with MBDA on this programme.

Significant progress has been made in securing positions on a number of fast jet platforms. The Meteor Beyond Visual Range Air-to-Air Missile is already in operational service on Gripen with the Swedish Air Force and has now achieved qualification for both Typhoon and Rafale aircraft. A contract has been received to procure further Brimstone missiles to equip Typhoon. Integration of MBDA missiles on F-35 Lightning II has progressed well, with successful Advanced Short Range Air-to-Air Missile qualification firings achieved and contracts received from the UK to integrate Meteor.

In December, MBDA entered into a contract with Qatar for the supply of Brimstone and Meteor missiles. The contract is subject to financing conditions and receipt by MBDA of first payment which are expected to be fulfilled no later than mid-2018.

Success in both domestic and export markets has significantly increased MBDA's production volumes resulting in the requirement to expand production capacities. A new manufacturing facility is fully operational in Bolton, UK, and a capacity enhancement is under way in Bourges, France.

Re-presentation of 2017 results

Effective 1 January 2018, BAE Systems revised its reporting segments to reflect the organisational changes described on page 17 and adopted International Financial Reporting Standard (IFRS) 15, Revenue from Contracts with Customers.

+ 06 Alternative performance measure definitions

Financial performance measures for the year ended 31 December 2017 as re-presented to reflect the organisational changes are as follows:

	As defined by the Group					Defined in IFRS ¹				
	KPI Sales £m	KPI Underlying EBITA £m	KPI Return on sales %	KPI Operating business cash flow £m	KPI Order intake ² £m	KPI Order backlog ² £bn	Revenue £m	Operating profit/(loss) £m	Return on revenue %	Net cash flow from operating activities £m
Year ended 31 December 2017										
Electronic Systems	3,635	562	15.5	450	4,175	5.4	3,635	542	14.9	569
Cyber & Intelligence	1,820	52	2.9	116	1,859	2.1	1,820	(367)	(20.2)	127
Platforms & Services (US)	2,928	242	8.3	222	3,542	4.6	2,825	218	7.7	286
Air	8,059	1,000	12.4	832	6,128	20.4	7,120	952	13.4	888
Maritime	3,151	258	8.2	278	4,671	9.1	3,119	247	7.9	396
HQ ³	336	(80)		(146)	337	—	47	(112)		(142)
Deduct Intra-group	(303)				(455)	(0.4)	(244)			
Deduct Taxation ⁴										(227)
Total	19,626	2,034	10.4	1,752	20,257	41.2	18,322	1,480	8.1	1,897

Financial performance measures for the year ended 31 December 2017 as re-presented to reflect both the organisational changes and the impact of the adoption of IFRS 15 are as follows:

	As defined by the Group					Defined in IFRS ¹				
	KPI Sales £m	KPI Underlying EBITA £m	KPI Return on sales %	KPI Operating business cash flow £m	KPI Order intake ² £m	KPI Order backlog ² £bn	Revenue £m	Operating profit/(loss) £m	Return on revenue %	Net cash flow from operating activities £m
Year ended 31 December 2017										
Electronic Systems	3,598	541	15.0	450	4,175	4.8	3,598	521	14.5	569
Cyber & Intelligence	1,818	58	3.2	116	1,859	2.1	1,818	(361)	(19.9)	127
Platforms & Services (US)	2,951	237	8.0	222	3,542	4.2	2,848	213	7.5	286
Air	7,210	967	13.4	832	6,128	19.5	6,312	921	14.6	888
Maritime	2,877	251	8.7	278	4,671	8.5	2,845	240	8.4	396
HQ ³	336	(80)		(146)	337	—	47	(112)		(142)
Deduct Intra-group	(303)				(455)	(0.4)	(244)			
Deduct Taxation ⁴										(227)
Total	18,487	1,974	10.7	1,752	20,257	38.7	17,224	1,422	8.3	1,897

The Group and segmental guidance for 2018 shown opposite is based on the Group's actual financial performance for 2017 as re-presented to reflect both the organisational changes and the impact of the adoption of IFRS 15.

1. International Financial Reporting Standards.

2. Including share of equity accounted investments.

3. HQ comprises the Group's UK-based head office and shared services activities, together with a 49% interest in Air Astana.

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

Guidance for 2018

For the year ending 31 December 2018, we expect the Group's underlying earnings per share to be in line with the full-year underlying earnings per share in 2017 of 42.1p.*

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 2017 are provided in the Group financial review on pages 28 to 34.

*Compared with the Group's actual financial 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\$1.40 to sterling exchange rate.



Electronic Systems

- High single-digit sales growth is expected in 2018 driven by a number of electronic warfare contracts with some 70% of projected sales in the 2017 closing order backlog.
- Margins¹ are expected to be in a range of 14% to 16%.



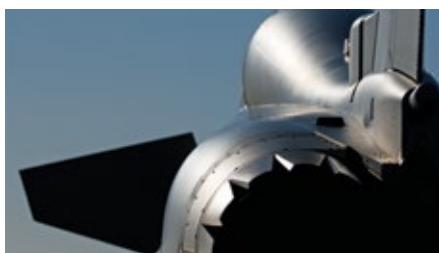
Cyber & Intelligence

- Comprising the US Intelligence & Security sector (70% of Cyber & Intelligence sales in 2017) and Applied Intelligence:
- In aggregate, sales in 2018 are expected to be marginally higher than 2017. Sales in Intelligence & Security are expected to be largely unchanged, with some growth coming from the UK Services and International Services & Solutions divisions of Applied Intelligence.
 - Margins¹ are expected to improve to around 5%. The Intelligence & Security business is expected to contribute around 8% margin, with Applied Intelligence moving to an overall break-even position.



Platforms & Services (US)

- Sales growth of 10% to 15% is expected, with increasing volumes from the US Combat Vehicles and Weapon Systems businesses, as well as higher ship repair activity. Almost 75% of guidance is in the closing order backlog.
- Another year of margin¹ improvement to a range of 9% to 10% is expected in 2018 absent further charges on the commercial shipbuilding contracts.



Air

- Sales are expected to be some 5% lower as activity on Typhoon for the European, Saudi and Oman contracts is largely complete. Around 85% of guidance is in the closing order backlog.
- Margins¹ are expected to be in the 11% to 13% range.



Maritime

- Sales are expected to be stable as activity levels on Carrier reduce and are largely offset by increases on submarine programmes. Around 90% of guidance is in the closing order backlog.
- Margin¹ levels are expected to be within the 8% to 9% range.



HQ

- HQ costs are expected to be similar to 2017.
- Underlying finance costs are expected to be around 15% lower, benefiting from the weaker US dollar, reduced charges arising from our share of equity accounted investments and lower net present value adjustments.
- The underlying effective tax rate for 2018 is expected to reduce from 21% to around 18% benefiting from US tax reform, with the final rate dependent on the geographical mix of profits.

1. Underlying EBITA as a percentage of sales.

Segmental looking forward

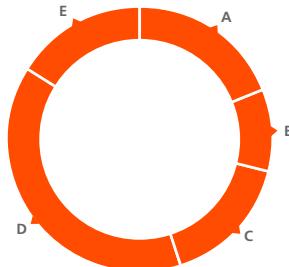
Effective 1 January 2018, BAE Systems has five principal reporting segments, Electronic Systems, Cyber & Intelligence, Platforms & Services (US), Air and Maritime, which align with the strategic direction of the Group.

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06
Alternative performance measure definitions

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19
Our markets

2017 sales¹

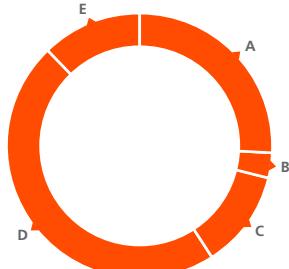
Sales by reporting segment for the year ended 31 December 2017 as re-presented to reflect the organisational structure effective from 1 January 2018 and the impact of the transition to IFRS 15 are as follows:



A	Electronic Systems
B	Cyber & Intelligence
C	Platforms & Services (US)
D	Air
E	Maritime

2017 underlying EBITA²

Underlying EBITA by reporting segment for the year ended 31 December 2017 as re-presented to reflect the organisational structure effective from 1 January 2018 and the impact of the transition to IFRS 15 is as follows:



A	Electronic Systems
B	Cyber & Intelligence
C	Platforms & Services (US)
D	Air
E	Maritime

Electronic Systems



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. That, along with strong programme positions, particularly on F-35 Lightning II and F-15 upgrades, and specific products such as APKWS™, position the business well for the medium term.

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



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.

Whilst the government's decision not to exercise future options on our contract to develop a shared IT environment for US agencies could impact revenue in 2018, the shift in the government's IT strategy could present new opportunities for the business.

With effect from 12 February 2018, the business has restructured to better align with its customer base and position the business to more effectively compete and grow in critical, mission-focused areas with three business areas: Integrated Defence Solutions; Intelligence Solutions; and Air Force Solutions.

Applied Intelligence

With effect from 1 January 2018, the Applied Intelligence business has restructured to focus on a more targeted portfolio of products and services, delivering for customers within three core business units: Government; Financial Services; and Technology & Commercial. The restructuring will enable a greater focus on customer needs and higher levels of operational efficiency, in the commercial business, that will accelerate improvements in competitiveness and profitability.

Sales growth is expected to continue as 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.

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.

US defence budget

Whilst we continue to operate under a Continuing Resolution, the bipartisan budget agreement passed on 9 February 2018 would increase the US defence budget by approximately 10% over current levels, reflecting continued growth in defence spending to \$700bn (£518bn) for the fiscal year ending 30 September 2018. This budget agreement increases the budget caps for two years and extends the Continuing Resolution to 23 March 2018 to allow lawmakers to pass a 2018 spending bill.

Platforms & Services (US)



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 of government-owned munitions facilities.

The land vehicles business is underpinned by strong positions on key franchise programmes. These include the US Army's Armored Multi-Purpose Vehicle, M109A7 self-propelled howitzer and Bradley upgrade programmes, and the CV90 and BvS10 export programmes from our BAE Systems Hägglunds business.

The business continues to pursue a range of domestic and international opportunities in combat and amphibious vehicles as well as weapon systems.

FNSS has grown its order book with both domestic and international orders.

These long-term contracts and our franchise position in tracked vehicles, which offer opportunities in international markets, make the land business well placed for growth in the medium term.

In the maritime domain, the Group has a strong position on naval gun programmes and US Navy ship repair. Additional dry dock ship repair capacity has been established in San Diego to support the US Navy's increased requirements in the Asia-Pacific region.

The Group remains a leading provider of gun systems and precision strike capabilities and, in the complex ordnance manufacturing business, we continue to manage the US Army's Radford and Holston munitions facilities under long-term contracts.

Air



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 pan-European MBDA joint venture.

In the UK, as current export contracts for Typhoon and Hawk complete, and UK Tornado support ends, sales are underpinned by our workshare on Typhoon for Kuwait, Typhoon and Hawk support, and F-35 Lightning II production and support. UK-based production of rear fuselage assemblies for F-35 Lightning II will increase over the next three years to reach its expected peak rate for the next decade. We play a significant role in the F-35 Lightning II sustainment programme in support of Lockheed Martin.

Discussions continue with current and prospective operators on contract awards for Typhoon and Hawk, and we continue to develop long-standing international partnerships in the air domain, maintaining our skills and capabilities.

The UK and Saudi support operations are underpinned by long-term contracts. 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 Australia, the business is structured around long-term sustainment and upgrade activities, and we are progressing significant opportunities with the Australian government in the maritime and land domains.

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



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

Maritime

In Maritime, there remains pressure on the Navy's near-term budgets and a highly-competitive environment in ship support and upgrade.

Within submarines, the business is executing on the Astute Class programme, with four boats still in build. On the Dreadnought programme, production on the first boat of four commenced in 2016. Investment continues in the Barrow facilities to provide the capability on these long-term programmes through the next decade.

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.

Corporate responsibility

Corporate responsibility is a key enabler for our business, supporting sustainable long-term performance by managing non-financial risks that can impact reputation and shareholder value.



Corporate responsibility in action

Launch of the revised Code of Conduct

We regularly review and update our Code of Conduct to ensure that it reflects best practice, emerging issues and new regulations. This was done in 2017 and the revised Code of Conduct was launched in January 2018. As part of the revision process, the Code of Conduct was externally benchmarked with two organisations, the Institute of Business Ethics and the Corporate Executive Board. Further review was conducted by internal consultation and collaboration across the Group, including trade union representatives. The final version was approved by the Board in December.



The Board delegates the detailed oversight of corporate responsibility 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 we meet our own standards and the expectations of our stakeholders. 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 Company.

For information on 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 about the business opportunities we pursue.

The Operational Framework is reviewed and approved by the Board each year. The twice-yearly Operational Assurance Statement (OAS) process is used to monitor compliance with the Operational Framework. 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.

**+
68** Our principal risks

Our corporate responsibility programmes focus on:

- developing an inclusive, diverse workplace to drive innovation and performance, and engaging with the communities in which we operate (see page 24);
- supporting our employees in making the right decisions (see below);
- continuously improving employee wellbeing and standards of safety for employees and those we work with (see page 63); and
- managing the environmental impacts of our facilities and products (see page 64).

Trust and integrity

We aim to be a recognised leader in business conduct. This 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 Company'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. Our principal risks include risks relating to laws and regulations, and our people (see pages 70 and 71, respectively).

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 2017, 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-corruption training.

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

We collect data on ethics enquiries and dismissals for reasons relating to unethical behaviour (see opposite). In 2017, there were 1,280¹ ethics enquiries, an increase of 14% on 2016. This positive trend reflects our efforts to encourage people to speak up and we will continue to communicate to our employees the methods of making contact. Our 2017 anonymity rate of 24% compares favourably with international benchmarks.

In 2017, 53% 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 ethics enquiries reported which required investigation were reviewed and reported either to the Ethics Review Committee or, in BAE Systems, Inc., to the Ethics Review Oversight Committee.

Total ethics enquiries¹



Anonymity rate



2017 ethics enquiries by type¹

1	680
2	217
3	146
4	122
5	115

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

Dismissals for reasons relating to unethical behaviour¹



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

1. See summary of Deloitte LLP assurance on page 65.

Corporate responsibility continued

 Our principal risks

 Operational framework

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. 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 the 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;
- **Gifts and Hospitality Policy** – which governs the reasonableness and proportionality of offering 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 Company's integrity and interests; and
- **Facilitation Payments Policy** – designed to ensure that the Company and its employees seek to eliminate the practice of facilitation payments.

Other policies, including our Export Control Policy, Lobbying Policy and Offset Policy, include measures to address bribery and corruption risks.

An outcome of these policies is our extensive due diligence procedures implemented to address the issues mentioned above. In particular, the Advisers Policy requires that intermediaries who are engaged to assist with our sales and marketing activities are approved via procedures which include appropriate internal and external due diligence and authorisation. Sales and marketing advisers with whom the Company has an ongoing relationship go through this process every two years.

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.

Suppliers

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 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. Our business leaders and the Global Procurement Council oversee compliance with the policies and principles. Our procurement teams assess suppliers against anti-bribery and 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 2017, 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.

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 or 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 2017, 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, baesystems.com.

Working with others

We continue to work with peers across the defence industry to improve ethical standards. During 2017, 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 2017 to share experiences and best practice on ethical issues of particular concern to the industry and to receive expert briefings.

2018 priorities

We will roll out the revised Code of Conduct to all employees. Managers will distribute the Code of Conduct to their direct reports alongside face-to-face, scenario-based training. This forms part of our continuing efforts to build a culture of responsible behaviour and ethical decision-making.

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 problems, such as heart disease, diabetes and cancer. 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 standard. These systems identify and control risk, and are used to assure that 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 that 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 101). In 2017, there was a 3% reduction in the Recordable Accident Rate, a 28% reduction in the total number of major injuries recorded and no fatalities as we continued to focus on reducing risk and embedding safety culture to drive improvement.

2018 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.

Recordable Accident Rate (per 100,000 employees)²



Major injuries recorded^{2,3}



BONUS

5% of the UK executive directors' bonuses are based on the achievement of safety KPIs (see page 101).

1. Occupational Health and Safety Assessment Series.
2. See summary of Deloitte LLP assurance on page 65.
3. 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.

Corporate responsibility continued



Corporate responsibility in action

Growth of our hybrid-electric transport systems

To date, we have over 8,000 hybrid-electric systems in service on buses from London to California. Each year, these buses transport over one billion passengers, whilst saving 17 million gallons of fuel and eliminating 170,000 tonnes of CO₂ from entering the atmosphere.

Using BAE Systems' hybrid and electric systems, transit bus agencies around the world are taking initiatives to clean up their cities and provide sustainable, quieter options for public transportation. In alignment with these initiatives, we have introduced a next-generation hybrid, our Series-ER, which extends the electric driving range, and have brought to market a new energy storage system and direct drive motor to compete in our European markets. We are prepared to respond to market demand for zero-emissions with our Series-EV technology, including a full-battery electric solution and our hydrogen fuel cell technology solution.

We have taken our proven, green bus technology to the water with the introduction of three hybrid and electric solutions: HybriGen® provides hybrid power for boat accessories and cleaner, quieter vessel propulsion; HybriGen® Zero addresses the inland towboat market with hybrid power, saving fuel, space and maintenance costs; and Hybrid Assist uses a parallel hybrid configuration to drive a vessel on electric power at low speeds with a boost of power for high speeds when required.

Resource efficiency

Resource efficiency is an important measure of business effectiveness for us and is embedded within our Environmental Policy. As a major manufacturer, our operations have an impact on the environment – from the energy and resources we use to the products we manufacture and the waste we generate. We are committed to minimising the risk of environmental impact of our operations and products, reducing our environmental footprint and, in turn, decreasing our operational costs. In line with the Environmental Policy, our businesses and operational sites devise their own ways of addressing their environmental priorities, given the diverse geographic and sectoral spread of our business.

Alongside the policy, the revised Code of Conduct supports our commitment to environmental management – every employee is to contribute to the efficient use of resources and compliance with environmental practices and policies.

An outcome of our Environmental Policy is that ongoing environmental performance is reported to our senior management team through Quarterly Business Reviews and adherence to our Environmental Policy is monitored by the environmental teams in our businesses via the Operational Assurance Statement process.

Our businesses set annual environmental and resource efficiency targets. Whilst the priorities and targets differ locally, our businesses are tackling resource efficiency challenges that are global in nature, chiefly materials resilience, energy and climate change, and waste, emissions and discharges.

Materials resilience

Where applicable, we adapt our materials management and use according to regulations as they are implemented. We have an overall aim to reduce the hazardous materials used at our sites during the manufacture of our products.

Energy and climate change

We are improving energy efficiency and de-carbonising our energy supply to reduce greenhouse gas emissions. The nature of our business, with large-scale projects and fluctuations in orders, makes it challenging to set a Group-wide emissions reduction target. Energy targets are set at business level and contribute to an overall energy reduction target for the Group.

We collect data on greenhouse gas emissions. The Group's total greenhouse gas emissions have decreased by 8% in the 12 months to 31 October 2017.

Our largest 20 sites accounted for 83% of our greenhouse gas emissions on average

over 2014 to 2016. Of these sites, 18 are certified to ISO 14001 and the other two have an environmental management system in place. In line with these environmental management systems, the top 20 sites are actively aiming to reduce the emissions they produce.

Waste, emissions and discharges

Targets to reduce waste, emissions and discharges are set by each business reflecting the scale and maturity of their facilities and the nature of their activities. The efficient use of resources and a decrease in waste produced reduces our environmental footprint and provides cost-saving benefits for the organisation.

We use our engineering expertise to improve resource efficiency and make our products more sustainable. We work to reduce environmental impacts at every stage of their lifecycle – from concept, design and manufacture through to use and disposal.

2018 priorities

We will continue to drive improvements in the management of materials and resources across all businesses.

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, and dismissals for reasons relating to unethical behaviour;

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 2017 visit baesystems.com/2017crdata

Greenhouse gas emissions data from 1 November 2016 to 31 October 2017 (tonnes CO₂e)

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

2017	525,032
2016	579,880

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

2017	528,411
2016	571,859

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

2017	147,125
2016	146,511

Total greenhouse gas emissions¹

2017	1,200,568
2016	1,298,250

Total greenhouse gas emissions per employee²

2017	16
2016	17

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.

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 592,745 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 and US 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, the latter has been used.

1. See summary of Deloitte LLP assurance opposite.

2. Excluding share of equity accounted investments.

How we manage risk

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



Board

The Board has overall responsibility for determining the nature and extent of the risk it is willing to take, and ensuring that risks are managed effectively across the Group.

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

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

Audit Committee

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

Corporate Responsibility Committee

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

Approach

The Group's 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 2017 and to the date of this report.

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

Financial and non-financial risks

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

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

Process

Businesses

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

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

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

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

In addition, every six months, the businesses complete an Operational Assurance Statement (OAS), which is a mandated policy under the Operational Framework. The OAS is in two parts: a self-assessment of compliance with the Operational Framework; and a report showing the key financial and non-financial risks for the relevant business. Together with reviews undertaken by Internal Audit and the work of the external auditors, the OAS forms the Group's process for reviewing the effectiveness of the system of internal controls.

Executive Committee

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

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

Principal risks

The Board has carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency and liquidity. Such risks have been identified as principal based on the likelihood of occurrence and the potential impact on the Group, and have been identified through the application of the policies and processes outlined above. These risks, together with details of how they are being mitigated and managed, are detailed on pages 68 to 71.

+ 76 Operational Framework

Risk management framework



*As defined in the Group's Operational 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
I. Defence spending The Group is dependent on defence spending. In 2017, 92% 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 US and UK. A National Security Capability Review is being undertaken by the Cabinet Office, and a Modernising Defence Programme was announced in January 2018 by the Defence Secretary. The outcome of both is aimed to be announced by the summer of 2018. The result of the EU referendum in the UK has led to a period of uncertainty and, in the longer term, there is a risk relating to the Group's ability to participate in further collaborative defence programmes in Europe.	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: <ul style="list-style-type: none">- In the US, after seven months under a Continuing Resolution that maintained funding at the prior year's level, the fiscal year 2017 defence budget ultimately rose by approximately 4%. Whilst the fiscal year 2018 budget remains under a Continuing Resolution, the bipartisan budget agreement passed on 9 February 2018 would increase the US defence budget by approximately 10% over current levels, reflecting continued growth in defence spending to \$700bn (£518bn) for the fiscal year ending 30 September 2018. This budget agreement increases the budget caps for two years and extends the Continuing Resolution to 23 March 2018 to allow lawmakers to pass a 2018 spending bill. The US business has become adept at managing through Continuing Resolutions and brief government shutdowns, mitigating any short-term interruptions across our portfolio.- The UK is Europe's largest defence market and, after a period of budgetary decline, defence spending has stabilised. The 2017 Spring Budget reinforced previous commitments to increase defence spending, as well as the continued pledge to maintain spending at 2% of GDP.- In Saudi Arabia, regional tensions continue to dictate that defence remains a high priority.
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 occurrence of any such events could have a material adverse effect on the Group's future results and financial condition.	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 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 government policy and regulations in the UK, US and all other relevant jurisdictions; and the inability to obtain or maintain the necessary export licences.		The Group's policy is to hedge all material firm transactional currency exchange rate exposures.
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 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.
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 is currently considering whether to permit an appeal of the High Court's decision.		Political risk insurance is held in respect of export contracts not structured on a government-to-government basis.
4. Competition in international markets The Group's business is subject to significant competition in international markets.		
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'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 is dependent upon US and UK government support in relation to a number of its business opportunities in export markets.		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.	<p>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.</p> <p>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.</p>	<p>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.</p> <p>Reduced access to export markets could have a material adverse effect on the Group's future results and financial condition.</p>
		<p>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.</p> <p>Internal and external market risk assessments form an important element of ongoing corporate development and training processes.</p> <p>A uniform global policy and process for the appointment of advisers engaged in business development is in effect.</p>
		<p>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.</p> <p>The special compliance officer, appointed pursuant to commitments concerning ongoing regulatory compliance made in the course of the 2011 settlement with the US Department of State, concluded his monitorship in May 2014 and, at the invitation of BAE Systems, agreed to remain in a limited capacity for a limited further period of time.</p>
6. Contract risk and execution The Group has many contracts, including a small number of large contracts and fixed-price contracts.	<p>In 2017, 47% of the Group's sales were generated by its 15 largest programmes. At 31 December 2017, the Group had five programmes with order backlog in excess of £1bn.</p> <p>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.</p> <p>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.</p>	<p>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.</p>
		<p>Contract-related risks and uncertainties are managed under the Group's mandated Lifecycle Management process.</p> <p>A leadership development programme for project directors has been deployed across the Group, covering the leadership competencies required to manage complex projects containing significant levels of risk and uncertainty.</p> <p>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.</p> <p>The Group has a well-balanced spread of programmes and significant order backlog which provides forward visibility.</p>
		<p>The Group has limited exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity.</p> <p>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.</p>
7. Contract awards and cash profiles The Group is dependent on the award timing and cash profile of its contracts.	<p>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.</p>	<p>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.</p>
		<p>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.</p> <p>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.</p>

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 anticipated members' 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, the 2017 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 the new funding valuations, the Group will increase current annual deficit recovery payments to the UK schemes to £220m a year from 1 April 2018. The deficits in each of the schemes are expected to be cleared between 2021 and 2026. Under the last agreement made in 2014, all scheme deficits were only projected to be cleared in 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 its ability to deliver its strategy, meet the business plan and, accordingly, have a negative impact on the Group's future results and financial condition.
		The Group recognises that its employees are key to delivering its strategy and business plan, and focuses on developing the existing workforce and hiring talented people to meet current and future requirements.
		The Group has well-established graduate recruitment and apprenticeship programmes and, in order to maximise the contribution that its workforce can make to the performance of the business, has an effective through-career capability development programme.
		In order to seek to maximise its talent pool, the Group is committed to creating a diverse and inclusive environment for its employees.

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 21 February 2018.

David Parkes
Company Secretary

Chairman's governance letter

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Dear Shareholders,

The importance of having a clearly defined strategy for management to pursue and the right culture to guide behaviour and drive performance to implement the strategy remains a priority focus for the Board, as I highlight in the Chairman's letter in this report (see pages 10 to 12).

Effective engagement with our stakeholders is equally an essential part of good governance, with particular emphasis on shareholders and customers.

Our shareholder contact is typically through our investor relations team on a day-to-day basis, which is supplemented by face-to-face meetings with our major shareholders by our Chief Executive and Group Finance Director at the time of our annual and half-year results. To ensure that our performance is viewed in the context of our broader Board policy, as Chairman, I try to meet with our major shareholders at least once a year to discuss governance, strategy, culture and succession.

Our Senior Independent Director is, of course, available to speak to shareholders at all times if an alternative or additional channel of communication is required.

This year, we decided to widen the circle of contact with Board members by inviting a small group of shareholders to engage directly with the Board in an informal gathering to discuss the requirements of shareholders in general, and to review BAE Systems in particular. The meeting proved to be valuable to both parties and we will continue this practice in the years ahead.

Our second additional measure was to invite shareholders to a more formal morning meeting with our non-executive directors and Chief Executive for a brief presentation by each of the non-executive committee chairs on our remuneration, audit and corporate responsibility policies and procedures. The presentations were followed by an open question and answer session, which enabled shareholders to probe more deeply into the methods and mindsets of the non-executive team. Feedback on this session was particularly positive, and we will continue to conduct this type of meeting on a two-yearly basis or when there is material change in Board membership.

Our customer contact is undertaken at all levels on a daily basis to ensure that the relationships we have continue to be open, transparent and productive. From a Board perspective, however, we felt it was important to provide the non-executive directors with first-hand knowledge of the challenges and opportunities with each of our major UK customers. To achieve this objective, we invited senior members of the Royal Navy and Ministry of Defence to join the Board for an open exchange on our strengths, weaknesses and opportunities. The forum provided a robust discussion which was both instructive and encouraging. We intend to extend invitations to other customers in the coming year in order to deepen our understanding of their needs and reinforce the relationships we enjoy.

As a discipline, a number of Board meetings are held on operational sites throughout the year which provide an opportunity for interaction with employees and a chance for non-executive directors to develop deeper insights into the quality of our current senior management and the potential for succession in the next generation.

During such visits, we meet individuals for breakfast and dinner, tour the sites and conduct town hall sessions with the workforce. During 2018, the Board will also accompany the executive management team to meet colleagues and customers in the US and the Kingdom of Saudi Arabia.

Additionally, the Corporate Responsibility Committee makes independent visits to operational sites across the world to evaluate and encourage the adoption of the highest standards of corporate behaviour.

To further our practice of Board involvement in 2018, we intend to nominate a non-executive director to accompany Charles Woodburn to participate in one of his regular meetings with trade unions representatives in the UK.

As we look forward to the year ahead, we are determined to continue this policy of deeper engagement with all stakeholders to ensure we understand and respect the needs of our shareholders, our suppliers, our colleagues and our customers.



Sir Roger Carr Chairman

Governance highlights

- Executive succession planning – the planned succession process whereby Charles Woodburn succeeded Ian King as Chief Executive was completed in an orderly manner.
- Non-executive directors – Revathi Advaithi was appointed to the Board as an independent non-executive, further strengthening it, particularly with regards to multinational business leadership, and engineering and manufacturing experience and expertise.
- Audit re-tender – after a comprehensive and robust selection process led by the Audit Committee, Deloitte was selected for appointment to succeed KPMG as the Company's auditors with effect from the Annual General Meeting in 2018.
- Shareholder engagement – the Board as a whole engaged directly with major shareholders, including the hosting of an event at which governance arrangements for the Board and its committees, and employee engagement activities were presented and discussed.
- Customer engagement – in order to help directors to develop their understanding of the Company's performance and relationship with key UK customers at first-hand, during the year, the Board visited a customer site and also met with senior Royal Navy and Ministry of Defence officials.
- Reporting – the Board's reporting on governance matters in these reports has been enhanced further, including greater focus on how the directors discharge their duties and promote the success of the Company.

Board evaluation

Period of evaluation

January/February with feedback and review taking place at a Board meeting held on 21 February 2018.

Evaluation process

Externally-facilitated self-assessment of the Board conducted in accordance with best practice described in the UK Corporate Governance Code and other guidance.

Facilitator

Fion Hague at Independent Board Evaluation (IBE), which provides no other services to BAE Systems.

Description of process

All directors interviewed by the facilitator for 1.5 hours based on a set agenda that had been tailored for BAE Systems. Ten senior executives were also interviewed.

Feedback

A comprehensive report was produced by IBE, which was provided to directors ahead of the Board meeting at which the principal findings were presented by Ms Hague. Among other things, the report covered shareholder and stakeholder relations; strategy; governance and compliance; Board focus; risk management; succession planning; Board composition; Board culture; relationship with senior management; decision-making; induction; papers; and Board resources.

Feedback from the evaluation will be provided to individual directors by the Chairman. Feedback on the Chairman's own performance will be provided by the Senior Independent Director after he has met with all the non-executive directors to consider the material provided by IBE.

Resulting actions

The Board discussed the report and agreed actions concerning:

- executive and non-executive succession planning;
- employee engagement, and diversity and inclusion; and
- the provision of additional Board time for wider and more open-ended discussion of certain matters.

The Board will work on implementing these in 2018.

Directors' duties

Here we outline how the directors discharge their duties 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 here.

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.

It is important to recognise that 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.

Culture and values

The right corporate culture underpins how a company creates and sustains value over the longer term, and is a key element of maintaining a reputation for high standards of business conduct. Culture and values are important in setting the behavioural standards expected of employees.

During the year, the Board, which sets the Company's values, considered the Company's culture and the behaviours this is seen to be driving. The Board uses employee engagement surveys to help understand corporate culture across the Group. The Corporate Responsibility Committee monitors the types of issues reported through the Company's Ethics Helpline and Ethics Officers to assist in monitoring corporate culture.

+ 87 Corporate Responsibility Committee report

Shareholders

A board needs to communicate effectively with its shareholders and understand their views.

The Annual Report is the principal means by which the Board reports to shareholders on its stewardship of the Company. This report and other matters are put to shareholders for their consideration and approval at the Company's Annual General Meeting, where the Board engages directly with shareholders. In addition, the Chairman meets regularly with our largest shareholders and provides feedback to the Board following these meetings.

+ 76 Board governance

Risk management

Risk management is the identification of key risks that could threaten the success of a company, and taking steps to reduce or eliminate them. A board needs to ensure that a company has effective risk management processes.

The Company has well-developed risk management processes, for which the Board has overall responsibility. The Audit and Corporate Responsibility committees jointly review the Operational Assurance Statement Risk Register and Non-financial Risk Register regularly. The Board considers risk as part of its annual strategy review process and also when considering major new business bids.

+ 66 How we manage risk

Directors

Standards

To promote the success of a company and maintain a reputation for high standards of business conduct, a board should set the expectations and requirements with regards to the behaviours and standards required by its employees and others associated with it.

Through the Operational Framework, which includes our Code of Conduct, the Board has agreed policies that set the standards of behaviour and business practice. Also, through these policies, the Board sets standards and requirements with regards to key governance matters, including: our people; our commitment to the community and the environment; standards of business conduct; and our relationship with suppliers.

+ **76** Operational framework

Employees

A company's employees are central to the long-term success of a company, as such a board needs to consider their interests, and have means of engaging with and understanding their views.

The Company has a well-developed structure through which senior management, including the Chief Executive, engages regularly with senior trade union officials to discuss and understand, in an open and well-informed basis, matters concerning UK employees. The Chief Executive briefs the Board on matters raised at these meetings. Board members engage with employees when visiting Company sites around the world, and it has held 'town hall' meetings as part of such visits.

+ **24** Our people

Major decisions

Many of the decisions and actions of large companies are made on the basis of authority delegated by the board. However, to ensure that major decisions – particularly those not in the normal course of business, involving large values or with a possible impact on the reputation of the company – are considered and taken by the directors. A board should reserve certain matters for its own decision.

The Operational Framework clearly details the matters that the Board has reserved for its own decision. Where matters are delegated, financial and other limits are set to ensure that major decisions are referred to the Board. This includes major business opportunities, capital expenditures and the nature of the business that the Company should undertake.

+ **76** Operational framework

Robust governance

In order to carry out their legal duties effectively, the directors of large companies should ensure they have a robust governance structure – underpinned by the right culture and values – which will ensure decisions are made at the appropriate level and, where necessary, by reference to required policies and procedures.

The Operational Framework documents the roles of the directors and executive management, detailing how and by whom key decisions are to be made. The Board and Audit Committee regularly review the effectiveness of the internal controls detailed in the Operational Framework, supported by our assurance processes. The Board uses its annual evaluation process to help ensure that it is effective in discharging its responsibilities.

+ **76** Operational framework

Business relationships

Fostering business relationships with key stakeholders, such as customers and suppliers, is key to a company's success. As such, a board should have oversight of these relationships.

The Board's annual programme provides opportunities for it to engage with our principal customers, and gain at first-hand an understanding of their requirements and the Company's performance in meeting these. The Chairman is engaged actively in developing customer relationships at the most senior level and reports regularly on this to the Board. During the year, the Corporate Responsibility Committee undertook a deep dive into how we engage with suppliers.

+ **18** Group strategic framework

Performance oversight

The board of a large company will normally delegate day-to-day management to executive management. However, it must maintain oversight of the company's performance and ensure that management is acting in accordance with its delegated authority, and the values and standards that underpin this.

At each Board meeting, the directors receive a comprehensive report from the Chief Executive on the performance of the Company. The effectiveness of such reporting is supported by a system of risk management and internal control processes – all of which is underpinned by the values and standards mandated in our Operational Framework.

+ **80** Board information

Strategy and planning

Promoting the long-term success of the company by setting the strategy and strategic objectives that will ensure its business model remains relevant and effective.

The Board approves the Company's strategy and business plan. Each year, in November, it spends a whole day reviewing and agreeing strategy, which is detailed in the Company's Integrated Business Plan (IBP). Through the year, and in preparation for the IBP, the Board undertakes a series of strategic updates with each of the Group's business sectors.

+ **18** Group strategic framework

Assurance

A board needs assurance that a company's financial reporting, risk management, governance and internal control processes are operating effectively. This is essential to the success of the company and its long-term reputation.

The Board, principally through the Audit and Corporate Responsibility committees, engages throughout the year with the Company's auditors and internal audit function, and receives feedback on their audit and review activities. In addition, it has put in place certain key assurance processes, such as the Operational Assurance Statement.

+ **77** Operational Assurance Statement

Remuneration and incentives

A board needs to ensure that executive management and other employees are remunerated and incentivised in a manner that is consistent with the directors' duty to promote the success of the company and the consequences of their decisions in the long term.

In addition to setting the remuneration of the executive directors, the Board's Remuneration Committee reviews and approves the remuneration structure for all senior executives, including incentive targets and their outcomes. It also oversees the operation of the all-employee share plans that reward and incentivise employees across the Group.

+ **91** Remuneration 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 auditors.

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.

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.

Oversight of performance and compliance with Operational Governance

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.

+
82 Audit Committee

+
87 Corporate Responsibility Committee

+
90 Nominations Committee

+
91 Remuneration Committee




I8 Group strategic framework

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	Responsible Trading Principles	Internal controls	Risk framework	Workplace and operational environment	Delegated authorities
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.	We do not compromise on the way we do business and here we mandate a principles-based approach to our business activity.	Provide assurance regarding: <ul style="list-style-type: none"> – 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. 	This is how we identify, analyse, evaluate and mitigate risk (see page 66).	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.	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.

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)	LCM (Lifecycle Management Policy)	M&A (Mergers & Acquisitions Policy)	TPL (Total Performance Leadership)
Approved by the Board annually, creates a consistent approach to strategic planning, aligning resources with the delivery of forecast financial performance and strategic objectives.	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.	A structured approach to mergers, acquisitions and disposals.	A set of people-related activities that help to identify, select, manage and reward leaders, and facilitates succession planning.

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. Prior to joining BAE Systems, Sir Roger was Chairman of Centrica plc and Deputy Chairman of the Court of the Bank of England. In the past, he has also served as CEO of Williams plc and chairman of Thames Water plc, Cadbury plc, Chubb and Mitchells & Butlers plc. He was Vice Chairman of the BBC Trust until it was dissolved in April last year.

He has been active in representing UK business having previously served as President of the CBI and as a member of the Prime Minister's Business Advisory Group. He was a member of the Higgs Committee on Corporate Governance, which assisted in further developing the UK Corporate Governance Code. Sir Roger is also a senior adviser to Kohlberg Kravis Roberts, a fellow of the Royal Society for the encouragement of Arts, Manufactures and Commerce, an honorary fellow of the Institute of Chartered Secretaries and Administrators, and a visiting fellow to the Said Business School, Oxford.

Other non-executive appointments

None.

Committee membership

Chairman of the Nominations Committee and the Non-Executive Directors' Fees 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 succeeded Ian King as 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.

Committee membership

Non-Executive Directors' Fees Committee.



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. This year, Peter's role was 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.

Non-executive appointments

Non-executive director of Aero Communications, Inc.

Committee membership

Non-Executive Directors' Fees Committee.



Revathi Advaiti
Non-executive director

Appointed to the Board: 2018 **Nationality:** US

Skills, competence and experience

Revathi brings extensive operational experience to the Board, gained from her leadership of multinational engineering and manufacturing businesses, where she has gained a good understanding of digital technology and international markets. Revathi is Chief Operating Officer, Electrical Sector, for 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 several senior roles within the sourcing and supply chain functions of the aerospace sector before being named vice president and general manager of Honeywell's Field Solutions business in 2006. Revathi returned to Eaton in 2008 as vice president and general manager of the Electrical Components Division. She serves on the board of governors of the National Electrical Manufacturers Association in the US and on the Advisory Council for the University of Pittsburgh's Center for Energy.

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 non-executive vice-chair of 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 FICC Market Standards Board, the European Securities and Markets Authority's stakeholder group and of the advisory council of TheCityUK. Elizabeth is currently chair of the advisory group to 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 member of the Royal Society of Arts 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 The Financial Times ranked Harriet sixth in 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.

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. 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 and AWE Management Limited.

Committee membership

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

Board information

Diversity – Board

**7 male
4 female**

Membership

	Committee membership	Nationality	Date of appointment to the Board	Date current term ends	Current term as director
Sir Roger Carr Chairman	N	UK	2013 ¹	2020	Second
Revathi Advaithi Non-executive director	C N	US	2018	2021	First
Elizabeth Corley Non-executive director	N R	UK	2016	2019	First
Harriet Green Non-executive director	C N	UK	2010	2019	Third
Chris Grigg Non-executive director	C N	UK	2013	2019	Second
Paula Rosput Reynolds Non-executive director	A N R	US	2011	2020	Third
Nick Rose Non-executive director and Senior Independent Director	A N R	UK	2010	2019	Third
Ian Tyler Non-executive director	A C N	UK	2013	2019	Second

The average length of appointment of non-executive members of the Board (as at 31 December 2017) was 5.3 years.

Charles Woodburn Chief Executive	UK	2016
Peter Lynas Group Finance Director	UK	2011
Jerry DeMuro President and Chief Executive Officer of BAE Systems, Inc.	US	2014

The average length of appointment of executive members of the Board (as at 31 December 2017) was 4.1 years.

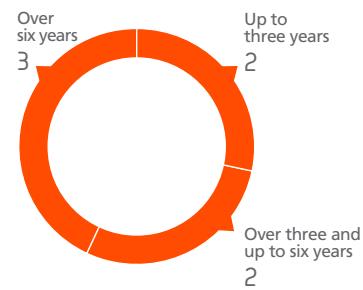
- | | |
|------------------------|--------------------------------------|
| Chairman | N Committee chair |
| Non-executive director | A Audit Committee |
| Executive director | N Nominations Committee |
| | C Corporate Responsibility Committee |
| | R Remuneration Committee |

Attendance

Individual directors' attendance at meetings of the Board and its committees in 2017

	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee
Sir Roger Carr	8/8	–	–	4/4	–
Elizabeth Corley	8/8	–	–	4/4	6/6
Jerry DeMuro	8/8	–	–	–	–
Harriet Green	7/8	–	4/4	3/4	–
Chris Grigg	8/8	–	4/4	4/4	–
Ian King	4/4	–	–	–	–
Peter Lynas	8/8	–	–	–	–
Paula Rosput Reynolds	8/8	6/6	–	4/4	6/6
Nick Rose	8/8	6/6	–	4/4	6/6
Ian Tyler	8/8	6/6	4/4	4/4	–
Charles Woodburn	8/8	–	–	–	–

Tenure – independent non-executive directors



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 2017 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 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

Assessment

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 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 the 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 Group 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 Group 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.

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; and
- potential change of UK government policy.

The scenarios tested included the impact of multiple adverse factors.

Conclusion

In undertaking its review of the IBP in 2017, 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

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 2017, 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.

At the beginning of 2018, Elizabeth Corley, a non-executive director of the Company, was appointed as 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 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.

All directors undertake a structured induction programme when they first join the Board, thereafter they regularly update and refresh their knowledge of the Company.

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,

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 would like to focus here on specific aspects of that activity.

We reported last year on progress to date on our audit tender which has been conducted in accordance with the audit tender and transition timeframe set out in the graphic below. I am pleased to report that the tender exercise was completed to timescale, enabling the Audit Committee to make a recommendation to the Board in May 2017 which it subsequently endorsed. Subject to shareholder approval at the 2018 Annual General Meeting (AGM), Deloitte LLP will succeed KPMG LLP as the Company's auditor at the end of that meeting. More detail on the audit re-tender is set out on page 83.

My Audit Committee colleagues and I are highly appreciative of the time and effort that audit firms expend in preparing their responses to tenders and would like to thank the participating firms for their professionalism and diligence in this regard.

Audit rotation regulations going forward will require large companies to re-tender their external audit service no less frequently than every ten years.

Our focus since the recommendation was endorsed by the Board has been two-fold: ensuring that audit quality is maintained for the 2017 half-year and full-year audits from the outgoing auditor, whilst at the same time ensuring that the proposed incoming auditor is readying itself for the engagement in terms of both audit engagement compliance issues and familiarisation with the business.

More detail on work undertaken by Deloitte on the transition arrangements is set out on page 83.

Audit re-tender and transition aside, the Committee has continued its monitoring of the financial reporting process and its integrity, risk management systems and assurance.

During the year, we have reviewed the initial disclosures for IFRS 15, Revenue from Contracts with Customers, and related briefings on the impact on the financial statements. Further information on IFRS 15 is provided in note 34 to the Group accounts on pages 199 to 201.

As reported on page 21, the Group has been restructuring its portfolio of interests in a number of industrial companies in Saudi Arabia in order to support the Kingdom's Vision 2030 industrialisation strategy. During the year, we have focused on controls in our Saudi business, as well as governance in relation to this portfolio of collaborative partnerships.

We have continued in our efforts to leverage optimal use of the Internal Audit function within the risk environment. An external assessment of the function originally scheduled to be undertaken in 2017 has been deferred until 2018 following organisational changes taking effect from 1 January 2018. The assessment has been commissioned and will commence in the first quarter of 2018.

External audit tender and transition timeline



Audit re-tender

Key elements of the audit re-tender were as follows:

- overseen by the Audit Committee who agreed the scope of the Request for Proposal (RFP);
- assessment of tender participants informed by complexity of the Group and scale of its international business;
- tender competed by highly capable and experienced international audit firms with strong track records and technical expertise;
- no contractual obligations restricted the selection of firms participating in the audit;
- current incumbent, KPMG LLP (and its predecessors), had been in place as the Company's auditors since 1981 without re-tender and was thus not invited to tender;
- evaluation criteria in the RFP included:
 - audit quality and independence;
 - understanding of the Group's business;
 - capability of audit team in terms of skills, experience and geographic reach;
 - clear planning and audit approach; and
 - robust challenge, insight and proactivity;
- business meetings and site visits scheduled to enable the participating firms to gain an understanding of the Group's business;
- presentations made to the Audit Committee by participating firms, with question and answer sessions;
- Audit Committee put forward formal recommendation to the Board that, of two audit firms capable of undertaking the audit appointment, Deloitte LLP was its preferred choice; and
- Board endorsed the Committee's recommendation and will recommend the appointment of Deloitte LLP at the 2018 AGM.

Audit transition

Activity undertaken by Deloitte, as the incoming auditor¹ for the year ending 31 December 2018, has included the following:

- reviewed non-audit services provided to the Group and steps taken to achieve audit independence from 1 January 2018;
- agreed interaction with KPMG, as outgoing auditor, during the 2017 audit cycle, including attendance at key audit meetings, observing the 2017 half-year process and shadowing the year-end audit;
- finalised audit team and agreed key transition milestones with the Committee and finance teams across the Group;
- held regular meetings with Group Finance Director, Director, Financial Control and Reporting, and business unit finance directors;
- worked closely with Internal Audit to understand their 2017 and 2018 work programmes, and used the outputs to inform the 2018 Audit Plan and risk assessment process;
- attended Audit Committee meetings since June 2017 and reported regularly on independence and audit transition plan status; and
- undertaken familiarisation visits and other meetings and interactions with sector and business unit management, and other senior executives to facilitate knowledge building, audit scoping and execution planning.

¹. Subject to shareholder approval at the 2018 AGM.

May 2017

Selection of new auditors for recommendation to the Board

August 2017

Announcement of half-year results

February 2018

Announcement of full-year results

May 2018

Board recommendation at Annual General Meeting to appoint new auditors

June 2017 to July 2017
Half-year results shadow period

December 2017 to February 2018
Full-year results shadow period

Audit Committee report continued

How the effectiveness of the external audit process 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:

- 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.

This review related to KPMG's final audit prior to rotating off our account. The feedback has been shared with them and will also help inform our discussions on audit scope and process with Deloitte, our incoming auditor.

How we ensure that the Group's financial statements, taken as a whole, are fair, balanced and understandable

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.

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. During the year, the 2016 external audit of the Group by KPMG was reviewed by the AQR. The review covered certain items of the Group-level audit (including retirement benefit obligations, taxation, procedures in relation to the risks of bribery and corruption, and the quality of communications with the Audit Committee) and the audit of recognition of revenues and profits on long-term contracts by two of the business unit audit teams. I met with the AQR to gain an understanding of its report and the Committee discussed the review findings with KPMG. The AQR reported a number of recommendations for improvement and also areas of high standard. The recommendations were incorporated into the 2017 audit work and the Committee is satisfied that they have been properly addressed. The Committee does not consider any of the findings to have a significant impact on KPMG's audit approach. We will make the lessons learned from this report available to our incoming auditor, Deloitte.

Audit independence

We have reviewed in detail the confirmation and information received from KPMG on the arrangements that they have in place to safeguard auditor independence and objectivity, including specific safeguards in place where they are providing permissible non-audit services to the Group.

As part of the auditor transition arrangements, we have reviewed on a regular basis the steps being taken by Deloitte, the proposed incoming auditor, to achieve audit independence from 1 January 2018 onwards.

Non-audit services policy

The Committee has a formal policy governing the engagement of the auditors to provide non-audit services which we review on an annual basis. The policy prohibits certain activities from being undertaken by the auditors and also places restrictions on the employment of former employees of the auditors.

Recognising that the auditors are best placed to undertake certain work of a non-audit nature, the policy permits the provision of Audit-Related Services and Permitted Non-Audit Services up to limits that are pre-approved by the Committee, with specific

approvals required beyond such limits by the Committee. A copy of the policy is available on the Company's website, baesystems.com.

As reported last year, we made revisions to the policy in order to ensure compliance with the Financial Reporting Council's revised regulations on ethical standards for auditors and EU regulations adopted by the UK which apply prohibitions to a range of engagements that could result in an auditor facing a conflict of interest. As a result, certain services formerly provided by KPMG, primarily tax services and investor information services, were no longer provided by them with effect from 1 January 2017.

Details of fees payable to the auditors are set out on page 151. In 2017, non-audit fees represented 15% of the audit fee. The principal non-audit services provided by the auditors related to the interim review and accounting advice primarily in respect of IFRS 15.

Financial statements

The Committee reviews all significant issues concerning the financial statements. The principal matters we considered concerning the 2017 financial statements were:

Recognition of revenue, profit and provisioning

We reviewed key estimates and judgements prior to publication of the financial statements. Our review included the key estimates and assumptions applied in determining the financial status of the more significant programmes, including Typhoon, UK aircraft carrier programme, Astute Class submarine programme and Saudi British Defence Co-operation Programme.

Pensions

Recognising the scale of the Group's pension obligation, we reviewed the key assumptions supporting the valuation of the retirement benefit obligation. This included a comparison of the discount and inflation rates used against externally-derived data. We reviewed the methodology used to allocate a proportion of the retirement benefit obligation to equity accounted investments and 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, as well as the results of the UK triennial funding valuations (see note 21 to the Group accounts on pages 174 to 183).

Goodwill

We considered the level of goodwill held on the Group's balance sheet in respect of a number of past major transactions and whether, given the future prospects of these businesses, the value of goodwill held on the balance sheet remains appropriate. The methodology for impairment testing used by the Group is set out in note 8 to the Group accounts on page 158. As a result of this review, there has been an impairment of goodwill held in respect of Applied Intelligence of £384m reflecting the future level and timing of expected returns from the business.

Taxation

Whilst tax policy is ultimately a matter for the Board's determination, we reviewed the Group's tax strategy as set out on page 34. 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 agreed the parameters of, and reviewed the supporting report for, the going concern statement (see page 81) 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.

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 general financial and LCM controls testing, and any required improvement actions, with management, and internal and external audit, with a view to ensuring the ongoing robustness of programme execution and risk mitigation.

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.

Internal audit

Internal Audit plays an integral role in the Company's governance structure and provides regular reports to the Committee, including the outputs of the twice-yearly OAS process and the tracking of remedial action in the case of any control failures.

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 covers 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. As part of this year's process, we reviewed the scope of annual audits and recalibrated them against the current 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, which has helped inform our view on how to optimise internal audit resource for value-added assurance.

After discussion of the 2017 evaluation output with the Internal Audit Director, the Committee concluded that the Internal Audit function remains effective. As reported earlier, an external assessment of the function will commence in the first quarter of 2018.

Nick Rose
Chairman of the Audit Committee

How the Committee assesses the effectiveness of Internal Audit**Who we survey:**

- Group-wide heads of Audit Review Boards
- Other business leaders
- External auditors

Areas for requested feedback include:

- Role of Internal Audit and independence
- Audit planning, processes and execution
- People resources and skilling
- Communications and reporting

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.

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 auditors 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, Hampshire, UK

- Conducted the audit tender selection and made recommendation to the Board.
- Agreed the AGM Trading Statement.

June

Committee

Washington DC, US

- Agreed audit engagement and audit fee.
- Agreed audit strategy and scope.
- Reviewed external auditor independence issues.
- Reviewed Deloitte's Audit Transition Plan.
- Discussed with external auditors the Financial Reporting Council's latest Quality Review on KPMG (which did not include the BAE Systems audit).
- 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 auditors that flowed from the audit 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.
- Audit Transition: Reviewed independence safeguards for incoming auditor.
- Regular quarterly items¹.

August

Meeting

London, UK

- Informal meeting with the Internal Audit Director to discuss best practice developments in internal audit and its strategic development.

October

Committee

London, UK

- Agreed the Trading Update.

November

Briefing

- Reviewed briefing on IFRS 15.

December

Committee

London, UK

- Considered the external auditor's controls report.
- Considered output of the Internal Audit Director's report.
- Presentation on governance in the Company's Saudi Arabian Kingdom Portfolio Companies.
- Received a report on export control compliance.
- Received a report on the Group's insurance arrangements.
- 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.
- Undertook a review of the effectiveness of the Internal Audit function.
- Regular quarterly items¹.

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 auditors without management present. The Audit Committee Chairman also meets separately with internal and external audit on an ad hoc basis.

Audit Committee timeline



Corporate Responsibility Committee report



Ian Tyler

Chairman of the Corporate Responsibility Committee

Members

Ian Tyler (Chairman)
Revathi Advaithi
Harriet Green
Chris Grigg

Dear Shareholders,

It is my pleasure to once again be reporting to you on the business of the Corporate Responsibility Committee during 2017. Through this report I aim to give you an insight into the programme of work that we have undertaken, our areas of focus during 2017 and how we aim to develop these into 2018.

The corporate responsibility landscape continues to evolve and, as such, the Committee monitors developments to ensure that our agenda remains relevant, whilst keeping a keen eye on the matters that have been our principal focus for some time. During 2017, we increased the intensity of our review of diversity and inclusion across the different areas of the business. We also looked at responsible trading, the way in which the Company interacts with our suppliers and how the Company engages with employees. I will provide detail on each of these areas through this report and begin with a discussion of our health and safety agenda, which remains a key priority.

Safety

Safety continues to be a key priority for the Committee and we remain focused on making progress towards achieving world-class performance wherever possible. During the year, we carried out a deep-dive review of the safety performance of the US business to understand the factors driving these specific safety performance metrics. In 2017, there was a 3% reduction in the Recordable Accident Rate and a 28% reduction in the total number of major injuries recorded. To ensure that we do not lose focus on this important area, the Board continues to prioritise safety in the business through the inclusion of a specific safety objective that is designed to be realistic, but stretching, and which forms part of our executive annual incentive scheme (see page 101).

Diversity and inclusion

In July, we welcomed Charles Woodburn to the Board in the position of Chief Executive. Charles has now taken on the role of Chairman of the Company's Diversity and Inclusion Council, and he will be engaging with the Committee on the Council's priorities and the progress that is being made to drive business performance.

In my report last year I explained that, during 2016, the Committee sought to gain an understanding from management on the Company's objectives and plans with regard to diversity and inclusion. At the conclusion of our programme of work in 2016, it was clear to me that, whilst taking a top-level view had been helpful to set the scene, it did not provide us with a rich enough view of what the challenges were at business unit level. Each business has its distinct challenges, and the Committee was keen to understand what these were and how the management boards were addressing them. We therefore invited each line of business to meet with the Committee to discuss how they were building the diversity and inclusion strategy into their work. From the discussions we held with the line leaders, we gained a more informed view of the progress being made, but we also gained an appreciation of why this is an evolving issue and one that we as a Committee need to continue to focus on in 2018.

The Committee held a very useful discussion on the particular challenges that the Saudi Arabian business faces in terms of local recruitment and retention, and gender diversity in particular. One of the issues that sits alongside our consideration of diversity and inclusion is the development of talent across all backgrounds and it is promising to see that developments in the educational opportunities for women are being translated into changes to the demographic of our employees.

At the end of 2017, the Committee had reviewed the diversity and inclusion approach for each line of business which has given the Committee a better understanding of the actions that are taking place at management board level to embed a culture of diversity and inclusion. During 2018, the Committee will continue to keep this high on its agenda as we consider the accountability measures that are required to ensure that we have the necessary commitment and engagement to deliver further improvement.

Responsible trading

The Committee has continued to review the issue of responsible trading. During the year we reviewed the anti-bribery and anti-corruption policies, which included the Lobbying, Adviser, and Gifts and Hospitality policies. These policies set out the expectations that we have of our employees.

Focus on diversity and inclusion

The Corporate Responsibility Committee continued to focus on diversity and inclusion throughout 2017 and this has remained a key agenda item at each of the quarterly meetings. Our goal is to build a culture of inclusion and inclusive leadership globally, and the Committee has played a key role in driving and supporting the development of market plans and strategies to foster diversity and inclusion throughout the organisation.

The Corporate Responsibility Committee has reinforced accountability for diversity and inclusion through the promotion of:

- demographic data analysis to identify targeted diversity and inclusion actions;
- numeric goals and milestones to increase the representation of minority groups and accelerate diversity;
- recruitment processes that support increasing pipelines and mitigate unconscious bias;
- inclusive leadership training programmes;
- employee resource groups and local councils; and
- a focus on early careers and next-generation recruitment to address retirement risk and Science, Technology, Engineering and Mathematics skills shortages.

Corporate Responsibility Committee report

continued

Focus on employee engagement

It is important for the members of the Board to be able to understand the views and opinions of employees. The Company engages with employees in a number of different ways to gain feedback on what is happening across the business and to build a dialogue on key issues. This includes meeting with employees and the use of employee engagement surveys. The opportunity to have face-to-face engagement with employees is regularly included in the agenda for site visits undertaken by the Board. These discussions are one of the ways in which the Board can gauge the success of the engagement and to listen directly to the views of employees.

During 2017, the Corporate Responsibility Committee reviewed the output of the employee engagement surveys and, in 2018, we will look closely at the ways in which the Board will develop the frameworks for how it engages with employees across the business.

The Committee also reviewed the different ways in which the Company assesses and makes judgements on the types of products and services that are developed and sold and the customers that we will do business with. We considered some of the key export markets where we operate and held in-depth discussions with the management team on our approach to existing and new business opportunities, and how we engage with governments and customers. In particular, the Committee reviewed and carefully considered the manner in which the Company operates in these markets, looking at government relationships and the controls we have in place aimed at ensuring that we operate legally and in accordance with our responsible business policies.

For all of these areas we aimed to understand how management assesses risk, from both an operational and reputational perspective. In support of this we also looked at the Product Trading Policy which looks to ensure that the required standards of integrity are met. We are continuing to focus on responsible trading as part of our 2018 agenda.

Responsible procurement

The Committee undertook a deep dive into the way in which the Company engages with suppliers. In 2016, the Company embarked on a major programme of change within its procurement function. The Committee therefore met with the Chief Procurement Officer to discuss the changes made to the global Procurement Policy, the structure and role of the Procurement Council and the Supplier Principles, launched in January 2017.

The Committee was interested in understanding two aspects of procurement in particular. The first was how the Company can be confident that its suppliers, and their supply chains in turn, are meeting similar responsible business standards to those that we set for ourselves. The Supplier Principles detail what the Company expects and these have been benchmarked against global best practice. The second aspect was how we as a customer engage with our supply chain and the relationships we build with this crucial element of our business. The Committee will revisit this topic in 2018 to review the progress that has been made.

Employee engagement

The Committee has considered how the Company engages with employees to gain an understanding of their views and opinions. There are challenges to engaging effectively with a large number of employees across a number of countries. To meet this challenge new engagement surveys have been developed, and we reviewed the way in which the 'Agile' survey is being used to gain a quick response from employees on specific topics. Each business has the ability to tailor the questions asked to suit their specific engagement needs which gives a new agility to the process. The Committee was also interested to understand how management responds to these surveys. It was encouraging to see that both the quantitative results and the qualitative comments were considered in detail by the management teams as part of their engagement process. The Committee will continue to review the employee engagement agenda during 2018.

Next year

As in previous years, the agenda for 2018 will be developed to ensure that we maintain a focus on our rolling agenda of safety, ethics, diversity and inclusion, and responsible business conduct. In addition to this, we look to include deep dives on other areas to broaden our understanding of the challenges and opportunities across the business in relation to corporate responsibility.

Ian Tyler

Chairman of the Corporate Responsibility Committee

The Corporate Responsibility Committee's year

February

Committee

London, UK

- Carried out the annual review of the Product Trading Policy. This policy governs BAE Systems' business behaviour to ensure that the Company's product trading reflects the Company's standards of integrity.
- Consideration of the Company's approach to diversity and inclusion and the way in which this is managed across the business.
- Received a presentation from the Group Human Resources Director on employee engagement tools and discussed the results of a recent internal survey.
- Review of performance against the 2016 safety performance objectives. A recommendation on the performance rating was made to the Remuneration Committee.

June

Committee

Washington DC, US

- Received a presentation on diversity and inclusion in BAE Systems, Inc.
- Discussion on the objectives of the business, the strategy to achieve this and the way in which performance was assessed.
- Review of the safety performance of BAE Systems, Inc. to consider the key areas of risk and the safety culture within the business.
- Discussed the programme of work that was being undertaken to update the Code of Conduct.

October

Committee

London, UK

- Received a presentation on diversity and inclusion in the International Operating Group. Discussion of the progress that has been made in BAE Systems Australia and Saudi Arabia and the different challenges for these areas of the business.
- Presentation from Group Procurement on the policies and guidance relating to responsible procurement. Consideration of the structure of the function and the way that it supports the global approach to responsible business.

December

Committee

London, UK

- Undertook the annual review of the Gifts and Hospitality, Facilitation Payments and Advisers Policies.
- Received a presentation on diversity and inclusion in Platforms & Services (UK). Discussion of the approach taken by the business to attract and retain diverse talent and the way in which this supported the leadership pipeline. Consideration of how targets could be used to drive improvements.
- Consideration of the structure and focus of the corporate responsibility objectives for 2018.
- Review of the corporate responsibility audit review programme for 2018.

Schedule for 2018

Committee

February

- Review of performance metrics for 2017.
- Product trading.
- Diversity and inclusion deep dive.

June

- Anti-bribery and corruption – overseas governance.
- Workplace safety deep dive.
- Environment update.
- Stakeholder and employee engagement.

September

- Review of responsible procurement.
- Workplace safety.
- Diversity and inclusion deep dive.

December

- Anti-bribery and anti-corruption and related policies – review of Lobbying, Adviser, and Gifts and Hospitality policies.
- Consideration of forward-looking objectives.
- Diversity and inclusion deep dive.
- Stakeholder and employee engagement update.

Corporate Responsibility Committee timeline

February

Committee

June

Committee

October

Committee

December

Committee

Nominations Committee report



Sir Roger Carr

Chairman of the Nominations Committee

Members

Sir Roger Carr (Chairman)

Revathi Advaithi

Elizabeth Corley

Harriet Green

Chris Grigg

Paula Rosput Reynolds

Nick Rose

Ian Tyler

Last year, I committed to further strengthen the non-executive representation on the Board. I'm delighted that we were able to achieve this with the appointment of Revathi Advaithi on 1 January this year. With an international industrial sector background and a good understanding of the digital economy, Revathi's knowledge and experience will be an asset to the Board. Heidrick & Struggles – JCA Group¹ worked with the Committee to assist in her recruitment and Spencer Stuart¹ performed a similar role in the Chief Executive search.

Looking ahead, next year Nick Rose, who chairs our Audit Committee and is also our Senior Independent Director, will have served on the Board for nine years and has indicated that he will retire in 2019. Consequently, the Committee has initiated a search process to identify a suitable candidate to succeed Nick in leading the Audit Committee.

BAE Systems recognises the value of being an inclusive employer with a diverse workforce. This also applies at Board level, and we continue to make good progress in increasing the diversity of the Board. In terms of gender, 36% of Board members are women, which exceeds our previously stated policy target of 33% or greater by 2020 – as targeted by the Hampton-Alexander Review. This remains our policy concerning gender. 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 also has a diversity that reflects the multi-national nature of our Company and the increasingly global nature of the business world in general. However, individual merit will always be the prime consideration when making appointments to the Board. We will continue to engage with search consultants to identify candidates in a manner that is consistent with achieving an appropriately diverse board.

One of the Committee's objectives over the last couple of years has been to develop a better understanding of the depth of our management resource. This has meant making time for the non-executive directors to meet with executives who either currently occupy senior management positions just below our Executive Committee, or show the potential to reach that level. Using informal events scheduled around our Board meetings, we have been successful in significantly increasing the Board's engagement with executives. This activity has helped the members of the Nominations Committee to perform the important role they undertake in overseeing succession planning and executive development across the Group.

This work will be a key priority for the Committee in 2018. We know we employ some highly talented people, and will engage with the Chief Executive and our new Group Human Resources Director in ensuring that they are developed and given the opportunities to lead this Company in the years to come.

Sir Roger Carr

Chairman of the Nominations Committee

Dear Shareholders,

I'm pleased to report that 2017 saw a successful conclusion to the Chief Executive succession planning process – as managed by the Nominations Committee – with Charles Woodburn succeeding Ian King on 1 July. It was back in March 2015 that the Committee first identified Charles as a possible candidate for the role, and I would like to thank him and Ian for the professional and helpful manner in which they conducted themselves during a rigorous and lengthy selection and handover process.

Charles is well supported in his new role by two very able and experienced fellow executive directors; Jerry DeMuro, who leads our US business, and Peter Lynas, Group Finance Director. I'm pleased that Peter has agreed to take a wider management role, and since November last year he has been responsible for UK Shared Services, Procurement and Group Mergers & Acquisitions.

1. Heidrick & Struggles – JCA Group and Spencer Stuart provide other recruitment services to BAE Systems.

Nominations Committee timeline

February
Committee

March
Committee

May
Committee

July
Committee

Remuneration Committee report



Paula Rosput Reynolds
Chairman of the Remuneration Committee

Members

Paula Rosput Reynolds (Chairman)
Elizabeth Corley
Nick Rose

Dear Shareholders,

The Remuneration Committee (the Committee) is pleased to provide this update on our progress in implementing the remuneration policy approved at the May 2017 AGM (the Policy). We appreciated the high level of support we received (95.09% in favour) and the continuing constructive dialogue we have had with a number of you. The Committee remains sensitive to the broad range of themes regarding executive remuneration expressed by investors, the UK government and the wider public, particularly as regards to restraint when setting quantum. We believe such restraint is appropriate as long as remuneration remains reflective of the business environment and contains appropriate incentives to achieve the Group's business objectives. In keeping with this theme, I believe you will find that our changes for 2018 are quite modest but are nevertheless responsive to the feedback that the Committee received during the last shareholder consultation cycle. To confirm, for 2018, no revisions are proposed to our executive remuneration framework which would constitute a change to the Policy.

Key changes proposed and approved at our 2017 AGM include:

- adoption of common metrics (50% on Earnings per Share, 50% on Total Shareholder Return) for all performance-related share awards;
- introducing reasonable discretion for the Committee to modify the final outcome of awards vesting in light of important factors in the business;
- amending the structure of our Long-Term Incentive Plan applicable to our UK executive directors to ensure a minimum period from grant to final release, based on a three-year performance period with a further two-year holding period for all awards to be granted from 2018 onwards; and
- a simplification of the Long-Term Incentive construct applicable to the US executive director.

2017 was a crossroads year for BAE Systems and the application of our Policy reflected these circumstances. Ian King retired from the Company at the end of June having served for over 40 years, including leading BAE Systems as Chief Executive since 2008. His retirement was handled precisely according to our Policy. This transition had been anticipated and the decision-making with respect to succession and remuneration was undertaken with an eye to ensuring a smooth transition of leadership through a period of significant change in the business environment. Thus, our then Chief Operating Officer, Charles Woodburn, was appointed Chief Executive with effect from 1 July 2017 and his remuneration was adjusted in accordance with the Policy. Our Group Finance Director, Peter Lynas, was subsequently asked to undertake enhanced responsibility for Procurement, Group Mergers & Acquisitions and UK Shared Services. As previously announced, the base salary of the Group Finance Director was increased to reflect these expanded responsibilities with effect from 1 November 2017 and this adjustment was also in accordance with the Policy.

Business performance and incentive outcomes in 2017

		2017 performance	2017 incentive outcome
Group EPS	AIP	42.3p	●
Group cash	AIP	£(940)m	●
Group order intake	AIP	£19.3bn	●
Average three-year EPS growth	LTI	4.7%	●
Three-year TSR	LTI	49.1%	●
Recordable Accident Rate (per 100,000 employees)	AIP	564	●
Major injuries recorded	AIP	28	●
● Below threshold	AIP	Annual Incentive Plan	
● Between threshold and target	LTI	Long-Term Incentive	
● Between target and stretch			

This resulted in the following incentive outcomes:

- 2017 annual bonus payouts for the executive directors ranged from 75.6% to 88.4% of maximum; and
- Performance Shares (EPS) granted to executive directors in March 2015 will vest at 46.9%. Performance Shares (TSR) and Share Option awards granted at the same time did not meet their performance condition and will lapse.

Remuneration Committee report

continued

Summary of key decisions for 2017

- Approval of early retirement for outgoing Chief Executive (Ian King) in June 2017.
- Approval of remuneration package applicable to newly-appointed Chief Executive (Charles Woodburn) in July 2017.
- Salary of the Chief Executive is being increased by 2.5% from 1 January 2018.
- As a result of his expanded role and increased responsibilities, the salary of the Group Finance Director increased by 6.9% on 1 November 2017. His salary is being increased by 2.5% from 1 January 2018.
- Salary of the President and Chief Executive Officer of BAE Systems, Inc. is being increased by 3% from 1 January 2018.
- Approval of remuneration packages for newly appointed Executive Committee members.
- Awards granted in spring 2017 of Performance Shares, Share Options and (to US executive director only) Restricted Shares.
- Performance Shares subject to (i) 50% on Earnings per Share (EPS) growth (3% to 7% average annual growth requirement); and (ii) 50% on the Total Shareholder Return (TSR) percentile ranking against sector peer comparator group and the companies in the FTSE 100 index, with each group having equal weight.
- Elimination of Share Options for UK executive directors and maintaining expected value in Performance Shares for 2018 awards.

The Company remains subject to rapidly-changing political, economic, defence and security conditions around the world. Such circumstances require that we be responsive to the environment and innovate for the long-run health of the business. Thus, in October, we announced a restructure of various of our operations, resulting in a number of senior leadership changes. The Committee adjusted remuneration for the affected senior executives to reflect new roles and enhanced responsibilities. In doing so, the Committee adhered to the Policy.

Throughout this period of transition, the Committee's overarching goal has remained constant – to ensure that we are providing compelling incentives for sustainable high performance by our executive team in a way that is transparent to our stakeholders and is supported by them. Further, our remuneration programmes are designed to assure that there is strong alignment between business results and rewards conferred. In reading this report, we hope you will agree that the results of our deliberations are consistent with these purposes.

Context to the Committee's decisions

The Committee is responsible for the full spectrum of 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.

There are multiple considerations in the design of the overall framework. First, is the balance of short-term and long-term incentives. Second, is the interplay between Group and business segment results and individual accomplishments, as well as the level of reward afforded to employees in the wider Group. Third, is to distinguish between the precise numerical results and the character of the results themselves, including the manner in which they are achieved. Fourth, is the balance between absolute shareholder value creation and the Group's performance relative to peers.

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. Our long-term incentive programme measures absolute performance of the Group and performance relative to peers. Our framework is intended to foster accountability for sustaining and growing the Group in a responsible manner.

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.

2018 remuneration

As noted above, the changes for 2018 are quite modest but are nevertheless responsive to the feedback that the Committee received during the last shareholder consultation cycle. The following actions will apply to our framework for 2018 and all are entirely in accordance with the bounds of the approved Policy. In line with our commitment to continued transparency and engagement with our shareholders, we have engaged with our major shareholders on these changes for 2018.

In order to increase focus on the achievement of non-financial objectives designed to support the Group's strategy, the weighting on non-financial performance measures will increase from 20% to 25%, with 75% remaining on financial metrics relating to Group EPS, Group cash and Group order intake.

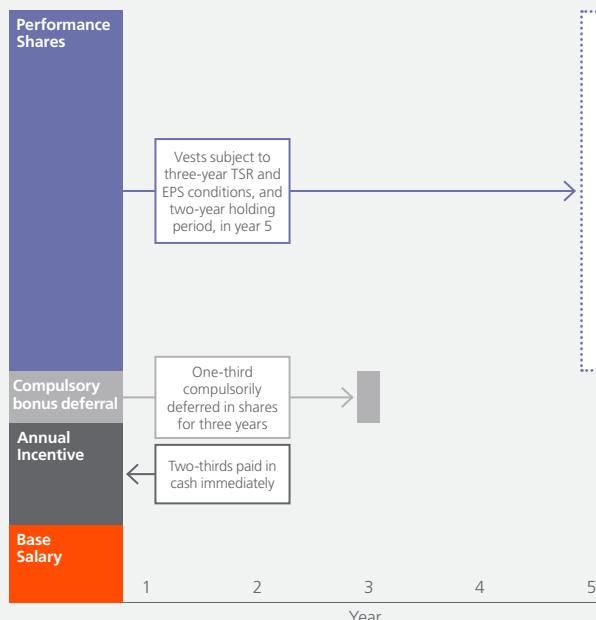
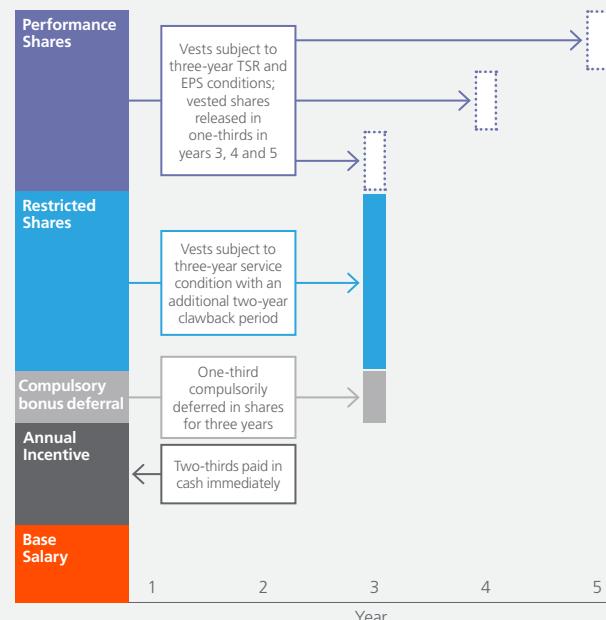
Long-Term Incentive (LTI) design simplification

As a further step towards simplification of our LTI framework, having already taken the decision to eliminate the use of Share Options as part of the construct applicable to our US executive director, the Committee will also cease the award of Share Options to the UK executive directors for 2018 onwards.

Consistent with the flexibility contained within the Policy, LTI awards will be delivered using Performance Shares only. This change will result in a lower total face value of the award without, we believe, diluting the incentive to achieve long-term sustainable value.

Long-Term Incentive award levels

	Current total expected (% of salary)	Current aggregate face value of awards (Performance Shares and Share Options) (% of salary)	New face value associated with Performance Share award only (% of salary)
Chief Executive	185	550	370
Group Finance Director	167.5	515	335

Application of 2018 package for UK executive directors**Application of 2018 package for US executive director**

Charts are illustrative and are not to scale. Details of executive director remuneration packages are on page 96. The full Policy approved at the 2017 AGM is set out on pages 117 to 129.

Remuneration Committee report continued

Wider employee agenda

Recognising the public interest in pay differentials, and the expected proposed legislation in this area, we are continuing to voluntarily disclose the pay ratio of our Chief Executive to that of the average employee of the Group.

The level of salary adjustment for the executive directors is in line with the average increase for employees generally across the Group in 2018.

To support the Committee in taking a greater responsibility for demonstrating how pay and incentives are aligned across the Company, the Committee undertook a reward framework deep-dive session covering information on the structure of remuneration across the Group, including pension benefits.

In February 2018, BAE Systems published its gender pay report in accordance with UK legislation. Our average gender pay gap is 11.2%. This is lower than the UK national average of 18.1%. We have a gender pay gap because we employ around four times more men than women in the UK and a greater proportion of our senior leadership team is male. We are determined to bridge the gender gap in our industry by encouraging more women to join BAE Systems and we have put in place a number of programmes and initiatives to support the development and progression of women into senior executive positions.

Concluding comments

On behalf of my colleagues on the Committee, and indeed the entire Board, we appreciate the input we have received from shareholders and representatives of institutional investors. The Committee remains committed to our policy of paying for performance. The changes for 2018 simplify the LTI construct considerably whilst ensuring that the incentive arrangements for executives remain meaningful and are aligned to the Company's strategic goals and the interests of our shareholders. The Remuneration Committee is actively engaged in monitoring performance and continuing to ensure that the level of challenge within our annual and long-term incentive plans remains appropriate.

On behalf of the Board

Paula Rosput Reynolds
Chairman of the Remuneration Committee

The Remuneration Committee's year

January

Committee

London, UK

- Agreed 2017 objectives for executive directors and Executive Committee members.
- Reviewed feedback from shareholder consultation on 2017 Directors' remuneration policy renewal.
- Reviewed Remuneration Committee terms of reference.

February

Committee

London, UK

- Determined 2016 bonuses against performance for executive directors and Executive Committee members for payment in March 2017.
- Approved 2016 Group All-Employee Free Share Plans payments.
- Determined vesting outcome for 2014 Long-Term Incentive awards.
- Approved 2017 Long-Term Incentive awards and associated performance targets for executive directors and Executive Committee members.
- Approved modifying the mix of Long-Term Incentives for US executive director.
- Reviewed feedback from shareholder consultation on 2017 remuneration review and policy renewal.
- Approved 2016 Annual remuneration report.

May

Committee

Farnborough, Hampshire, UK

- Considered institutional investor shareholder updates.
- Approved remuneration package for new or existing Executive Committee members.

September

Committee

Farnborough, Hampshire, UK

- Agreed basis for 2017 annual remuneration review including elimination of share options for UK executive directors.
- Received update on progress against Annual Incentive Plan objectives for executive directors and Executive Committee members.
- Received update on performance conditions for Long-Term Incentive awards.
- Approved remuneration package for new or existing executive director or Executive Committee members.
- Received details of recent pay review exercise for key senior executives.

November

Committee

New Milton, Hampshire, UK

- Reviewed level of executive directors' and Executive Committee members' shareholdings relative to the 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.
- Approved remuneration package for new or existing Executive Committee members.
- Reviewed outline of 2017 Annual remuneration report.

December

Committee

London, UK

- Reviewed and set salaries and bonus opportunity levels for executive directors and Executive Committee members.
- Proposed and set 2018 Annual Incentive targets.

Remuneration Committee timeline

January

Committee

February

Committee

May

Committee

September

Committee

November

Committee

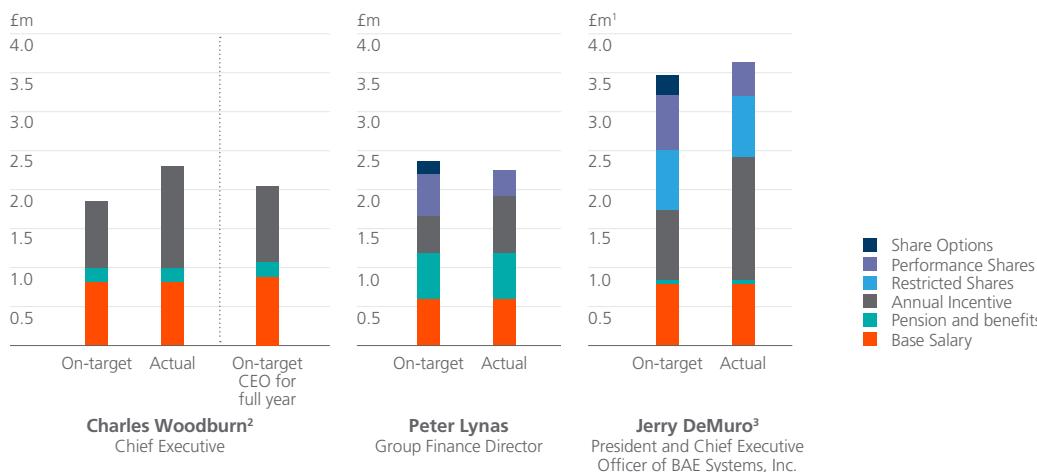
December

Committee

Annual remuneration report at a glance

Executive directors' remuneration

The charts below show the 2017 actual remuneration achieved, as disclosed in the single total figure of remuneration on page 99, compared with the 2017 on-target opportunity. On-target remuneration assumes target vesting of incentives payable in respect of the performance period with year-end 2017. For Charles Woodburn, the first two bars below reflect his remuneration for 2017 as Chief Operating Officer to 30 June and Chief Executive from 1 July. The third bar provides on-target remuneration assuming he was Chief Executive for the full year, for comparison purposes only.



1. The figures for Jerry DeMuro have been converted from US dollars to sterling.

2. Charles Woodburn was appointed to the Board in 2016 and his first LTI is not due to vest until 2019 (subject to performance conditions being met).

3. Long-term incentive figures in the charts above are based on the 2015 Performance Shares, Share Options and Restricted Shares awards. For Jerry DeMuro, the single total figure of remuneration on page 99 includes his 2017 Restricted Shares award as required by regulation.

Summary of remuneration framework

The overall remuneration framework applicable in 2018 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 ² CEO	Peter Lynas GFD	Jerry DeMuro CEO Inc.
Base Salary (with effect from 1 January 2018)	Recognise market value of role and individual's skills, experience and performance to ensure the business can attract and retain talent.	£897,000	£641,650	\$1,053,700
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) Performance condition Deferral into Deferred Bonus Plan	112.5%/225% 75% financial/25% non-financial One-third compulsory deferral	80%/160% 50% on relative TSR/50% on three-year EPS growth
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) Performance condition	370% 50% on relative TSR/50% on three-year EPS growth	335% 298%
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.

2. The appointment of Charles Woodburn as Chief Executive with effect from 1 July 2017 is detailed on page 100.

Annual remuneration report

for the year ended 31 December 2017

This section details the remuneration of the executive and non-executive directors (including the Chairman) during the financial year ended 31 December 2017 and will be proposed for an advisory vote by shareholders at the 2018 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.

Directors' remuneration in the year ending 31 December 2018

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 2018 will be implemented as follows:

- The salary of the Chief Executive is being increased by 2.5% to £897,000 with effect from 1 January 2018.
- The salary of the Group Finance Director is being increased by 2.5% to £641,650 with effect from 1 January 2018.
- The salary of the President and Chief Executive Officer of BAE Systems, Inc. is being increased by 3% to \$1,053,700 with effect from 1 January 2018.
- 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 2018 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.
- The fee for the Chairman is set at £700,000 per annum until February 2020.

As agreed by the Non-Executive Directors' Fees Committee (whose composition is detailed on page 114), the fee structure for non-executive directors, which will not be reviewed until 1 April 2020, is as follows:

- Basic fee is £80,000 per annum.
- Senior Independent Director's fee is £25,000 per annum.
- Remuneration Committee Chairman's fee is £25,000 per annum.
- Corporate Responsibility Committee Chairman's fee is £25,000 per annum.
- Audit Committee Chairman's fee is £25,000 per annum.
- Travel allowance of £4,500 per meeting, payable on each occasion that a scheduled Board meeting necessitates air travel of more than five hours (one way), subject to a maximum of six travel allowances per year.

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Remuneration policy

The Company's remuneration policy approved at the 2017 AGM, which took effect on 10 May 2017, is detailed on pages 117 to 129.

The Company's remuneration policy approved at the 2014 AGM, which was in effect until 10 May 2017, is available on the Company's website: baesystems.com

Annual remuneration report

continued

Single total figure of remuneration

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

	Fees		Benefits		Other		Total	
	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000
Chairman								
Sir Roger Carr	696	650	—	—	—	—	696	650
Non-executive directors								
E P L Corley ¹	79	69	2	2	5	9	86	80
H Green	79	75	3	2	5	9	87	86
C M Grigg	79	75	2	—	5	9	86	84
P Rosput Reynolds	103	95	7	7	27	27	137	129
N C Rose	127	120	1	2	5	9	133	131
I P Tyler	103	95	1	1	5	9	109	105

1. Appointed to the Board on 1 February 2016.

Chairman

Sir Roger Carr was appointed as Chairman on 1 February 2014 on a fixed annual fee of £650,000 throughout his initial three-year term as Chairman. As reported last year, his fee was reviewed in 2016 and was increased to £700,000 per annum with effect from 1 February 2017. This fee will not be reviewed again for the remainder of his current three-year term.

Non-executive directors

As reported last year, the fee structure for the non-executive directors was reviewed and was increased for the first time since 2012. With effect from 1 April 2017, the fee structure on a per annum basis is 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 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	
	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000	2017 £'000	2016 £'000
I G King ^{*6}	491	982	33	47	838	1,820	504	–	219	613	1	1	2,086	3,463
C N Woodburn ^{**7}	813	486	23	17	1,311	823	–	n/a	154	95	1	1,621	2,302	3,042
P J Lynas	592	571	29	34	724	752	332	–	570	405	1	1	2,248	1,763
J DeMuro ⁸	794	736	35	25	1,578	1,531	441	–	11	12	950	693	3,809	2,997

* Retired as Chief Executive and from the Board on 30 June 2017.

**Appointed to the Board on 9 May 2016 as Chief Operating Officer, and appointed as Chief Executive on 1 July 2017.

The above table has been subject to audit.

1. The benefits received by Ian King include the provision of a car allowance and the private use of a chauffeur-driven car (2017 £28k; 2016 £47k). In addition, upon his retirement, Ian King received a leaving gift totalling £5k, with any tax due on this payment being settled by the Company. The benefits received by Charles Woodburn include the provision of a car allowance and the private use of a chauffeur-driven car (2017 £23k; 2016 £17k). The benefits received by Peter Lynas include the provision of a car allowance and the private use of a chauffeur-driven car (2017 £21k; 2016 £19k). In addition, Peter Lynas received a second residence allowance of £8k (2016 £15k) on the basis disclosed in previous years. Jerry DeMuro's benefits include private use of a chauffeur-driven car and parking (2017 £3k; 2016 £4k); medical and dental benefits (2017 £14k; 2016 £12k); insured life and disability benefits (2017 £9k; 2016 £8k); and the private use of a company aircraft (2017 £9k; 2016 £1k).
2. Further detail on bonus payments is provided on page 101. 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. The same deferral treatment applies to the net bonus paid to Ian King in respect of the pro-rated bonus for his six months of service in 2017.
3. This column relates to the estimated or actual value of Long-Term Incentive Plans for which the performance period ended in the relevant financial year. With respect to the 2015 LTIP PS^{EPS} award, average annual EPS growth over the three-year performance period was approximately 4.75% and, consequently, 46.9% of the shares under this award will vest. The 2015 LTIP PS^{TSR} and LTIP SO awards (for which the performance periods also ended on 31 December 2017) did not meet their TSR performance condition and will lapse (see page 104 for further detail).
4. The figures for Ian King and 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. The figures for Ian King 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 (see note 2 on page 107 for details on pension paid for the six months from retirement to 31 December 2017). The figures for Peter Lynas allow for the impact of a pension sharing order effective in 2017. 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 salary increases since 31 December 2016.
 - 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 2017 figures, the reference CPI inflation was 1%.
The figures for Charles Woodburn relate to a salary supplement in lieu of Company pension contributions.
5. The figures for Jerry DeMuro include company contributions paid into his Section 401(k) defined contribution arrangement.
6. This column includes (i) the value of Free Share awards under the UK all-employee Share Incentive Plan (SIP) of £505 for Charles Woodburn and Peter Lynas, and Matching Shares under voluntary investment in the SIP for Ian King (for the six months to 30 June 2017) and Charles Woodburn; and (ii) for Jerry DeMuro, the value of the 2017 grant of Restricted Shares (£837k). This award formed part of Jerry DeMuro's 2017 LTIP allocation but is required to be reported under 'Other' as it has no performance conditions attached; his prior year figure relates to a similar Restricted Shares award in 2016. The balance of the 2017 figure (£113k) relates to the value of notional reinvested dividends in respect of his 2014 Restricted Share Plan award which vested in March 2017, the third anniversary of grant. The value of the related award was reported in the 2014 Remuneration report. The prior year figure for Charles Woodburn includes the cash payment of £1,620,000 to recognise forfeited compensation from his previous employer, as set out in note 7 below.

Annual remuneration report continued

Single total figure of remuneration continued

6. As previously reported, Ian King retired from the Company on 30 June 2017 having served for over 40 years, including leading BAE Systems as Chief Executive since 2008. His leaving arrangements were as follows:
 - (a) His retirement constituted early retirement with Company consent for share plan and pension purposes and, accordingly: (i) he was entitled to an immediate pension. Under the rules of the 2000 Pension Plan and Executive Pension Scheme, a pension of 1/30th of three-year final average salary for each year of service subject to the payment of members' contributions (currently 8%) is payable at 62 years of age. Benefits paid prior to age 62 are subject to actuarial reduction, currently a reduction of 4% to annual benefits for each year that retirement takes place prior to age 62, with proportionate reductions applied in respect of part years. He was 61 at the date of his retirement and his pension payments were reduced accordingly; (ii) unvested share awards and options under the Company's Long-Term Incentive Plan will vest at the normal vesting date, subject to testing of the relevant performance conditions at the end of the normal performance period. Share awards were reduced pro-rata on the basis of complete months from the grant date to 30 June 2017. Any share options that vest will remain exercisable for a period of six months from the vesting date; and (iii) unvested deferred bonus awards were preserved and will vest at the normal vesting dates.
 - (b) He will continue to be covered by the Company's Directors' and Officers' insurance policy and his director's indemnification arrangements will remain in force.
 - (c) He will continue to be bound by those provisions of his service agreement which continue to apply following cessation of employment, including post-termination restrictive covenants and confidentiality provisions.
 - (d) He was eligible for an Annual Incentive payment for 2017, determined by the Committee, based on an assessment of individual and Company performance. Any bonus was to be pro-rated for his six months of service during 2017 and will be paid at the normal date following the end of the 2017 financial year. One-third of the net bonus will be compulsorily deferred into shares in the normal way (see page 101 for further detail).
 - (e) No award was granted under the Long-Term Incentive Plan in 2017.
 - (f) No termination payment was paid.
 - (g) Taxable benefits comprising the provision of a car allowance and the private use of a chauffeur-driven car ceased from 30 June 2017.
7. As previously reported, Charles Woodburn was appointed as Chief Operating Officer on 9 May 2016 and joined the Board as an executive director on the same date. His salary on appointment was £750,000, with a maximum bonus opportunity of 200% of salary, of which one-third will be deferred in shares for a period of three years. He also received LTIP awards at the following levels: Performance Share award of 230% of salary and Share Option award of 300% of salary. In addition, he received the following awards to take into account the fair value of the awards being forfeited which significantly extend the vesting/holding period of the incentives being given up:
 - (i) cash payment of £1,620,000 in respect of incentives earned and payable within six months, of which 50% of this net amount was to be used to purchase BAE Systems shares within 120 days following payment. Due to BAE Systems being in a closed period from 1 January 2017 until the announcement of the Company's results on 23 February 2017, the Remuneration Committee agreed to extend the period in which Charles was required to buy the shares to the end of February 2017. These shares continue to be held in accordance with BAE Systems' Minimum Shareholding Requirement; and
 - (ii) a one-off grant of Performance Shares equal to 266% of salary, subject to the same performance conditions applicable to awards made under the LTIP with vesting in equal tranches of one-third in 2019, one-third in 2020 and the final third in 2021.
- His pension arrangements are set out on pages 107 and 108.
On his appointment as Chief Executive on 1 July 2017, his salary increased to £875,000 per annum. All other provisions of his remuneration package are as set out in the Company's remuneration policy in respect of the Chief Executive role.
8. Jerry DeMuro is paid in US dollars with the disclosed figures above being converted into sterling at the required exchange rate. The 2017 salary reflects his 3.0% salary increase and the exchange rate fluctuations experienced in 2017.

Annual bonus

Annual bonuses for the 2017 year are paid in March 2018. 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. As previously reported, one-third of the net bonus due to Ian King for the six-month period he served in 2017 will be compulsorily deferred into shares in the normal way.

Chief Operating Officer to 30 June 2017 and Chief Executive since 1 July 2017

Charles Woodburn

Measures	Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2017	Target for 2017	Stretch for 2017	Actual performance ¹	Percentage of maximum opportunity
		Below	Threshold	Target	Stretch					
Financial	Group EPS	40.0				39.8p	40.6p	42.6p	42.3p	92.5%
	Group cash	25.0				£(1,947)m	£(1,807)m	£(1,508)m	£(940)m	100.0%
	Group order intake	15.0	■			n/a	£23.6bn	£24.5bn	£19.3bn	0%
Personal	Safety	5.0							See note 2 below	40.0%
	Key strategic objectives	15.0							See Key strategic objectives section on page 102	77.0%
Total bonus (as a percentage of maximum)										75.6%

Group Finance Director

Peter Lynas

Measures	Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2017	Target for 2017	Stretch for 2017	Actual performance ¹	Percentage of maximum opportunity
		Below	Threshold	Target	Stretch					
Financial	Group EPS	40.0				39.8p	40.6p	42.6p	42.3p	92.5%
	Group cash	25.0				£(1,947)m	£(1,807)m	£(1,508)m	£(940)m	100.0%
	Group order intake	15.0	■			n/a	£23.6bn	£24.5bn	£19.3bn	0%
Personal	Safety	5.0							See note 2 below	40.0%
	Key strategic objectives	15.0							See Key strategic objectives section on page 103	83.0%
Total bonus (as a percentage of maximum)										76.5%

President and Chief Executive Officer of BAE Systems, Inc.

Jerry DeMuro

Measures	Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2017	Target for 2017	Stretch for 2017	Actual performance ¹	Percentage of maximum opportunity
		Below	Threshold	Target	Stretch					
Financial	Group EPS	13.3				39.8p	40.6p	42.6p	42.3p	92.5%
	Group cash	8.3				£(1,947)m	£(1,807)m	£(1,508)m	£(940)m	100.0%
	Group order intake	5.0	■			n/a	£23.6bn	£24.5bn	£19.3bn	0%
	BAE Systems, Inc. profit	26.7				\$1,119m	\$1,138m	\$1,186m	\$1,189.6m	100.0%
	BAE Systems, Inc. cash	16.7				\$1,991m	\$2,044m	\$2,148m	\$2,355m	100.0%
	BAE Systems, Inc. order intake	10.0				n/a	\$10.6bn	\$11.1bn	\$11.3bn	100.0%
Personal	Safety	5.0							See note 2 below	40.0%
	Key strategic objectives	15.0							See Key strategic objectives section on page 103	82.5%
Total bonus (as a percentage of maximum)										88.4%

Chief Executive to 30 June 2017

Ian King

Measures	Weight (as a percentage of target)	Actual performance against targets set				Threshold for 2017	Target for 2017	Stretch for 2017	Actual performance ¹	Percentage of maximum opportunity
		Below	Threshold	Target	Stretch					
Financial	Group EPS	40.0				39.8p	40.6p	42.6p	42.3p	92.5%
	Group cash	25.0				£(1,947)m	£(1,807)m	£(1,508)m	£(940)m	100.0%
	Group order intake	15.0	■			n/a	£23.6bn	£24.5bn	£19.3bn	0%
	Safety	5.0							See note 2 below	40.0%
	Key strategic objectives	15.0							See Key strategic objectives section on page 102	79.0%
Total bonus (as a percentage of maximum)										75.9%

The above table has been subject to audit.

1. Adjusted to be on a like-for-like basis with the targets.

2. Performance against the safety element of the bonus was determined by the Corporate Responsibility Committee (whose composition is stated on page 87) taking account of the level of significant risk reduction and improvement in safety culture, as well as targeted improvements against key safety indicators including a reduction in recordable accidents. While the Group achieved a 3% reduction in recordable accidents, it did not meet the 10% target level. A 30% reduction in the most severe accidents was delivered resulting in an overall performance award factor of 40% of maximum.

Annual remuneration report continued

Key strategic objectives

Achievement against key strategic objectives represents 15% 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.

Ian King

Chief Executive (until 30 June 2017)

Overview	Key achievements in the six-month period
For 2017, the focus of Ian's personal objectives was on sustaining the building blocks to meet long-term growth as well as continuing to foster an inclusive environment and developing a strong pipeline of talent for future succession within the business.	<ul style="list-style-type: none"> – Assuring continuity in executive leadership – Successful handover to Charles Woodburn – Securing production contracts on key maritime programmes – Maintaining the Company's UK workshare across strategic manufacturing activity – Driving positive customer relationships to secure additional orders in key international markets

Payout (% of maximum): 79%

Charles Woodburn

Chief Operating Officer (until 30 June 2017) and Chief Executive (from 1 July 2017)

Overview	Key achievements in the year
Prior to his transition to the role of Chief Executive, Charles's objectives as Chief Operating Officer focused on driving competitiveness and technology to position the business for long-term growth.	<ul style="list-style-type: none"> – Establishing a global procurement strategy to drive savings across the enterprise – Achieving major milestones in respect of Air sector capability upgrade programmes – Establishing global cyber collaboration across all key markets – Taking a lead role in ensuring R&D funding is pulled through into product plans – Undertaking the transition from Ian King with a clear sense of purpose communicated clearly to internal and external audiences – Implementation of new operating and organisational models to deliver improved efficiency and competitiveness

Payout (% of maximum): 77%

Peter Lynas

Group Finance Director

Overview	Key achievements in the year
<p>Peter's objectives were focused on maintaining the Group's investor proposition and ensuring the delivery of deficit recovery plans for the UK pension schemes.</p>	<ul style="list-style-type: none">– Sustaining the Group's investment-grade credit rating through budget discipline, cash management and a strong well-monitored framework of controls– Reaching agreement on pension deficit recovery plans with Trustees and the Pensions Regulator– Exceeding performance benchmarks on internally-managed pension scheme asset portfolios

Payout (% of maximum): 83%

Jerry DeMuro

President and Chief Executive Officer of BAE Systems, Inc.

Overview	Key achievements in the year
<p>Jerry's objectives included defending and capturing growth in our core franchises, with specific focus on organic growth initiatives in Precision Munitions, Space, and Land Vehicles as well as driving collaboration and international market opportunities.</p>	<ul style="list-style-type: none">– Successful execution of key programme milestones across Electronics, Land, and Services sectors– Continued progress in securing additional international business– Growing domestic portfolio positions in each of BAE Systems, Inc.'s businesses– Driving efficiencies in Enterprise Shared Services to reduce cost whilst maintaining agreed service standards– Identifying and delivering key global collaboration opportunities

Payout (% of maximum): 82.5%

Annual remuneration report

continued

Long-Term Incentive Plan (LTIP) performance

Annual average EPS growth

	Threshold	Maximum	Actual	Percentage of maximum achieved
Outperformance of performance conditions ending on 31 December 2017				
2017 EPS requirement	41.3p	45.9p	43.3p	
Annual average EPS growth	3%	7%	4.75%	46.9%

Relative TSR against comparator group

	Threshold	Maximum	Actual	Percentage of maximum achieved
Outperformance of performance conditions ending on 31 December 2017				
TSR against comparator group	68.7%	128.0%	41.0%	0%

The following awards had performance periods that ended on 31 December 2017:

2015 Performance Shares (LTIP PS)

- Performance conditions: half on relative TSR against comparator group, half on EPS growth of 3% to 7% per annum. The TSR three-year performance period ended on 31 December 2017 and the related performance condition was not met, thus this portion of the award will lapse. With respect to the 2015 LTIP PS^{EPS} award (for which the performance period ended on 31 December 2017), the growth of EPS over the three-year performance period was approximately 4.75% and, consequently, 46.9% of the shares under this portion of the award will vest. 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 46.9% of the EPS portion.

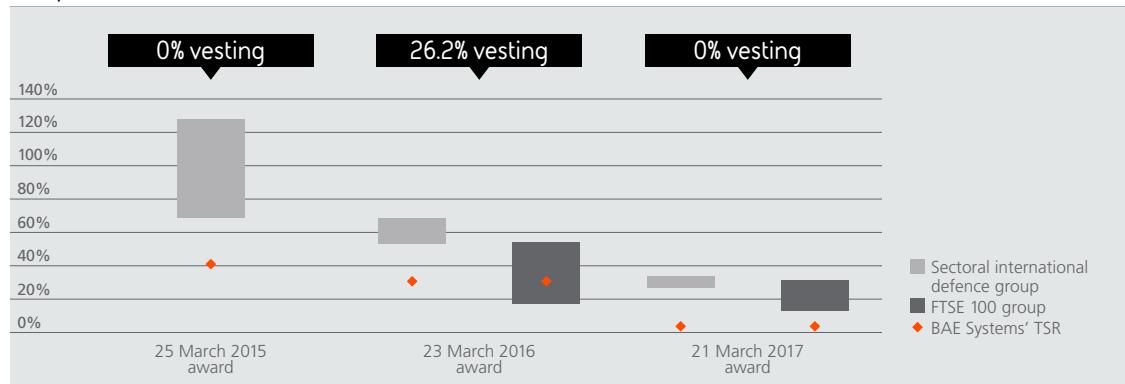
2015 Share Options (LTIP SO)

- Performance condition: relative TSR against comparator group. The TSR three-year performance period ended on 31 December 2017 and the related performance condition was not met, thus the award will lapse.

A summary of TSR performance to 31 December 2017 on outstanding TSR-related LTIP awards is illustrated in the chart below.

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.

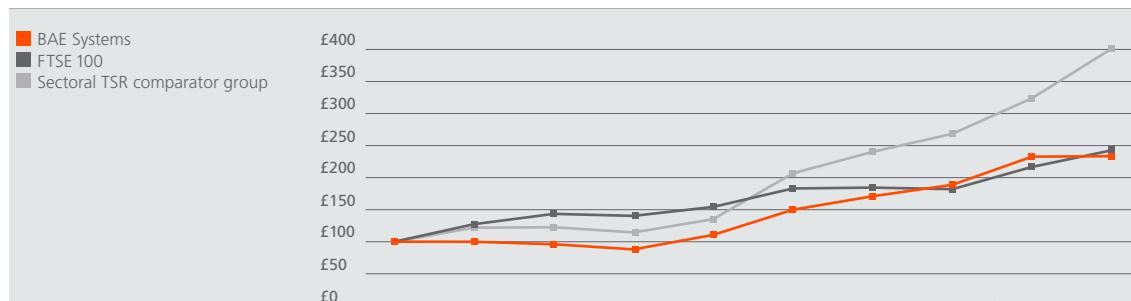
TSR performance under the TSR-related awards as at 31 December 2017



Total Shareholder Return (TSR) performance and Chief Executive pay

The graph below shows the value by 31 December 2017, on a TSR basis, of £100 invested in BAE Systems on 31 December 2008 compared with the value of £100 invested in the FTSE 100 index, including the effect of dividends. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity index of which BAE Systems is a constituent member and reflects the 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 TSR comparator group of other international defence companies which is of relevance to our international shareholder base.

Value at 31 December 2017 of £100 investment at 31 December 2008



Change in Chief Executive's remuneration over nine years

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 ¹
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	
Charles Woodburn	–	–	–	–	–	–	–	–	–	1,279
	4,030	4,810	4,613	2,574	2,499	3,519	2,929	3,463	3,365	
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%	
Charles Woodburn	–	–	–	–	–	–	–	–	–	75.8%
LTI as a percentage of maximum vesting²										
Ian King	65.5%	57.6%	44.3%	nil	nil	16.8%	nil	nil	11.3%	
Charles Woodburn	–	–	–	–	–	–	–	–	–	n/a

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 the financial year.

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

The percentage change from 2016 to 2017 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. The relevant remuneration figures applying for 2017 in respect of the Chief Executive role are included in the table for reference. As Charles Woodburn's overall remuneration is lower than Ian King's, the calculation for 2017 results in a downward movement in the year-on-year percentage change. If the table below reflected Ian King's remuneration for the full financial year, the percentage movement on a like-for-like basis would be a 0% increase in salary and a decrease of 7.9% in bonus.

	Chief Executive remuneration to 31 December 2017 £'000	Change in Chief Executive's remuneration %	Change in average UK employee ¹ remuneration %
Base salary	929	-5.5	+2.9
Taxable benefits	44	-4.9	+2.9
Bonus	1,585	-12.9	-2.7

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.

Annual remuneration report continued

Pay ratio of Chief Executive to average employee

The ratio of remuneration of the Chief Executive to the average employee of the entire Group over the last four years was as follows:

	2014	2015	2016	2017
Chief Executive's remuneration (£'000)	3,519	2,929	3,463	3,365
Average employee remuneration (£'000)	58	62	67	72
Ratio	60:1	47:1	52:1	47:1

The Chief Executive's remuneration is calculated on the same basis as the single total figure of remuneration table. The 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.

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 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 above provides the ratio of remuneration of the Chief Executive to the average employee of the Group for the past four 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.

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 2016 and 2017.

Underlying EBITA¹ (£m)



Returns to shareholders (£m)



Total employee costs² (£m)



Average headcount³ ('000)



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 28).

2. After excluding the impact of exchange translation, total employee costs increased by 4% per employee on 2016.

3. Excluding share of equity accounted investments.

Pension entitlements**Total pension entitlements**

Director	Age	Normal retirement age	Accrued benefit at 1 January 2017 ^{1,2,3,4} £ per annum	Accrued benefit at 31 December 2017 ^{1,2,3,4} £ per annum	Figures included in the remuneration table on page 99		
					Added pension value received in the year from defined benefit scheme ² £	Added pension value received in the year from defined contribution scheme £	Total £
Ian King*	61	62	857,652	875,235	218,946	n/a	218,946
Charles Woodburn	46	65	7,270	17,486	n/a	–	–
Peter Lynas	59	62	251,954	285,564	569,871	n/a	569,871
Jerry DeMuro	62	65	99,884	136,043	n/a	10,816	10,816

*Retired on 30 June 2017.

1. The defined benefit figure includes both funded and unfunded arrangements for Ian King and Peter Lynas. Accrued benefit for Ian King and Peter Lynas is annual pension payable on retirement prior to any reduction for early payment or exchanging pension for cash.
2. Ian King's accrued benefit in this column is his accrued benefit at his retirement date of 30 June 2017, prior to any reduction for early retirement. There was no further accrual of benefit between 30 June 2017 and 31 December 2017. He retired at 30 June 2017 with a pension of £745,229 per annum (with his pension payments totalling £372,615 for the six months from retirement to 31 December 2017) and a cash lump sum of £1,132,032 (excluding Additional Voluntary Contributions). These figures allow for a reduction in respect of Early Retirement Factors to allow for the benefit being drawn before his Normal Retirement Age. The brought forward accrued benefit figure as at 1 January 2017 has been reduced by £3,516 from that disclosed in 2016 to properly reflect the longevity adjustment factor that applies.
3. Peter Lynas has accrued defined benefit pension which is reduced if taken before normal retirement age. 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. Accrued benefit figures for Peter Lynas include the impact of a pension sharing order effective in 2017.
4. 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.

The above table has been subject to audit.

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.

Annual remuneration report continued

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 32 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.

Ian King is a member of the ExPS (which he joined in 1999) and the 2000 Plan, with benefits in line with those set out above and had opted to take an unfunded promise. At his retirement on 30 June 2017 he had 34 years' service in the 2000 Plan and became a pensioner member. As reported last year, when he retired as a director and ceased employment on 30 June 2017, his retirement constituted early retirement with Company consent for pension purposes and, accordingly, he was entitled to an immediate pension. Under the rules of the 2000 Plan and the ExPS, and as set out above, a pension of 1/30th of three-year final average salary for each year of service subject to the payment of members' contributions (currently 8%) is payable at 62 years of age. Benefits paid prior to age 62 for ExPS and age 65 for 2000 Plan will be subject to actuarial reduction, currently a reduction of 4% to annual benefits for each year that retirement takes place prior to 62 for ExPS and 65 for 2000 Plan, with proportionate reductions applied in respect of part years. Ian King was 61 at the date of his retirement and his pension payments were reduced accordingly.

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 limit 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 (2018 \$18,500; 2017 \$18,000). In 2017, the company paid contributions of \$14,628 into this arrangement.

External directorships

Fees retained in 2017 by executive directors, during the period in which they served in that capacity, in respect of non-executive directorships were: Peter Lynas £85,000 in respect of his directorship of SSE plc; Jerry DeMuro \$50,000 in respect of his directorship of Aero Communications, Inc.; and Ian King £35,000 in respect of his non-executive directorship of Schroders plc for the six months to 30 June 2017.

These amounts are not included in the remuneration table on page 99.

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	21.03.17	132,897	115% of salary	862,502	nil	Three years to 31.12.19	TSR/secondary financial measure	25%
LTIP PS ^{EPS}	Performance Shares/nil cost option	21.03.17	132,897	115% of salary	862,502	nil	Three years to 31.12.19	EPS/secondary financial measure	25%
LTIP SO	Share option	21.03.17	346,687	300% of salary	2,249,999	6.49	Three years to 31.12.19	TSR/secondary financial measure	25%
Peter Lynas									
LTIP PS ^{TSR}	Performance Shares/nil cost option	21.03.17	96,944	107.5% of salary	629,167	nil	Three years to 31.12.19	TSR/secondary financial measure	25%
LTIP PS ^{EPS}	Performance Shares/nil cost option	21.03.17	96,945	107.5% of salary	629,173	nil	Three years to 31.12.19	EPS/secondary financial measure	25%
LTIP SO	Share option	21.03.17	270,543	300% of salary	1,755,824	6.49	Three years to 31.12.19	TSR/secondary financial measure	25%
Jerry DeMuro									
LTIP PS ^{TSR}	Performance Shares	21.03.17	156,092	121% of salary	1,013,037	n/a	Three years to 31.12.19	TSR/secondary financial measure	25%
LTIP PS ^{EPS}	Performance Shares	21.03.17	156,092	121% of salary	1,013,037	n/a	Three years to 31.12.19	EPS/secondary financial measure	25%
LTIP SO	Share option	21.03.17	503,106	390% of salary	3,265,158	6.49	Three years to 31.12.19	TSR/secondary financial measure	25%
LTIP RS	Retention	21.03.17	129,002	100% of salary	837,223	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. SO – Share Options. RS – Restricted Shares.

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

No grant of awards was made to Ian King in March 2017 in view of his previously announced retirement on 30 June 2017.

The table above has been subject to audit.

Annual remuneration report

continued

Description of share plans and summary of performance conditions

Performance Share Plan (PSP)/LTIP Performance Shares

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*. For US participants, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition being achieved. Since 2015, shares have been awarded under the LTIP (a single umbrella plan) that was approved at the 2014 AGM as detailed on page 119 and are termed 'Performance Shares'. Shares under award attract dividends prior to tranche vesting.

*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 (see the UK executive director graphic on page 93). They will be exercisable until the seventh anniversary of grant.

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

Plan	Performance condition
LTIP PS ^{EPS}	For awards made from 2015, rate of average annual EPS growth over the three-year performance period, with 25% vesting at 3% average growth per annum, 50% vesting at 5% average growth per annum and 100% vesting at 7% average growth per annum, with vesting on a straight-line basis between these parameters. Awards will not vest unless the Board is satisfied that there has been a sustained improvement in the Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; order book; risk; and project performance.
PSP ^{TSR} /LTIP PS ^{TSR}	The proportion of the award capable of exercise is determined by: (i) for awards made up to and including 2015, the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. For awards made from 2016, 50% of the TSR measure is on the current peer 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 below the top 50% of TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters; and (ii) whether there has been a sustained improvement in the Company's underlying financial performance. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA ¹ ; order book; turnover; risk; and project performance.

1. Operating profit excluding amortisation and impairment of intangible assets, finance costs and taxation expense of equity accounted investments.

The TSR peer 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	

The TSR comparator group for awards from 2012 to 2015 comprises:

Cobham	Leonardo ³	Raytheon
General Dynamics	Lockheed Martin	SAIC
ITT Exelis ⁴	Meggitt	Thales
L3 Technologies ²	Northrop Grumman	United Technologies

2. Formerly named L-3 Communications.

3. Formerly named Finmeccanica.

4. ITT Exelis is now part of Harris Corporation.

Executive Share Option Plan 2012 (ExSOP²⁰¹²)/LTIP Share Options

Options are normally exercisable between the third and tenth anniversary of their grant, subject to the performance condition set out below being achieved. Since 2015, shares have been awarded under the single umbrella plan (the Long-Term Incentive Plan) that was approved at the 2014 AGM as detailed on page 119 and are termed 'Share Options'. Awards made from 2015 are subject to a further two-year clawback period after the initial three-year vesting period. As set out elsewhere in this report, executive directors will no longer receive share option awards from 2018.

Plan	Performance condition
ExSOP ²⁰¹² / LTIP SO	For awards made up to and including 2015, the proportion of the award capable of exercise is determined by the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 12 other international defence companies over a three-year performance period. For awards made from 2016, 50% of the TSR measure is on the current peer 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 below the top 50% of TSRs achieved by the comparator group, with 25% vesting at median, 100% vesting if it is in the top quintile and vesting on a straight-line basis between these two parameters.

Restricted Share Plan (RSP)/LTIP Restricted Shares

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US. The shares are subject only to the condition that the participant remains employed by the Group at the end of the vesting date (three years after the award date). Shares under award attract dividends prior to vesting. Since 2015, shares have been awarded under the single umbrella plan that was approved at the 2014 AGM as detailed on page 119 and are termed 'Restricted Shares'. Awards made from 2015 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. The MSR does not apply after the individual has ceased to be a director. Any case of non-compliance would be dealt with by the Committee.

The following table sets out MSR Initial Value and Subsequent Value:

	Initial Value	Subsequent Value
Ian King*	150%	300%
Charles Woodburn	150%	300%
Peter Lynas	100%	200%
Jerry DeMuro	175% (212.5% from 2018)	350% (425% from 2018)

*Retired on 30 June 2017.

Peter Lynas was in excess of his 'Subsequent Value' MSR at 31 December 2017, as was Ian King on 30 June 2017, the date of his retirement. Jerry DeMuro joined the Board in 2014 and his personal holding of shares in the Company at 31 December 2017 stood at 153%. The higher MSR values applicable to Jerry DeMuro recognise the higher LTI opportunity and broader US market practice. Charles Woodburn joined the Board in May 2016 and his personal shareholding in the Company at 31 December 2017 stood at 63%.

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.

Annual remuneration report

continued

Share interests as at 31 December 2017 (or on ceasing to be a director of the Company)

The interests of the directors, who served during the year ended 31 December 2017, in the shares of BAE Systems plc, or scheme interests in relation to those shares, were as follows:

	Shares	Scheme interests: Options and awards over shares				
		Share awards with performance conditions	Share awards without performance conditions	Share options with performance conditions	Share options with performance conditions, vested but unexercised	Total scheme interests
Sir Roger Carr	126,093	—	—	—	—	—
E P L Corley	10,000	—	—	—	—	—
J DeMuro	202,335	941,831	389,187	1,517,828	—	2,848,846
H Green	—	—	—	—	—	—
C M Grigg	24,555	—	—	—	—	—
I G King ¹	1,923,894	—	—	1,198,463	—	1,198,463
P J Lynas	232,944	—	—	1,582,740	—	1,582,740
P Rosput Reynolds	25,200	—	—	—	—	—
N C Rose	55,000	—	—	—	—	—
I P Tyler	—	—	—	—	—	—
C N Woodburn	96,966	—	—	1,687,187	—	1,687,187

1. Retired from the Board on 30 June 2017. Ian King's scheme interests stated as at 30 June 2017 are after pro-rating in accordance with his leaving arrangements referred to on page 100.

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 Depository Shares. Details of the share interests in options and awards held by the executive directors as at 31 December 2017 are given on page 113 and details of share options exercised in 2017 are given on page 114.

Performance Shares granted under the LTIP are classified as share awards with performance conditions for the US executive director and as share options with performance conditions for the UK executive directors.

Since 31 December 2017, Charles Woodburn has acquired an additional 77 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 97,043.

Revathi Advaithi, who was appointed to the Board on 1 January 2018, had a nil shareholding in BAE Systems plc at the date of her appointment and at the date of this report.

There have been no changes in the interests of the remaining directors in the shares of BAE Systems plc between 31 December 2017 and the date of this report.

Breakdown of scheme interests: Options and awards held as at 31 December 2017 (or on ceasing to be a director of the Company)

Ian King*

	31 December 2017*	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{TSR}	167,842¹	25.03.15	nil	25.03.18
LTIP PS ^{EPS}	167,843²	25.03.15	nil	25.03.18
LTIP PS ^{TSR}	104,535³	23.03.16	nil	23.03.19
LTIP PS ^{EPS}	104,536³	23.03.16	nil	23.03.19
	544,756¹			
LTIP SO	402,822¹	25.03.15	5.43	25.03.18
LTIP SO	250,885³	23.03.16	4.99	23.03.19
	653,707			

*The figures for Ian King are stated as at 30 June 2017, the date of his ceasing to be a director. His share options and awards stated as at 30 June 2017 are after pro-rating in accordance with his leaving arrangements referred to on page 100. There were no subsequent changes to his scheme interests between 30 June 2017 and 31 December 2017 which remain subject to the relevant performance conditions.

Jerry DeMuro

	31 December 2017	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{TSR}	146,620¹	25.03.15	n/a	25.03.18
LTIP PS ^{EPS}	146,621²	25.03.15	n/a	25.03.18
LTIP PS ^{TSR}	168,203³	23.03.16	n/a	23.03.19
LTIP PS ^{EPS}	168,203³	23.03.16	n/a	23.03.19
LTIP PS ^{TSR}	156,092³	21.03.17	n/a	21.03.20
LTIP PS ^{EPS}	156,092³	21.03.17	n/a	21.03.20
	941,831			
LTIP SO	472,579¹	25.03.15	5.43	25.03.18
LTIP SO	542,143³	23.03.16	4.99	23.03.19
LTIP SO	503,106³	21.03.17	6.49	21.03.20
	1,517,828			
LTIP RS	121,174	25.03.15	n/a	25.03.18
LTIP RS	139,011	23.03.16	n/a	23.03.19
LTIP RS	129,002	21.03.17	n/a	21.03.20
	389,187			

1. The outstanding option or award will lapse after the end of the financial year having not met the full performance condition.
2. The outstanding option or award will partially lapse after the end of the financial year having not met the full performance condition.
3. Subject to a performance condition that is yet to be tested.

Peter Lynas

	31 December 2017	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{TSR}	110,373¹	25.03.15	nil	25.03.18
LTIP PS ^{EPS}	110,373²	25.03.15	nil	25.03.18
LTIP PS ^{TSR}	123,060³	23.03.16	nil	23.03.19
LTIP PS ^{EPS}	123,060³	23.03.16	nil	23.03.19
LTIP PS ^{TSR}	96,944³	21.03.17	nil	21.03.20
LTIP PS ^{EPS}	96,945³	21.03.17	nil	21.03.20
	660,755			
LTIP SO	308,018¹	25.03.15	5.43	25.03.18
LTIP SO	343,424³	23.03.16	4.99	23.03.19
LTIP SO	270,543³	21.03.17	6.49	21.03.20
	921,985			

Charles Woodburn

	31 December 2017	Date of grant	Exercise price £	Date from which exercisable or part exercisable
LTIP PS ^{TSR}	334,833³	06.09.16	nil	06.09.19
LTIP PS ^{EPS}	334,833³	06.09.16	nil	06.09.19
LTIP PS ^{TSR}	132,897³	21.03.17	nil	21.03.20
LTIP PS ^{EPS}	132,897³	21.03.17	nil	21.03.20
	935,460			
LTIP SO	405,040³	06.09.16	5.56	06.09.19
LTIP SO	346,687³	21.03.17	6.49	21.03.20
	751,727			

Annual remuneration report continued

Options exercised during 2017

Ian King

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
ExSOP ²⁰¹²	256,279	3.01	29.03.12	23.02.17	6.11
PSP ^{TSR}	17,797	nil	29.03.12	11.05.17	6.39

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

The tables on page 113 and above have been subject to audit.

Performance conditions

Performance conditions for the LTIP, PSP and ExSOP²⁰¹² are detailed on pages 110 and 111.

Statement of voting

Shareholder voting on the resolutions to approve the Directors' remuneration policy and the Annual remuneration report put to the 2017 AGM was as follows:

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

Annual remuneration report

Votes for	%	Votes against	%	Total votes cast	Votes withheld (abstentions)
2,322,287,980	97.25	65,571,040	2.75	2,387,859,020	22,440,400

Non-Executive Directors' Fees Committee

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, since 1 July 2017, Charles Woodburn. Ian King also served as a member of the committee until his retirement on 30 June 2017.

Peter Lynas

	Exercised during the year	Exercise price £	Date of grant	Date of exercise	Market price on exercise £
PSPTS ^R	10,090	nil	29.03.12	24.05.17	6.52

The PSP option exercised by Peter Lynas attracted reinvested dividends which equated to an additional 1,601 shares.

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.

Adviser	Services provided	Appointment	Governance	Fees (in respect of services provided to the Committee)
PricewaterhouseCoopers (PwC)	During 2017, provided information on market practice in relation to different aspects of remuneration, market trends and benchmarking of the remuneration packages for the executive population. Subsequently appointed in 2018 as independent adviser to the Committee.	By the Company at the request of the Committee. Committee appointment.	In 2017 PwC did not directly engage with the Committee but will do so in 2018 following the appointment as independent adviser to the Company. 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.	£54,000 Fee basis: Hourly
Willis Towers Watson (WTW)	During 2017, advised the Committee members on remuneration matters, including independent advice on the information and proposals presented to the Committee by Company executives.	Committee appointment.	WTW engaged directly with the members of the Committee. The Committee is aware that WTW provides a variety of other services to the Company, including corporate risk management advice and insurance brokerage services. WTW also provides a range of HR consultancy services related to human capital management and employee benefits. WTW is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£34,159 Fee basis: Hourly
Linklaters	Provided legal services, principally regarding remuneration policy regulations and revision of the rules of the BAE Systems Long-Term Incentive Plan 2014 to reflect changes to reward structures.	By the Company with the approval of the Committee.	Only provides legal compliance, legal drafting and review services, and does not advise the Committee. The Committee is aware that Linklaters is one of a number of legal firms that provides legal advice and services to the Company on a range of matters. Linklaters is regulated by the Law Society.	£41,731 Fee basis: Hourly
New Bridge Street (part of Aon Hewitt)	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 New Bridge Street provides a variety of other HR-related services to the Company. The nature of the advice provided to the Committee is limited to factual information concerning the performance of the Company's shares. New Bridge Street is a member of the Remuneration Consultants Group (RCG) and is a signatory to the RCG's code of conduct.	£14,900 Fee basis: Fixed fee

During the year, the Committee received material assistance and advice on remuneration policy from the then Group Human Resources Director, Lynn Minella, and the Human Resources Director, Reward, Paul Farley. Ian King, in his then role as Chief Executive, and Charles Woodburn in his role as Chief Executive, also provided advice that was of material assistance to the Committee.

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 2017 Annual Report in order to aid readability, and to report subsequent Board membership changes.

Directors' remuneration for 2018

For 2018, 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 2018.

As set out in our Remuneration Committee Chairman's letter on pages 91 to 94, the Committee intends to make the following changes to our executive remuneration arrangements for 2018 which do not constitute a change to the Policy approved by shareholders in 2017.

Long-Term Incentive (LTI) construct for UK executive directors

As a further step towards simplification of our LTI framework, having already taken the decision to eliminate the use of Share Options as part of the LTI construct applicable to our US executive director, the Committee also will cease the award of Share Options to the UK executive directors for 2018 onwards.

Consistent with the flexibility contained within the Policy, LTI awards will be delivered using Performance Shares only. This change will result in a lower total face value of the award without, we believe, diluting the incentive to the achievement of long-term sustainable value. The conversion from Share Options to Performance Shares has been calculated in line with the methodology explained in the Policy on page 120 and is shown in the table below:

	Current total expected value	Current aggregate face value of awards (Performance Shares and Share Options)	New face value associated with Performance Share award only
Chief Executive	185%	550%	370%
Group Finance Director	167.5%	515%	335%

This approach significantly simplifies our LTI arrangements without changing the underlying market-competitive expected values of 185% for the Chief Executive and 167.5% for the Group Finance Director.

Metrics and weightings applicable in 2018

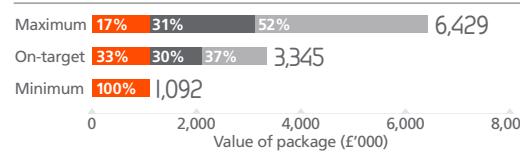
- The performance metrics and weightings applicable to the 2018 annual incentive are 75% on financial metrics relating to Group EPS, Group cash and Group order intake, 5% on safety and 20% on personal objectives designed to support the Group's strategy.
- Performance Shares will continue to have 50% of the award based on TSR performance as follows: 50% of the TSR measure on the current peer comparator group of 13 other international defence companies and 50% on a TSR percentile ranking against the companies in the FTSE 100 index. For 2018, 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 2018 are subject to the long-term operating cash performance of the US business in place of TSR growth.
- There is no change in 2018 to the criteria and weightings applying to Restricted Shares. As set out previously, the US executive director will receive an equal weight in expected value in Performance Shares and Restricted Shares.
- As set out above, from 2018, UK executive directors will receive Performance Shares only.

Illustration of application of policy for 2018

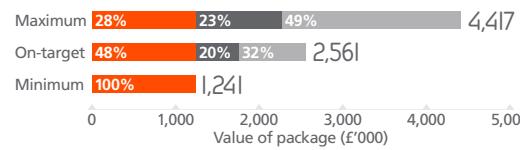
The following charts show the value of the package each of the executive directors would receive based on 2018 base salaries, remuneration and 2018 LTI awards assuming the following scenarios: minimum fixed pay (including salary, benefits and pension as provided in the single total figure table on page 99), and the Restricted Shares award for the US executive director; pay receivable assuming on-target performance is met; and maximum pay assuming variable elements pay out in full. The scenarios below exclude any share price appreciation and dividends.

UK legislation requires that these charts are given in relation to the first year in which the remuneration policy takes legal effect (see page 125). The charts below are reporting the actual levels for 2018.

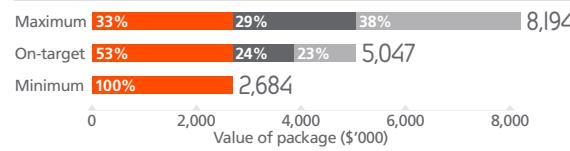
Chief Executive (£'000)



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 110.
- 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)

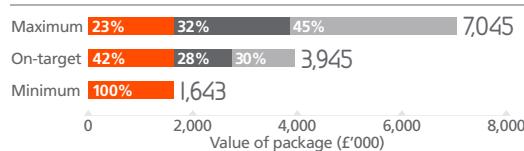
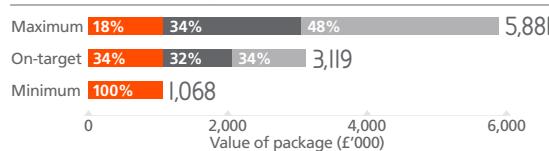
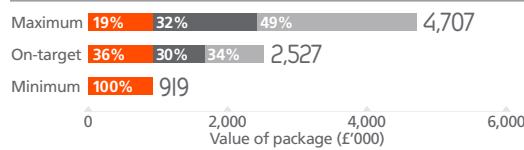
6. The Committee has agreed a policy whereby the executive directors are required to establish and maintain a minimum personal shareholding equal to a set percentage of base salary. An Initial Value must be achieved as quickly as possible using shares vesting or options exercised through the executive 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:

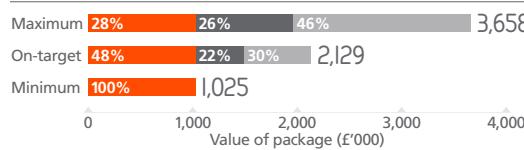
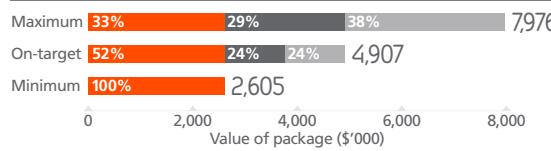
	Initial Value	Subsequent Value
Chief Executive	150%	300%
Chief Operating Officer	100%	200%
Group Finance Director	100%	200%
President and Chief Executive Officer of BAE Systems, Inc.	212.5%	425%

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 paid 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 Advaithi ¹	01.01.2018	31.12.2020
Elizabeth Corley	01.02.2016	31.01.2019
Harriet Green	01.11.2010	31.10.2019
Chris Grigg	01.07.2013	30.06.2019
Paula Rosput Reynolds	01.04.2011	31.03.2020
Nick Rose	08.02.2010	07.02.2019
Ian Tyler	08.05.2013	07.05.2019

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 2017 financial year are listed on pages 78 and 79. Ian King also served as a director until his retirement on 30 June 2017. Revathi Advaithi was appointed to the Board on 1 January 2018.

Dividend

An interim dividend of 8.8p per share was paid on 30 November 2017. The directors propose a final dividend of 13p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2018 to shareholders on the share register on 20 April 2018. Information on dividend waivers is given on page 185.

Annual General Meeting (AGM)

The Company's AGM will be held on 10 May 2018. 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 2017;
- 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 2 August 2017, 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 US dollar planning rate from the profit forecast made in the Group's full-year results announcement on 23 February and in the Annual Report 2016):

"In aggregate, we expect the Group's underlying earnings per share for 2017 to be 5% to 10% higher than full-year underlying earnings per share in 2016 of 40.3p. This outlook remains unchanged despite moving the US dollar planning rate for the year from \$1.25 to \$1.28."

Underlying earnings per share was 43.5p in 2017.

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 2017.

Issued share capital

As at 31 December 2017, 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 2017, the number of shares held in treasury totalled 291,449,361 (having a total nominal value of £7,286,234 and representing 8.4% of the Company's called up share capital at 1 January 2017). During 2017, the Company used 10,216,622 treasury shares (having a total nominal value of £255,416 and representing 0.3% of the Company's called up share capital at 31 December 2017) to satisfy awards under the Free and Matching elements of the Share Incentive Plan (5,457,845 shares in aggregate), awards under the Free and Matching elements of the International Share Incentive Plan (314,147 shares in aggregate), awards vested under the Performance Share Plan (486,223 shares), awards vested under the Restricted Share Plan (861,480 shares), and options exercised under the Executive Share Option Plan (3,096,927 shares). The treasury shares utilised in respect of the Share Incentive Plan, the International Share Incentive Plan and the Restricted Share Plan were disposed of by the Company for nil consideration. The 3,096,927 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 £12,047,653. As at 31 December 2017, 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 31 December 2017).

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, Restricted Share Plan, Share Incentive Plan, International Share Incentive Plan, Group All-Employee Free Shares Plan and International Profit Sharing Scheme are subject to restrictions on the transfer of shares prior to vesting and/or release.

The Company is not aware of any arrangements between its shareholders that may result in restrictions on the transfer of shares and/or voting rights.

Significant direct and indirect holders of securities

As at 31 December 2017 (and unchanged as at 21 February 2018), 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.	10.11%
Franklin Resources Inc., and affiliates	4.92%
Invesco Limited	4.97%
Silchester International Investors LLP	3.01%

Statutory and other information continued

Exercise of rights of shares in employee share schemes

The trustees of the employee trusts do not seek to exercise voting rights on shares held in the employee trusts other than on the direction of the underlying beneficiaries. No voting rights are exercised in relation to shares unallocated to individual beneficiaries.

Restrictions on voting deadlines

The notice of any general meeting shall specify the deadline for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be proposed at the general meeting. The number of proxy votes for, against or withheld in respect of each resolution are publicised on the Company's website after the meeting.

Appointment and replacement of directors

Subject to certain nationality requirements mentioned below, the Company may by ordinary resolution appoint any person to be a director.

The directors also have the power to make appointments to the Board at any time. Any individual so appointed will hold office until the next AGM and shall then be eligible for re-election.

The majority of directors holding office must be British. Otherwise, the directors who are not British shall vacate office in such order that those who have been in office for the shortest period since their appointment shall vacate their office first, unless all of the directors otherwise agree among themselves. Any director who holds the office of either Chairman (in an executive capacity) or Chief Executive shall also be British.

The Company must have not less than six directors holding office at all times. If the number is reduced to below six, then such number of persons shall be appointed as directors as soon as is reasonably practicable to reinstate the number of directors to six. The Company may by ordinary resolution from time to time vary the minimum number of directors.

At each AGM of the Company, any director who was elected or last re-elected at or before the AGM held in the third calendar year before the then current calendar year must retire by rotation and such further directors must retire by rotation so that in total one-third of the directors retire by rotation each year. A retiring director is eligible for re-election. It is the Board's intention that all directors will stand for election or re-election in 2018 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 2017 AGM, the directors were given the power to buy back a maximum number of 317,752,630 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 2018 AGM or 30 June 2018. A special resolution will be proposed at the 2018 AGM to renew the Company's authority to acquire its own shares.

At the 2017 AGM, the directors were given the power to issue new shares up to a nominal amount of £26,476,737. This power will expire on the earlier of the conclusion of the 2018 AGM or 30 June 2018. Accordingly, a resolution will be proposed at the 2018 AGM to renew the Company's authority to issue further new shares. At the 2017 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £26,476,737 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2018 AGM or 30 June 2018, however, no resolution to renew this additional authority will be proposed at the 2018 AGM.

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 2017 which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

The directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited, BAE Systems Executive Pension Scheme Trustees Limited and Alvis Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan, the BAE Systems Executive Pension Scheme and the Alvis Pension Scheme, respectively, which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

All such indemnity provisions are in force as at the date of this Directors' report.

Change of control – significant agreements

The following significant agreements contain provisions entitling the counterparties to exercise termination, alteration or other similar rights in the event of a change of control of the Company:

- The Group has entered into a £2bn Revolving Credit Facility dated 12 December 2013 which provides that, in the event of a change of control of the Company, the lenders are entitled to renegotiate terms, or if no agreement is reached on negotiated terms within a certain period, to call for the repayment or cancellation of the facility. The Revolving Credit Facility was undrawn as at 31 December 2017.
- 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 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.

Statutory and other information continued

- 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. 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 first phase of manufacture of Boat 1 of the Dreadnought Class programme. The MoD is entitled to terminate the contract in the event of a change of control of BAE Systems Marine Limited, provided that the MoD must act reasonably in exercising this right.

In addition, the Company's share plans contain provisions as a result of which options and awards may vest and become exercisable on a change of control of the Company in accordance with the rules of the plans.

Auditors

As detailed on page 82, following the conclusion of a formal tender process led by the Company's Audit Committee, the Board has approved the proposed appointment of Deloitte LLP as the Company's auditors for the financial year ending 31 December 2018, subject to approval by Company's shareholders at the AGM on 10 May 2018.

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' report, directors' remuneration report and corporate governance statement that complies with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Statement of disclosure of information to auditors

The directors who held office at the date of approval of this Directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he/she ought to have taken to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

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
21 February 2018

Directors' report

The Directors' report was approved by the board of directors on 21 February 2018.

David Parkes
Company Secretary

Independent Auditor's report to the members of BAE Systems plc only

Opinions and conclusions arising from our audit

1. Our opinion is unmodified

We have audited the financial statements of BAE Systems plc (the Company) for the year ended 31 December 2017 which comprise the Consolidated income statement, the Consolidated statement of comprehensive income, the Consolidated statement of changes in equity, the Consolidated balance sheet, the Consolidated cash flow statement, the Company Statement of comprehensive income, the Company Statement of changes in equity, the Company Balance sheet and the related notes, including the accounting policies, on pages 144 to 207.

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2017 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with UK accounting standards, including FRS 101, Reduced Disclosure Framework; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the Audit Committee.

We were appointed as auditor by the directors during the period of the Company's incorporation in 1981. The period of total uninterrupted engagement is for the 37 financial years ended 31 December 2017. We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that Standard were provided during 2017 by KPMG.

2. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the Group financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. We summarise below the key audit matters, in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

Group financial statements

2.1. Net retirement benefit obligations

Refer to page 84 (Audit Committee report) and pages 174 to 183 (accounting policy and financial disclosures)

Group's share of the net IAS 19 deficit:

£3,920m (2016 £6,054m)

Risk versus 2016: ▲ ▼

The risk: Subjective valuation

The valuation of the defined benefit pension deficit depends on a number of judgemental assumptions and estimates, including the discount rates used to calculate the current value of the future payments the Group expects to pay pensioners, the rate of inflation that must be incorporated in the estimate of the future pension payments and the life expectancy of pension scheme members.

There is a considerable amount of judgement required in setting the above assumptions and, given the size of the schemes, a small change in the assumptions and estimates may have a significant impact on the retirement benefit obligations.

Further assumptions are made in the determination of the Group's share of assets and liabilities of the multi-employer schemes in which it participates and the corresponding amounts attributed to other participating employers.

Our response

Our audit procedures included:

Our actuarial expertise: We used our own actuarial specialists to challenge key assumptions and estimates used in the calculation of the pension deficit. The key assumptions and estimates we tested included the discount rate, inflation and life expectancy assumptions that were applied to the valuation. We also compared the IAS 19 valuation with the triennial funding valuations of the UK schemes notwithstanding that they were prepared on a different basis and as at different dates.

Benchmarking assumptions: We performed a comparison of key assumptions against our own benchmark ranges which are derived from externally-available data as well as comparing against those used by other companies reporting on the same period.

Methodology assessment: We used our own actuarial specialists to assess the appropriateness and consistency of the methodology applied by management in setting the key assumptions. We challenged the reasons for any changes in methodology and considered the presence of indicators for bias.

Multi-employer allocation: We challenged management in respect of their selection of the basis upon which to allocate a portion of the multi-employer retirement benefit obligations to other participating employers and, in respect of the largest participating employer (being MBDA), agreed the amount allocated to their records.

Assessing transparency: We considered the adequacy of the Group's disclosure in respect of retirement benefits, in particular the net retirement benefit obligation and the assumptions used, which are set out in note 21 to the financial statements.

Results

We found the valuation of the net retirement benefit obligation to be acceptable (2016 result: acceptable).

2.2. Recognition of revenues and profits on long-term contracts

Refer to page 84 (Audit Committee report) and pages 148 to 150 (accounting policy and financial disclosures)

Revenues: £11,910m (2016 £11,659m)

Risk versus 2016: ▲▼

The risk: Subjective estimate

Long-term contracts include complex technical and commercial requirements and often specify performance milestones to be achieved throughout the contract period, which can last many years. At each balance sheet date, estimates and assumptions involving a high degree of judgement and estimation uncertainty are required in order to:

- assess the proportion of revenues to recognise in line with milestones achieved and progress made on contracts;
- forecast the outturn profit margin on each contract, incorporating appropriate allowances for technical and commercial risks related to performance milestones yet to be achieved, particularly in the case of fixed-price contracts; and
- appropriately identify, value and provide for loss-making contracts.

The directors have detailed procedures and processes, called Lifecycle Management (LCM), in place to manage the commercial, technical and financial aspects of long-term contracts. The LCM process includes the regular preparation of a Contract Status Report (CSR), which includes key accounting and forecast information for the relevant contract.

The contracts requiring the highest degree of judgement that occupied a significant proportion of the audit effort included:

- Typhoon aircraft (European, Saudi and Omani);
- Astute Class submarines;
- Queen Elizabeth Class aircraft carrier;
- US commercial shipbuilding contracts; and
- Saudi British Defence Co-operation Programme.

Our response

Our audit procedures included:

Control design, observation and operation:

We tested the design and operating effectiveness of key controls within the LCM process that support contract-related balances, including:

- transactional controls that underpin the production of long-term contract-related balances, including cost information on contracts: We tested the operation of purchase-to-pay cycle and payroll controls;
- programme-level controls: We inspected results from periodic peer reviews performed by experienced employees independent to the contract to challenge assumptions made and judgements taken at pre-determined stages of the contract lifecycle; and
- higher-level controls: We observed monthly contract review meetings, quarterly business unit review meetings and Group-level review meetings.

For significant contracts (including those listed in our audit risk description), determined on the basis of the current and future technical or commercial complexity, financial significance and any forecast to be in significant loss-making positions:

Personnel interviews: We obtained an understanding of the performance and status of the contract through discussion with contract project teams, Group and business unit directors, as well as through attendance at project teams' contract review meetings. We applied our cumulative knowledge of the status of the contracts and challenged the appropriateness of the contract position at the reporting date, including any central overlays to positions reported by subsidiaries and whether or not there were any indications of management override of controls or management bias.

Benchmarking assumptions: We challenged the Group's positions through the examination of externally-available evidence, such as customer correspondence, and, in the case of one significant programme, met the customer directly to further corroborate the status of contracts and recoverability of work-in-progress and receivables.

Our valuations expertise: In the case of one specific project, we used our own valuation specialist to assess the valuation performed on behalf of the Group by an external valuation expert.

Results

The results of our testing were satisfactory and we considered the amount of revenue and profit on long-term contracts recognised to be acceptable (2016 result: acceptable).

2.3. Valuation of goodwill

Refer to page 85 (Audit Committee report) and pages 158 to 160 (accounting policy and financial disclosures)

Goodwill: £9,996m (2016 £10,902m)

Risk versus 2016: ▼

The risk: Forecast-based valuation

The Group holds a significant amount of goodwill relating to UK and overseas (principally US) acquisitions during the past 20 years. The Group estimates recoverable amounts based on value in use which requires significant estimation and judgement in forecasting future cash flows and determining discount rates.

The US Department of Defense fiscal year 2018 budget and the current programme of work support the planning assumptions for the Group's US businesses. However, future year budgets and the allocation of the budget between the Group and its competitors remains uncertain. This places continued importance on the US business to secure export contracts. Both of these factors contribute to the risk that the goodwill allocated to the Group's US Cash-Generating Units (CGUs) may not be recoverable, although we consider this risk to have reduced from the prior year.

The Applied Intelligence CGU with an allocated goodwill balance of £0.2bn at the reporting date (2016 £0.6bn) operates in a highly competitive and fragmented market where significant investment is required for growth and where the future business pipeline is much shorter than in most other business units in the Group. As such, we consider the uncertainty in forecasting cash flows higher and the valuation of this CGU to have a higher risk due to these sector-related factors. An impairment charge of £384m was recognised in respect of this CGU in 2017 (2016 £nil).

The remaining goodwill of £1.9bn is primarily allocated to CGUs based in the UK. Whilst there remains an inherent risk in the forecasting of future cash flows for these businesses, many of them hold sizeable order backlog, much of which is with government agencies, providing increased support to the forecasts. We consider the valuation risks around these CGUs to be lower than Applied Intelligence.

Independent Auditor's report continued

Our response

Our audit procedures included:

Historical comparison: Assessing the reasonableness of the directors' assumptions by reference to past performance.

Benchmarking assumptions: Assessing the reasonableness of the directors' assumptions by reference to publicly-available information, such as future defence expenditure. We also compared the directors' assumptions to externally-derived data (for example, bond yields and inflation statistics) and internally-derived data to challenge other key inputs, such as projected economic growth and gearing leverage.

Comparing valuations: We compared the sum of the discounted cash flows to the Group's market capitalisation to assess the reasonableness of those cash flows and challenged management's explanation in reconciling the two.

Our sector experience: Our valuation specialists assisted in evaluating the reasonableness of assumptions and methodologies underlying the discount rates adopted by the directors, including the discount rate applied in the valuation of the Applied Intelligence CGU.

Sensitivity analysis: We have run scenario-specific models, including changes to the discount rate, forecast cash flows and break-even analyses to stress-test the valuations of CGUs' recoverable amounts.

Assessing transparency: We considered the adequacy of the Group's disclosure in respect of the sensitivities to changes in key assumptions and the risks inherent in the valuation of goodwill.

Results

We found the Group's assessment of the recoverable amount of goodwill to be acceptable (2016 result: acceptable).

2.4. Tax accruals

Refer to page 85 (Audit Committee report) and page 171 (accounting policy and financial disclosures)

Tax accruals: £351m (2016 £365m)

Risk versus 2016: ▲ ▼

The risk: Dispute outcomes

Accruals for tax contingencies require the directors to make judgements and estimates in relation to tax risks. This is one of the key judgement areas that our audit is concentrated on due to the Group operating in a number of tax jurisdictions, the complexities of local and international tax legislation, and the number of years which some matters can take to resolve.

The tax matters are at various stages, from the first identification of risks to discussions with tax authorities and through to tax tribunal or court proceedings.

Our response

Our audit procedures included:

Our taxation expertise: Our tax specialists assisted in assessing the Group's tax positions, its exposure to future cash outflows and the assumptions used by the directors to estimate the tax accruals. This included an inspection of the Group's correspondence with the relevant tax authorities and the Group's external tax advisers.

Benchmarking assumptions: We used our knowledge and experience of the application of the international and local legislation by the relevant authorities and courts in order to challenge the positions taken by the directors. In support of these positions, we separately met with certain key external tax advisers of the Group. In respect of certain matters, we compared the position taken by the directors with outcomes of similar cases.

Assessing transparency: We have also considered the adequacy of the Group's tax disclosures.

Results

The results of our testing were satisfactory and we found the resulting estimate of tax accruals to be acceptable (2016 result: acceptable).

2.5. Deferred tax assets

Refer to page 85 (Audit Committee report) and pages 169 to 171 (accounting policy and financial disclosures)

Deferred tax assets: £724m (2016 £1,251m)

Risk versus 2016: ▼

The risk: Subjective estimate

The directors are required to estimate the valuation of deferred tax assets and to record those assets to the extent their recovery is probable. This requires a significant element of judgement.

The majority of the deferred tax asset balance is in relation to the Group's retirement benefit obligations. As a result of the reduction in the valuation of the Group's net share of the retirement benefit obligations, the Group's related deferred tax asset has also reduced: compared with last year, the period required for the Group to recover the amount of deferred tax is less. For this reason, we have determined that the audit risk has reduced from the prior year.

Our response

Our audit procedures included:

Assessing forecasts: We assessed and challenged the directors' judgement as to why it is deemed probable that the deferred tax assets recognised will be recovered, considering:

- the appropriateness and reliability of forecasts used by management to estimate the recovery period;
- the timeframe of the pension deficit recovery plan; and
- the consistency of this judgement with other assumptions and estimates made by the directors, for example, those used to test impairment of assets, including goodwill.

Benchmarking assumptions: We considered the funding arrangements agreed with the Trustees of the UK pension schemes. We compared the views and estimates arrived at by the directors (as described above) with advice received by the Trustees in arriving at the funding arrangements on the covenant provided by the Group over the deficit recovery periods.

Tests of detail: We analysed the calculations used to determine the estimated recovery period and tested the accuracy of these calculations.

Results

As a result of our work, we found the level of deferred tax assets recognised to be acceptable (2016 result: acceptable).

Parent company financial statements**2.6. Amounts relating to Group affiliates**

These comprise:

Investments in subsidiary undertakings and participating interests: **£8,439m** (2016 £8,399m)

Amounts owed by subsidiary undertakings and Group joint ventures: **£2,576m** (2016 £2,954m)

Amounts owed to subsidiary undertakings and Group joint ventures: **£(8,183)m** (2016 £(8,461)m)

The risk: Material amounts

The carrying amount of the Company's investments in subsidiaries held at cost less impairment and intercompany receivables represent 77% (2016 79%) of the Company's total assets. The Company's intercompany liabilities represent 80% (2016 79%) of the Company's total liabilities.

We do not consider the valuation of these investments and recovery of intercompany receivables or completeness of intercompany liabilities to be at a high risk of significant misstatement, or to be subject to a significant level of judgement. However, due to their materiality in the context of the Company financial statements, this is considered to be the area that had the greatest effect on our overall parent company audit.

Our response

Tests of detail: We compared the investments and receivables to the net assets of the relevant entities to identify whether these net assets, being an approximation of their minimum recoverable amounts, were in excess of the investment carrying amounts. We agreed that the intercompany liabilities set-off against subsidiary counterparties in the Group consolidation.

Our sector experience: We evaluated key assumptions in the impairment models for certain significant investments, in particular those for profit contribution and growth, against our own knowledge of the historic trading performance of the relevant entities.

Control observation: We tested the automated controls over the process for matching and elimination of intercompany balances in the Group consolidation.

Results

We found the assessment of the amounts recorded to be acceptable.

3. Our application of materiality and an overview of the scope of our audit

The materiality for the Group financial statements as a whole was set at £55m (2016 £55m), determined with reference to a benchmark of Group profit before taxation from continuing operations, of which it represents 4.9% (2016 4.8%).

Materiality for the parent company financial statements as a whole was set at £32m (2016 £30m), as communicated by the Group audit team. This is lower than the materiality we would otherwise have determined with reference to a benchmark of company net assets and represents 0.8% (2016 0.8%) of the Company's net assets.

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements

exceeding £3m for income statement items, in addition to other identified misstatements that warranted reporting on qualitative grounds.

Of the Group's 41 (2016 41) reporting components, we subjected 11 (2016 11) to full-scope audits for Group purposes and 14 (2016 14) to specified risk-focused procedures. The latter were in our opinion not individually financially significant enough to require an audit for Group reporting purposes, but did present specific individual risks that needed to be addressed.

The components within the scope of our work accounted for the following percentages of the Group's results:

	Number of components	Group revenue %	Group profit before taxation %	Group total assets %
2017				
Audits for Group reporting purposes¹	11	67	67	84
Specified risk-focused audit procedures²	14	24	24	13
Total	25	91	91	97
2016				
Audits for Group reporting purposes ¹	11	69	69	84
Specified risk-focused audit procedures ²	14	25	24	10
Total	25	94	93	94

1. In the UK, US, Saudi Arabia and Australia. 2. In the UK, US and Saudi Arabia.

For the remaining components, we performed analysis at an aggregated level to confirm our preliminary assessment that there were no significant risks of material misstatements within these.

The Group audit team instructed component auditors as to the significant areas to be covered, including the relevant risks detailed above and the information to be reported back. The Group audit team approved the component materiality levels, which ranged from £2.7m to £32m (2016 £4m to £37m), having regard to the mix of size and risk profile across the components. The work on seven of the 25 (2016 seven of the 25) in-scope components was performed by component auditors and the remainder, including the audit of the parent company, by the Group audit team.

The Group audit team held a global audit conference in 2014, where all significant component audit teams came together in London to consider the audit risk and strategy. Similar planning days took place in 2017 with the most significant component teams from the UK, US and Saudi Arabia. In addition, the Group audit team visited component teams in the UK, US, Saudi Arabia and Australia to assess the audit risk and strategy, discuss and moderate the results of controls testing and discuss preliminary findings of audit procedures. Video and telephone conference meetings were also held with these component auditors and any others in our audit scope that were not physically visited. At these visits and meetings, the findings reported to the Group audit team were discussed in more detail, and any further work required by the Group audit team was then performed by the component auditor.

4. We have nothing to report on going concern

We are required to report to you if:

- we have anything material to add or draw attention to in relation to the directors' statement in the financial statements on page 142 on the use of the going concern basis of accounting with no material uncertainties that may cast significant doubt over the Group and Company's use of that basis for a period of at least 12 months from the date of approval of the financial statements; or
- the related statement under the Listing Rules set out on page 81 is materially inconsistent with our audit knowledge.

We have nothing to report in these respects.

5. We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

Independent Auditor's report continued

Strategic report and Directors' report

Based solely on our work on the other information:

- we have not identified material misstatements in the Strategic report and the Directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

Directors' remuneration report

In our opinion the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

Disclosures of principal risks and longer-term viability

Based on the knowledge we acquired during our financial statements audit, we have nothing material to add or draw attention to in relation to:

- the directors' confirmation within the viability statement 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 and liquidity;
- the principal risks disclosures describing these risks and explaining how they are being managed and mitigated; and
- the directors' explanation in the viability statement of how they have assessed the prospects of the Group, over what period they have done so and why they considered 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.

Under the Listing Rules, we are required to review the viability statement. We have nothing to report in this respect.

Corporate governance disclosures

We are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our financial statements audit and the directors' statement that they consider that the annual report and financial statements taken as a whole is fair, balanced and understandable, and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy; or
- the section of the Annual Report describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We are required to report to you if the part of the Director's report section relating to the Company's compliance does not properly disclose a departure from the 11 provisions of the UK Corporate Governance Code specified by the Listing Rules for our review.

We have nothing to report in these respects.

6. We have nothing to report on the other matters on which we are required to report by exception

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' remuneration report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

7. Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on pages 134 and 135, the directors are responsible for: the preparation of the financial statements, including being satisfied that they give a true and fair view; 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; assessing the Group and 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 they 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

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 other irregularities (see below), or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities

Irregularities – ability to detect

Our audit aimed to detect non-compliance with relevant laws and regulations (irregularities) that could have a material effect on the financial statements. In planning and performing our audit, we considered the impact of laws and regulations in the specific areas of export control, defence contracting and anti-bribery and corruption legislation. We identified these areas through discussion with the directors and other management (as required by auditing standards), from our sector experience and from inspection of the Group's legal correspondence. In addition, we had regard to laws and regulations in other areas, including financial reporting, and company and taxation legislation.

We considered the extent of compliance with those laws and regulations that directly affect the financial statements, being anti-bribery and corruption and as part of our procedures on the related financial statement items. For the remaining laws and regulations, we made enquiries of directors and other management (as required by auditing standards), and inspected legal correspondence.

We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit. This included communication from the Group to component audit teams of relevant laws and regulations identified at Group level, with a request to report on any indications of potential existence of irregularities in these areas, or other areas directly identified by the component team.

As with any audit, there remained a higher risk of non-detection of irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal controls.

8. The purpose of our audit work and to whom we owe our responsibilities

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Ian Starkey
Senior Statutory Auditor

For and on behalf of

KPMG LLP
Statutory Auditor

Chartered Accountants
15 Canada Square
London, E14 5GL
21 February 2018

Financial statements



Financial statements

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Group accounting policies

Accounting policies are included within the relevant note to the Group accounts.

Group accounts

Preparation

Basis of preparation

The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis, as discussed in the Directors' report on page 81, and in accordance with EU-endorsed International Financial Reporting Standards (IFRS) and the Companies Act 2006 applicable to companies reporting under IFRS.

The consolidated financial statements are presented in pounds sterling and, unless stated otherwise, rounded to the nearest million. They have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and other relevant financial assets and financial liabilities (including derivative instruments).

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date, 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	<p>The majority of long-term contracts are accounted for under IAS 11, Construction Contracts. Revenue on long-term contracts is recognised when performance milestones have been completed. Profit is recognised progressively as risks have been mitigated or retired.</p> <p>The ultimate profitability of long-term 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.</p>	1
Carrying value of goodwill	<p>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.</p> <p>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.</p>	8
Deferred tax asset on retirement benefit obligations	<p>The Group has recognised a deferred tax asset in respect of the deficits in its pension/retirement schemes.</p> <p>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.</p>	14
Tax provisions	<p>Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiations or litigation. The Group's 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.</p> <p>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.</p>	16
Valuation of retirement benefit obligations	<p>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.</p> <p>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.</p>	21

Preparation continued

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.

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 significant estimates in relation to the Group's critical accounting policies are set out above. The only significant risk of a material adjustment to the carrying amounts of assets and liabilities during 2018 relates to the determination of the discount rate and inflation assumptions underpinning the valuation of the liabilities of the Group's defined benefit pension schemes. A description of the discount rate and inflation assumptions, together with sensitivity analysis, is set out in note 21 to the Group accounts.

Changes in accounting policies

IFRS 9, Financial Instruments

IFRS 9 is effective from 1 January 2018. The standard, replacing the requirements of IAS 39, Financial Instruments: Recognition and Measurement, introduces new requirements for recognition, classification and measurement, a new impairment model for financial assets based on expected credit losses, and simplified hedge accounting.

Any changes to the classification and measurement of financial instruments are applied retrospectively by adjusting opening retained earnings at 1 January 2018. There is no requirement to restate comparatives for prior periods. The Group has determined that there is no adjustment to retained earnings on transition to IFRS 9.

IFRS 15, Revenue from Contracts with Customers

IFRS 15 is effective from 1 January 2018. The standard requires the identification of performance obligations in contracts with customers and allocation of the total contractual value to each of the performance obligations identified. Revenue is recognised as each performance obligation is satisfied either at a point in time or over time. The standard will replace IAS 11, Construction Contracts, IAS 18, Revenue, and all other existing revenue accounting requirements within IFRS. The impact of the adoption of IFRS 15 on BAE Systems is set out in note 34.

IFRS 16, Leases

IFRS 16 is effective from 1 January 2019. The standard, which replaces IAS 17, Leases, was EU endorsed in October 2017. Whilst lessor accounting is similar to IAS 17, lessee accounting is significantly different. Under IFRS 16, the Group will recognise within the balance sheet a right-of-use asset and a lease liability for future lease payments in respect of all leases unless the underlying assets are of low value or the lease term is 12 months or less. Within the income statement, rental expense on the impacted leases will be replaced with depreciation on the right-of-use asset and interest expense on the lease liability.

As set out in note 32, BAE Systems has operating lease commitments totalling £1.6bn at 31 December 2017 and, therefore, IFRS 16 will have a material impact on the Group. The implications of the standard are currently under review and the Group has not yet determined which transition option will be applied. As the impact of transition is dependent on the option chosen, the Group is unable to quantify the effect at this time.

Consolidation

The financial statements of the Group consolidate the results of the Company and its subsidiary entities, and include its share of its joint ventures' results accounted for under the equity method.

A subsidiary is an entity controlled by the Group. The Group controls a subsidiary when it is exposed, or has the rights, to variable returns from its involvement with the subsidiary and has the ability to affect those returns through its power over the subsidiary.

The results of subsidiaries are included in the income statement from the date of acquisition.

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

Joint ventures are accounted for under the equity method where the Consolidated income statement includes the Group's share of their profits and losses, and the Consolidated balance sheet includes its share of their net assets within equity accounted investments.

The assets and liabilities of overseas subsidiaries and equity accounted investments are translated at the exchange rates ruling at the balance sheet date. The income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity, but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised in equity since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Consolidated income statement for the year ended 31 December

	Notes	2017 £m	Total £m	2016 £m	Total £m
Continuing operations					
Sales	1	19,626		19,020	
Deduct Share of sales by equity accounted investments	1	(2,575)		(2,427)	
Add Sales to equity accounted investments	1	1,271		1,197	
Revenue	1	18,322		17,790	
Operating costs	2	(17,089)		(16,274)	
Other income	4	131		136	
Group operating profit		1,364		1,652	
Share of results of equity accounted investments	1	116		90	
<i>Underlying EBITA</i>	1	2,034		1,905	
<i>Non-recurring items</i>	1	(13)		(12)	
EBITA		2,021		1,893	
<i>Amortisation of intangible assets</i>	1	(86)		(87)	
<i>Impairment of intangible assets</i>	1	(384)		–	
<i>Financial expense of equity accounted investments</i>	5	(34)		(28)	
<i>Taxation expense of equity accounted investments</i>	6	(37)		(36)	
Operating profit	1	1,480		1,742	
<i>Financial income</i>		416		713	
<i>Financial expense</i>		(762)		(1,304)	
Net finance costs	5	(346)		(591)	
Profit before taxation		1,134		1,151	
Taxation expense	6	(250)		(213)	
Profit for the year		884		938	
Attributable to:					
Equity shareholders		854		913	
Non-controlling interests		30		25	
		884		938	
Earnings per share					
Basic earnings per share	7	26.8p		28.8p	
Diluted earnings per share		26.7p		28.7p	

Consolidated statement of comprehensive income for the year ended 31 December

	Notes	2017			2016		
		Other reserves ¹ £m	Retained earnings £m	Total £m	Other reserves ¹ £m	Retained earnings £m	Total £m
Profit for the year		–	884	884	–	938	938
Other comprehensive income							
Items that will not be reclassified to the income statement:							
Subsidiaries:							
Remeasurements on retirement benefit schemes		–	2,105	2,105	–	(1,468)	(1,468)
Tax on items that will not be reclassified to the income statement	6	–	(490)	(490)	–	260	260
Equity accounted investments (net of tax)		–	53	53	–	(53)	(53)
Items that may be reclassified to the income statement:							
Subsidiaries:							
Currency translation on foreign currency net investments		(625)	–	(625)	1,287	–	1,287
Amounts credited to hedging reserve		59	–	59	96	–	96
Tax on items that may be reclassified to the income statement	6	(11)	–	(11)	(17)	–	(17)
Equity accounted investments (net of tax)		(15)	–	(15)	45	–	45
Total other comprehensive income for the year (net of tax)		(592)	1,668	1,076	1,411	(1,261)	150
Total comprehensive income for the year		(592)	2,552	1,960	1,411	(323)	1,088
Attributable to:							
Equity shareholders		(587)	2,522	1,935	1,408	(348)	1,060
Non-controlling interests		(5)	30	25	3	25	28
		(592)	2,552	1,960	1,411	(323)	1,088

1. An analysis of other reserves is provided in note 23.

Consolidated statement of changes in equity for the year ended 31 December

	Attributable to equity holders of BAE Systems plc						
	Issued share capital £m	Share premium £m	Other reserves ¹ £m	Retained earnings £m	Total £m	Non-controlling interests £m	
At 1 January 2017	87	1,249	6,685	(4,583)	3,438	26	3,464
Profit for the year	–	–	–	854	854	30	884
Total other comprehensive income for the year	–	–	(587)	1,668	1,081	(5)	1,076
Share-based payments (inclusive of tax)	–	–	–	53	53	–	53
Net purchase of own shares	–	–	–	(1)	(1)	–	(1)
Ordinary share dividends	–	–	–	(684)	(684)	(8)	(692)
At 31 December 2017	87	1,249	6,098	(2,693)	4,741	43	4,784
At 1 January 2016	87	1,249	5,277	(3,624)	2,989	13	3,002
Profit for the year	–	–	–	913	913	25	938
Total other comprehensive income for the year	–	–	1,408	(1,261)	147	3	150
Share-based payments (inclusive of tax)	–	–	–	59	59	–	59
Net sale of own shares	–	–	–	3	3	–	3
Ordinary share dividends	–	–	–	(670)	(670)	(24)	(694)
Partial disposal of shareholding in subsidiary undertaking	–	–	–	(3)	(3)	9	6
At 31 December 2016	87	1,249	6,685	(4,583)	3,438	26	3,464

1. An analysis of other reserves is provided in note 23.

Consolidated balance sheet as at 31 December

	Notes	2017 £m	2016 £m
Non-current assets			
Intangible assets	8	10,378	11,264
Property, plant and equipment	9	2,230	2,098
Investment property	10	101	110
Equity accounted investments	11	384	299
Other investments		6	6
Other receivables	12	387	351
Retirement benefit surpluses	21	302	223
Other financial assets	13	226	345
Deferred tax assets	14	724	1,251
		14,738	15,947
Current assets			
Inventories	15	723	744
Trade and other receivables including amounts due from customers for contract work	12	3,586	3,305
Current tax	16	20	5
Other financial assets	13	89	204
Cash and cash equivalents	17	3,271	2,769
Assets held for sale		26	2
		7,715	7,029
Total assets	18	22,453	22,976
Non-current liabilities			
Loans	19	(4,069)	(4,425)
Other payables	20	(1,722)	(1,027)
Retirement benefit obligations	21	(4,222)	(6,277)
Other financial liabilities	13	(133)	(102)
Deferred tax liabilities	14	(4)	(10)
Provisions	22	(413)	(372)
		(10,563)	(12,213)
Current liabilities			
Loans and overdrafts	19	(14)	–
Trade and other payables	20	(6,322)	(6,540)
Other financial liabilities	13	(104)	(212)
Current tax	16	(305)	(311)
Provisions	22	(345)	(234)
Liabilities held for sale		(16)	(2)
		(7,106)	(7,299)
Total liabilities		(17,669)	(19,512)
Net assets		4,784	3,464
Capital and reserves			
Issued share capital	23	87	87
Share premium		1,249	1,249
Other reserves	23	6,098	6,685
Retained earnings – deficit		(2,693)	(4,583)
Total equity attributable to equity holders of BAE Systems plc		4,741	3,438
Non-controlling interests		43	26
Total equity		4,784	3,464

Approved by the Board on 21 February 2018 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	2017 £m	2016 ¹ £m
Profit for the year		884	938
Taxation expense	6	250	213
Research and development expenditure credits	4	(20)	(22)
Share of results of equity accounted investments	1	(116)	(90)
Net finance costs	5	346	591
Depreciation, amortisation and impairment	2	728	345
Profit on disposal of property, plant and equipment	2,4	(1)	(5)
Profit on disposal of investment property	2,4	(9)	(12)
Loss on disposal of businesses	2	13	—
Cost of equity-settled employee share schemes		61	55
Movements in provisions		150	(122)
Decrease in liabilities for retirement benefit obligations		(138)	(214)
(Increase)/decrease in working capital:			
Inventories		(29)	95
Trade and other receivables		(449)	(93)
Trade and other payables		454	(263)
Taxation paid		(227)	(187)
Net cash flow from operating activities		1,897	1,229
Dividends received from equity accounted investments	11	72	38
Interest received ¹		23	10
Purchase of property, plant and equipment, and investment property		(389)	(408)
Purchase of intangible assets		(87)	(82)
Proceeds from sale of property, plant and equipment, and investment property		34	45
Proceeds from sale of intangible assets		1	—
Purchase of subsidiary undertakings		(3)	—
Equity accounted investment funding	11	(3)	(5)
Cash flow from sale of subsidiary undertakings		(6)	6
Cash and cash equivalents disposed of with subsidiary undertakings		(2)	—
Net cash flow from investing activities		(360)	(396)
Interest paid ¹		(204)	(210)
Net (purchase)/sale of own shares		(1)	3
Equity dividends paid	23	(684)	(670)
Dividends paid to non-controlling interests		(8)	(24)
Cash flow from matured derivative financial instruments		(83)	480
Cash flow from movement in cash collateral		(15)	32
Cash flow from repayment of loans		—	(286)
Net cash flow from financing activities	25	(995)	(675)
Net increase in cash and cash equivalents		542	158
Cash and cash equivalents at 1 January		2,771	2,537
Effect of foreign exchange rate changes on cash and cash equivalents		(49)	76
Cash and cash equivalents at 31 December		3,264	2,771
Comprising:			
Cash and cash equivalents	17	3,271	2,769
Overdrafts	19	(7)	—
Cash classified as held for sale		—	2
Cash and cash equivalents at 31 December		3,264	2,771

1. Re-presented to reclassify interest paid from investing to financing activities.

Notes to the Group accounts

1. Segmental analysis

Revenue and profit recognition

Revenue represents income derived from the provision of goods and services by the Company and its subsidiary undertakings.

Long-term contracts

The majority of the Group's long-term contract arrangements are accounted for under IAS 11, Construction Contracts. Revenue is recognised when the Group has obtained the right to consideration in exchange for its performance, which is when a separately identifiable phase (milestone) of a contract or development has been completed.

Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. No profit is recognised until the outcome of a contract can be reliably estimated. Profit is recognised progressively as risks have been mitigated or retired.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods sold and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

Revenue from the sale of goods not under long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

Revenue from the sale of software licences is recognised on delivery to the customer when the Group has no remaining obligations to perform and collection of the consideration is considered probable. In circumstances where the Group has future obligations to perform as part of a software licence and related services contract, revenue is recognised over the contract term.

Revenue and profits on intercompany trading are determined on an arm's-length basis.

Research and development

The Group undertakes research and development activities either on its own behalf or on behalf of customers.

Where the research and development activity is performed on behalf of customers, the revenue arising is recognised in the income statement in accordance with the Group's revenue recognition policy on long-term contracts.

Reporting segments

During the year ended 31 December 2017, the Group had the following six 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, 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 of government-owned munitions facilities;
- **Platforms & Services (UK)** comprises the Group's UK-based air, maritime, land and shared services activities;
- **Platforms & Services (International)** comprises the Group's businesses in Saudi Arabia, Australia and Oman, together with its 37.5% interest in the pan-European MBDA joint venture; and
- **HQ** comprises the Group's head office activities, together with a 49% interest in Air Astana.

Effective 1 January 2018, the Group revised its reporting segments to reflect the organisational changes described on page 17. The Group continues to have six reporting segments and there were no changes to the Electronic Systems, Cyber & Intelligence and Platforms & Services (US) reporting segments. The Platforms & Services (UK) and Platforms & Services (International) management structures have been removed with the organisation streamlined, and Air and Maritime reporting segments created.

Air comprises the Group's UK-based air activities for European and International markets and UK-based US Programmes, and its businesses in Saudi Arabia and Australia, together with its 37.5% interest in the pan-European MBDA joint venture. Maritime comprises the Group's UK-based maritime and land activities. The HQ reporting segment includes the Group's UK-based head office and shared services activities, as well as a 49% interest in Air Astana.

These reporting segments align with the Group's strategic direction, determined with reference to the products and services they provide, and the markets in which they operate.

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 149) and underlying EBITA (see page 150). Finance costs and taxation expense are managed on a Group basis.

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 segment

	Sales		Deduct		Add		Revenue	
	2017 £m	2016 £m	Share of sales by equity accounted investments	2017 £m	2016 £m	Sales to equity accounted investments	2017 £m	2016 £m
Electronic Systems	3,635	3,282	(95)	(79)	95	79	3,635	3,282
Cyber & Intelligence	1,820	1,778	–	–	–	–	1,820	1,778
Platforms & Services (US)	2,928	2,874	(103)	(91)	–	–	2,825	2,783
Platforms & Services (UK)	7,682	7,806	(1,088)	(1,118)	1,030	1,011	7,624	7,699
Platforms & Services (International)	4,138	3,943	(1,002)	(906)	–	–	3,136	3,037
HQ	287	233	(287)	(233)	–	–	–	–
	20,490	19,916	(2,575)	(2,427)	1,125	1,090	19,040	18,579
Intra-group sales/revenue	(864)	(896)	–	–	146	107	(718)	(789)
	19,626	19,020	(2,575)	(2,427)	1,271	1,197	18,322	17,790

	Intra-group revenue		Revenue from external customers	
	2017 £m	2016 £m	2017 £m	2016 £m
Electronic Systems	73	92	3,562	3,190
Cyber & Intelligence	88	58	1,732	1,720
Platforms & Services (US)	23	43	2,802	2,740
Platforms & Services (UK)	529	592	7,095	7,107
Platforms & Services (International)	5	4	3,131	3,033
	718	789	18,322	17,790

Sales and revenue by customer location

	Sales		Revenue	
	2017 £m	2016 £m	2017 £m	2016 £m
UK	4,057	4,033	3,825	3,869
Rest of Europe ¹	2,073	2,174	1,457	1,645
US	7,698	6,920	7,695	6,920
Canada	100	92	100	92
Saudi Arabia	3,228	4,043	3,107	3,808
Rest of Middle East	1,235	720	1,149	693
Australia	629	535	628	534
Rest of Asia and Pacific	503	369	314	167
Africa, and Central and South America	103	134	47	62
	19,626	19,020	18,322	17,790

1. Includes £0.9bn (2016 £1.0bn) generated under the Typhoon workshare agreement with Eurofighter Jagdflugzeug GmbH.

Revenue by category

	2017 £m	2016 £m
Long-term contracts	11,910	11,659
Sale of goods	3,547	3,223
Provision of services	2,854	2,903
Royalty income	11	5
	18,322	17,790

Notes to the Group accounts continued

1. Segmental analysis continued

Revenue by major customer

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2017 £m	2016 £m
US Department of Defense	4,558	4,319
UK Ministry of Defence ¹	4,348	4,402
Kingdom of Saudi Arabia Ministry of Defence and Aviation	2,967	3,726

1. Includes £0.9bn (2016 £1.0bn) 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 Platforms & Services (UK) and Platforms & Services (International) 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 not relevant to an understanding of the Group's underlying performance and include:

2017

The loss of £13m represents the loss on disposal of the BAE Systems San Francisco Ship Repair business.

2016

The loss of £12m represented an impairment against the carrying value of the BAE Systems San Francisco Ship Repair business.

Operating profit/(loss) by reporting segment

	Underlying EBITA		Amortisation and impairment of intangible assets		Financial and taxation expense of equity accounted investments		Non-recurring items		Operating profit/(loss)	
	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m
Electronic Systems	562	494	(20)	(20)	–	–	–	–	542	474
Cyber & Intelligence	52	90	(419)	(31)	–	–	–	–	(367)	59
Platforms & Services (US)	242	211	(9)	(15)	(2)	(2)	(13)	(12)	218	182
Platforms & Services (UK)	794	810	(16)	(15)	(4)	(15)	–	–	774	780
Platforms & Services (International)	472	400	(6)	(6)	(39)	(29)	–	–	427	365
HQ	(88)	(100)	–	–	(26)	(18)	–	–	(114)	(118)
	2,034	1,905	(470)	(87)	(71)	(64)	(13)	(12)	1,480	1,742
Net finance costs									(346)	(591)
Profit before taxation									1,134	1,151
Taxation expense									(250)	(213)
Profit for the year									884	938

Share of results of equity accounted investments within reporting segments

	Underlying EBITA		Amortisation of intangible assets		Financial expense		Taxation income/(expense)		Share of results of equity accounted investments	
	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m
Electronic Systems	6	5	–	–	–	–	–	–	6	5
Platforms & Services (US)	13	12	–	–	(3)	(2)	1	–	11	10
Platforms & Services (UK)	14	15	–	–	(2)	(5)	(2)	(10)	10	–
Platforms & Services (International)	133	107	(4)	(4)	(7)	(6)	(32)	(23)	90	74
HQ	25	19	–	–	(22)	(15)	(4)	(3)	(1)	1
	191	158	(4)	(4)	(34)	(28)	(37)	(36)	116	90

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 held in long-term contract balances as a contract cost within trade and other receivables and recognised in the income statement in accordance with the Group's revenue recognition policy on long-term contracts.

	2017 £m	2016 £m
Raw materials, subcontracts and other bought-in items used	6,414	5,742
Change in inventories of finished goods and work-in-progress	656	1,415
Cost of inventories expensed	7,070	7,157
Staff costs (note 3)	5,830	5,440
Depreciation, amortisation and impairment	728	345
Lease expense	295	284
Loss on disposal of property, plant and equipment, and investment property	1	2
Loss on disposal of businesses	13	–
Other operating charges	3,152	3,046
Operating costs	17,089	16,274

Operating costs include research and development expenditure of £1,576m (2016 £1,416m), of which £238m (2016 £206m) was funded by the Group. In addition, the Group's share of the research and development expenditure of its equity accounted investments was £131m (2016 £99m).

Fees payable to the Company's auditor and its associates included in operating costs

	2017			2016		
	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*	2,034	–	2,034	1,776	–	1,776
Fees payable to the Company's auditor and its associates for other services pursuant to legislation:						
The audit of the Company's subsidiaries*	2,809	4,471	7,280	2,663	4,143	6,806
Interim review*	506	–	506	497	–	497
Other	65	18	83	112	3	115
Audit-related assurance services:						
Advice on accounting matters ¹	515	90	605	–	–	–
Tax compliance services²	–	107	107	17	576	593
Tax advisory services²	–	35	35	9	122	131
Other assurance services:						
Non-statutory financial statements audit	–	–	–	–	7	7
Other non-audit services:						
Investor relations ²	–	–	–	200	–	200
Other	38	53	91	83	31	114
Total fees payable to the Company's auditor and its associates	5,967	4,774	10,741	5,357	4,882	10,239

*Total fees payable to the Company's auditor and its associates for audit services and interim review

9,820

9,079

Fees in respect of BAE Systems pension schemes:

Audit	–	292	292	–	278	278
Tax compliance	–	5	5	–	2	2
Tax advisory	–	–	–	23	–	23
	–	297	297	23	280	303

1. 2017 includes advice in respect of IFRS 15.

2. With effect from 1 January 2017, certain tax services and investor information services are no longer provided by KPMG in order to ensure compliance with the Financial Reporting Council's revised regulations on ethical standards for auditors and EU regulations adopted by the UK which apply prohibitions to a range of engagements that could result in an auditor facing a conflict of interest.

Notes to the Group accounts

continued

3. Employees

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2017 Number '000	2016 Number '000	2017 Number '000	2016 Number '000
Electronic Systems	14	14	14	14
Cyber & Intelligence	11	12	11	12
Platforms & Services (US)	11	11	11	11
Platforms & Services (UK)	30	29	30	29
Platforms & Services (International)	9	9	9	9
HQ	1	1	1	1
	76	76	76	76

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were as follows:

	2017 £m	2016 £m
Wages and salaries ¹	4,972	4,672
Social security costs ²	360	339
Share-based payments (note 29)	61	55
Pension costs – defined contribution plans (note 21) ²	193	189
Pension costs – defined benefit plans (note 21)	242	183
US healthcare costs (note 21)	2	2
	5,830	5,440

1. After excluding the impact of exchange translation, wages and salaries increased by 3% per employee on 2016.

2. 2016 reclassified.

4. Other income

Leases

Lease income under operating leases is recognised in the income statement on a straight-line basis over the lease term.

	2017 £m	2016 £m
Research and development expenditure credits	20	22
Rental income from operating leases – investment property	23	24
Rental income from operating leases – other	16	18
Profit on disposal of property, plant and equipment	2	7
Profit on disposal of investment property	9	12
Management recharges to equity accounted investments (note 30)	16	16
Royalties	9	8
Other ¹	36	29
Other income	131	136

1. Includes £11m (2016 £10m) in respect of management fees relating to the building works at the Barrow site for the Dreadnought submarine programme. There are no other individual amounts in excess of £10m.

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.

	2017 £m	2016 £m
Interest income	24	10
Gain on remeasurement of financial instruments at fair value through profit or loss ^{1,2}	54	665
Foreign exchange gains ³	338	38
Financial income	416	713
Interest expense on bonds and other financial instruments	(202)	(208)
Facility fees	(4)	(4)
Net present value adjustments	(44)	(43)
Net interest expense on retirement benefit obligations (note 21)	(165)	(169)
Loss on remeasurement of financial instruments at fair value through profit or loss ^{1,2}	(317)	(55)
Foreign exchange losses ³	(30)	(825)
Financial expense	(762)	(1,304)
Net finance costs	(346)	(591)

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 decrease in the gain on remeasurement of financial instruments primarily reflects exchange rate movements on derivatives relating to US dollar-denominated borrowings (2017 £19m; 2016 £446m). Loss on remeasurement of financial instruments includes £299m (2016 £23m) in respect of these exchange rate movements.
3. The foreign exchange gains primarily reflect exchange rate movements on US dollar-denominated borrowings (£319m). The foreign exchange losses in 2016 in respect of these exchange rate movements were £592m.

Additional analysis

	2017 £m	2016 £m
Net finance costs:		
Group	(346)	(591)
Share of equity accounted investments	(34)	(28)
	(380)	(619)

Analysed as:

Underlying net interest expense:		
Group	(226)	(245)
Share of equity accounted investments	(19)	(12)
	(245)	(257)

Other:

Group:		
Net interest expense on retirement benefit obligations	(165)	(169)
Fair value and foreign exchange adjustments on financial instruments and investments ¹	45	(177)
Share of equity accounted investments:		
Net interest expense on retirement benefit obligations	(8)	(8)
Fair value and foreign exchange adjustments on financial instruments and investments	(7)	(8)
	(380)	(619)

1. The net gain/(loss) primarily reflects foreign exchange translational gains/(losses) on US dollar-denominated bonds held by BAE Systems plc.

Notes to the Group accounts

continued

6. Taxation expense

Income tax expense comprises current and deferred tax. Current and deferred tax is recognised in profit or loss except to the extent that it relates to a business combination or items recognised directly in equity or other comprehensive income.

Current tax

Current tax is the expected tax payable or receivable on the taxable profit or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for temporary differences:

- on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss;
- related to investments in subsidiaries and equity accounted investments to the extent that it is probable that they will not reverse in the foreseeable future; and
- arising on the initial recognition of goodwill.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

Taxation expense

	2017 £m	2016 £m
Current taxation		
UK:		
Current tax	(132)	(74)
Adjustments in respect of prior years	(21)	29
	(153)	(45)
Overseas:		
Current year	(160)	(164)
Adjustments in respect of prior years	40	(5)
	(120)	(169)
Total current taxation	(273)	(214)
Deferred taxation		
UK:		
Origination and reversal of temporary differences	48	14
Adjustments in respect of prior years	3	4
Tax rate adjustment	(1)	–
	50	18
Overseas:		
Origination and reversal of temporary differences	(54)	(28)
Adjustments in respect of prior years	(13)	13
Tax rate adjustment ¹	40	(2)
	(27)	(17)
Total deferred taxation	23	1
Taxation expense	(250)	(213)
UK	(103)	(27)
Overseas	(147)	(186)
Taxation expense	(250)	(213)

1. The US federal tax rate has been reduced from 35% to 21% with effect from 1 January 2018, while the estimated state tax rate has increased from 5% to 6%. In line with this change, the rate applying to US deferred tax assets and liabilities at 31 December 2017 has been reduced from 40% to 27%, creating a rate adjustment in 2017, which is partly reflected in the Consolidated income statement and partly in the Consolidated statement of comprehensive income.

6. Taxation expense continued

Reconciliation of taxation expense

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

	2017 £m	2016 £m
Profit before taxation	1,134	1,151
UK corporation tax rate	19.25%	20.0%
Expected income tax expense	(218)	(230)
Effect of tax rates in foreign jurisdictions, including US state taxes	(101)	(81)
Effect of intra-group financing	15	15
Expenses not tax effected	(8)	(15)
Income not subject to tax	46	37
Research and development tax credits and patent box benefits	18	12
Non-deductible goodwill impairment	(74)	–
Chargeable gains	(2)	(3)
Utilisation of previously unrecognised tax losses	3	3
Adjustments in respect of prior years	9	41
Adjustments in respect of equity accounted investments	22	18
Tax rate adjustment ¹	39	(2)
Other	1	(8)
Taxation expense	(250)	(213)

1. 2017 includes a £40m credit in respect of US tax reform enacted in December 2017.

Calculation of the underlying effective tax rate

	2017 £m	2016 £m
Profit before taxation	1,134	1,151
Add back:		
Taxation expense of equity accounted investments (note 1)	37	36
Goodwill impairment (note 8)	384	–
Adjusted profit before taxation	1,555	1,187
Taxation expense	(250)	(213)
Taxation expense of equity accounted investments (note 1)	(37)	(36)
Exclude: Impact of US tax reform enacted in December 2017	(40)	–
Adjusted taxation expense (including equity accounted investments)	(327)	(249)
Underlying effective tax rate	21%	21%

Notes to the Group accounts

continued

6. Taxation expense continued

Tax recognised in other comprehensive income

	2017			2016		
	Before tax £m	Tax (expense)/ benefit £m	Net of tax £m	Before tax £m	Tax benefit/(expense) £m	Net of tax £m
Items that will not be reclassified to the income statement:						
Subsidiaries:						
Remeasurements on retirement benefit schemes	2,105	(407)	1,698	(1,468)	246	(1,222)
Tax rate adjustment ¹	–	(83)	(83)	–	14	14
Equity accounted investments	66	(13)	53	(66)	13	(53)
Items that may be reclassified to the income statement:						
Subsidiaries:						
Currency translation on foreign currency net investments	(625)	–	(625)	1,287	–	1,287
Amounts credited/(charged) to hedging reserve	59	(11)	48	96	(17)	79
Equity accounted investments	(14)	(1)	(15)	43	2	45
	1,591	(515)	1,076	(108)	258	150

1. 2017 comprises £67m in relation to the US and £16m in relation to the UK.

	2017			2016		
	Other reserves £m	Retained earnings £m	Total £m	Other reserves £m	Retained earnings £m	Total £m
Current tax						
Subsidiaries:						
Remeasurements on retirement benefit schemes	–	23	23	–	27	27
	–	23	23	–	27	27
Deferred tax						
Subsidiaries:						
Remeasurements on retirement benefit schemes	–	(430)	(430)	–	219	219
Tax rate adjustment ¹	–	(83)	(83)	–	14	14
Amounts charged to hedging reserve	(11)	–	(11)	(17)	–	(17)
Equity accounted investments	(1)	(13)	(14)	2	13	15
	(12)	(526)	(538)	(15)	246	231
Tax on other comprehensive income	(12)	(503)	(515)	(15)	273	258

1. 2017 comprises £67m in relation to the US and £16m in relation to the UK.

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 are not relevant to an understanding of the Group's underlying performance.

The impact of US tax reform enacted in December 2017 has been excluded because it does not reflect the Group's in-year underlying tax rate.

	2017			2016		
	£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	854	26.8	26.7	913	28.8	28.7
Add back/(deduct):						
Amortisation and impairment of intangible assets, post tax ¹	68			69		
Impairment of goodwill	384			–		
Non-cash movements, being net interest expense on retirement benefit obligations, post tax ¹	137			140		
Non-cash movements, being fair value and foreign exchange adjustments on financial instruments and investments, post tax ¹	(30)			146		
Non-recurring items, post tax ¹	10			9		
Impact of US tax reform enacted in December 2017	(40)			–		
Underlying earnings, post tax	1,383	43.5	43.3	1,277	40.3	40.1
		Millions	Millions		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share	3,182	3,182		3,171	3,171	
Incremental shares in respect of employee share schemes	15			14		
Weighted average number of shares used in calculating diluted earnings per share	3,197			3,185		

1. The tax impact is calculated using the underlying effective tax rate of 21% (2016 21%).

Notes to the Group accounts

continued

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.

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 5 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 exceeds its recoverable amount.

The recoverable amount is the greater of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate. For an asset that does not generate largely independent cash flows, the recoverable amount is determined for the Cash-Generating Unit to which the asset belongs.

Impairment losses are recognised in the income statement.

An impairment loss in respect of goodwill is not reversed. An impairment loss in respect of other intangible assets, property, plant and equipment, investment property and equity accounted investments is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised or if there has been a change in the estimate used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

8. Intangible assets continued

	Goodwill £m	Software ¹ £m	Development costs ¹ £m	Programme and customer- related £m	Other ¹ £m	Total £m
Cost or valuation						
At 1 January 2016	14,041	382	102	604	83	15,212
Additions:						
Acquired separately ²	–	43	–	–	4	47
Internally developed ²	–	34	1	–	–	35
Disposals ³	–	(5)	(15)	(122)	(3)	(145)
Reclassification from held for sale	–	–	–	–	3	3
Transfer from property, plant and equipment	–	57	–	–	–	57
Foreign exchange adjustments	1,362	47	13	62	12	1,496
At 31 December 2016	15,403	558	101	544	99	16,705
Additions:						
Acquired separately	–	42	–	–	–	42
Internally developed	–	45	–	–	–	45
Business acquisitions	3	–	–	–	–	3
Disposals ³	–	(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
Amortisation and impairment						
At 1 January 2016	4,201	232	56	534	72	5,095
Amortisation	–	37	10	32	4	83
Disposals ³	–	(5)	(15)	(122)	(3)	(145)
Reclassification from held for sale	–	–	–	–	3	3
Foreign exchange adjustments	300	34	8	52	11	405
At 31 December 2016	4,501	298	59	496	87	5,441
Amortisation ⁴	–	43	8	20	14	85
Impairment charge	384	–	–	–	–	384
Disposals ³	–	(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
Net book value						
At 31 December 2017	9,996	325	28	25	4	10,378
At 31 December 2016	10,902	260	42	48	12	11,264
At 1 January 2016	9,840	150	46	70	11	10,117

1. Re-presented to separate software and development costs from other intangible assets.

2. Re-presented to separate internally developed software intangible asset additions from those acquired separately.

3. Includes intangible assets with nil net book value no longer used by the Group.

4. Amortisation of £85m includes £82m charged to the income statement as an amortisation expense and £3m recoverable on customer contracts.

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 6.60% (2016 7.01%) (adjusted for risks specific to the market in which the Cash-Generating Unit (CGU) operates), have been used in discounting these projected risk-adjusted cash flows.

Notes to the Group accounts

continued

8. Intangible assets continued

Significant CGUs

Goodwill allocated to CGUs which are largely dependent on US government spending on defence, aerospace and security represents £7.9bn (2016 £8.4bn) 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	
		2017 £bn	2016 £bn	2017 %	2016 %
Electronic Systems	Continued demand from the US government for electronic warfare systems (where the business has a leadership position), other technology-based solutions and growth in the commercial avionics market	3.8	4.0	8	9
Intelligence & Security (within Cyber & Intelligence)	Continued demand in the US for the Group's services in the areas of homeland security, law enforcement and counter-intelligence	0.7	0.7	8	9
Platforms & Services (US)	Continued demand in the Group's principal markets for existing and successor military tracked vehicles, naval guns, missile launchers, artillery systems, munitions, upgrade programmes and support, and in the US for complex infrastructure, maritime and aviation services	3.4	3.7	8	9

The headroom, calculated as the difference between net assets including allocated goodwill as at 31 December 2017 and the value-in-use calculations, for the CGUs listed above, is shown below. The table also shows the headroom assuming a 1% reduction in the terminal value growth rate assumption and a 1% increase in the discount rate used in the value-in-use calculations.

Cash-Generating Unit	Headroom as at 31 December		Headroom assuming a 1% reduction in the terminal value growth rate assumption		Headroom assuming a 1% increase in the discount rate	
	2017 £bn	2016 £bn	2017 £bn	2016 £bn	2017 £bn	2016 £bn
Electronic Systems	5.7	3.5	4.0	2.2	3.7	2.0
Intelligence & Security	0.6	0.3	0.4	0.2	0.4	0.1
Platforms & Services (US)	3.5	1.6	2.2	0.7	2.0	0.5

Other CGUs

The remaining goodwill balance of £2.1bn (2016 £2.5bn) is allocated across multiple CGUs, including £0.2bn (2016 £0.6bn) 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 reflects lower growth assumptions in the Applied Intelligence CGU. The recoverable amount of the Applied Intelligence CGU is based on value in use calculated using a pre-tax discount rate of 16% (2016 11%).

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 a customer 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.

Notes to the Group accounts

continued

9. Property, plant and equipment continued

	Land and buildings £m	Plant and machinery £m	Total £m
Cost			
At 1 January 2016	1,770	2,806	4,576
Additions ¹	235	326	561
Reclassification as held for sale	(20)	(2)	(22)
Transfer to investment properties	(9)	–	(9)
Transfer to other intangible assets	–	(57)	(57)
Reclassification between categories	28	(28)	–
Disposals	(22)	(72)	(94)
Foreign exchange adjustments	194	256	450
At 31 December 2016	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
Depreciation and impairment			
At 1 January 2016	1,005	1,873	2,878
Depreciation charge for the year	73	178	251
Impairment charge for the year	8	1	9
Reclassification as held for sale	(20)	(2)	(22)
Transfer to investment properties	(9)	–	(9)
Disposals	(13)	(70)	(83)
Foreign exchange adjustments	104	179	283
At 31 December 2016	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
Net book value			
At 31 December 2017	1,129	1,101	2,230
At 31 December 2016	1,028	1,070	2,098
At 1 January 2016	765	933	1,698

1. Includes £109m (2016 £143m) of land and buildings, and £42m (2016 £25m) of plant and machinery at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

9. Property, plant and equipment continued

Net book value

	Land and buildings £m	Plant and machinery £m	Total £m
Freehold property	963	—	963
Long leasehold property	31	—	31
Short leasehold property	135	—	135
Plant and machinery	—	1,024	1,024
Fixtures, fittings and equipment	—	77	77
At 31 December 2017	1,129	1,101	2,230

Net impairment

	2017 £m	2016 £m
Electronic Systems	(4)	—
Platforms & Services (US)	—	9
Platforms & Services (International)	1	—
	(3)	9

2017

The impairment write back in Electronic Systems relates to the carrying value of a property in New Jersey, US.

2016

The impairment charge in Platforms & Services (US) represented a charge against the carrying value of the BAE Systems San Francisco Ship Repair business.

Assets in the course of construction

	Land and buildings ¹ £m	Plant and machinery ² £m	Total £m
At 31 December 2017	259	296	555
At 31 December 2016	246	352	598

1. Includes £178m (2016 £161m) at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

2. 2016 included £78m in respect of a new dry dock in San Diego, US, which became operational in February 2017.

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:

	2017 £m	2016 £m
Receipts due:		
Not later than one year	24	25
Later than one year and not later than five years	95	90
Later than five years	51	72
	170	187

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

Notes to the Group accounts

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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 2016	176
Additions	9
Transfer from property, plant and equipment	9
Disposals	(24)
At 31 December 2016	170
Additions	15
Disposals	(24)
At 31 December 2017	161
Depreciation and impairment	
At 1 January 2016	56
Depreciation charge for the year	2
Transfer from property, plant and equipment	9
Disposals	(7)
At 31 December 2016	60
Depreciation charge for the year	3
Impairment charge	2
Disposals	(5)
At 31 December 2017	60
Net book value	
At 31 December 2017	101
At 31 December 2016	110
At 1 January 2016	120
Fair value	
At 31 December 2017	173
At 31 December 2016	167

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.

11. Equity accounted investments

A joint venture is a joint arrangement whereby the parties that have joint control have rights to the net assets of the arrangement.

Carrying value

The carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill, and is assessed for impairment as a single asset. The carrying amounts of the Group's equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment in accordance with the policy shown in note 8.

Principal equity accounted investments

Joint venture	Principal activities	Shareholding	Principally operates in
Eurofighter Jagdflugzeug	Management and control of the European Typhoon programme	33%	Germany
MBDA	Development and manufacture of guided weapons	37.5%	Europe

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.

	2017		2016	
	Eurofighter Jagdflugzeug £m	MBDA £m	Eurofighter Jagdflugzeug £m	MBDA £m
Revenue (100%)	3,011	2,723	2,986	2,416
Underlying EBITA ¹ excluding depreciation	10	351	18	320
Depreciation and amortisation	(1)	(46)	(2)	(74)
Financial income	2	64	2	60
Financial expense	–	(82)	(9)	(77)
Taxation expense	(4)	(84)	(26)	(56)
Profit/(loss) for the year (100%)	7	203	(17)	173
Remeasurements on retirement benefit schemes, net of tax	–	141	–	(139)
Amounts charged to hedging reserve, net of tax	–	(6)	–	(30)
Foreign exchange adjustments	–	(8)	–	31
Total comprehensive income for the year (100%)	7	330	(17)	35
Group's share of total comprehensive income for the year	2	124	(5)	13
Non-current assets	12	2,065	11	1,996
<i>Cash and cash equivalents</i>	30	2,420	26	1,613
<i>Current assets excluding cash and cash equivalents</i>	1,144	4,029	1,746	3,870
Current assets	1,174	6,449	1,772	5,483
<i>Non-current financial liabilities excluding trade and other payables, and provisions</i>	–	(4)	–	(101)
<i>Other non-current liabilities</i>	(29)	(789)	(26)	(937)
Non-current liabilities	(29)	(793)	(26)	(1,038)
<i>Current financial liabilities excluding trade and other payables, and provisions</i>	(3)	8	–	(32)
<i>Other current liabilities</i>	(1,130)	(7,206)	(1,740)	(6,100)
Current liabilities	(1,133)	(7,198)	(1,740)	(6,132)
Net assets (100%)	24	523	17	309

1. Operating profit excluding amortisation and impairment of intangible assets (EBITA), and non-recurring items.

Notes to the Group accounts

continued

11. Equity accounted investments continued

	2017			2016		
	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m
Group's share of net assets	8	196	204	5	116	121
Goodwill adjustment	–	6	6	–	5	5
Carrying value	8	202	210	5	121	126
	2017			2016		
	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m	Eurofighter Jagdflugzeug £m	MBDA £m	Total £m
Dividends received	–	47	47	–	13	13

Group summary

The Group also has a number of individually immaterial joint ventures, the carrying values of the most significant of which at 31 December 2017 are as follows: Advanced Electronics Company (£53m), FADEC International (£40m), Air Astana (£30m) and Panavia Aircraft (£19m). The following table shows a reconciliation of opening to closing carrying value for both the Group's principal and immaterial joint ventures in aggregate.

	Principal equity accounted investments £m	Other £m	Total £m
At 1 January 2016	121	129	250
<i>Group's share of profit for the year</i>	59	31	90
<i>Group's share of remeasurements on retirement benefit schemes</i>	(66)	–	(66)
<i>Tax on items that will not be reclassified to the income statement</i>	13	–	13
<i>Foreign exchange adjustments</i>	13	20	33
<i>Amounts (charged)/credited to hedging reserve</i>	(14)	5	(9)
<i>Tax on items that may be reclassified to the income statement</i>	3	(1)	2
Group's share of total comprehensive income for the year	8	55	63
Equity accounted investment funding	–	5	5
Dividends received from equity accounted investments	(13)	(25)	(38)
Foreign exchange adjustments	10	9	19
At 31 December 2016	126	173	299
<i>Group's share of profit for the year</i>	79	37	116
<i>Group's share of remeasurements on retirement benefit schemes</i>	66	–	66
<i>Tax on items that will not be reclassified to the income statement</i>	(13)	–	(13)
<i>Foreign exchange adjustments</i>	(4)	(5)	(9)
<i>Amounts (charged)/credited to hedging reserve</i>	(2)	4	2
<i>Tax on items that may be reclassified to the income statement</i>	–	(1)	(1)
Group's share of total comprehensive income for the year	126	35	161
Equity accounted investment funding	–	3	3
Dividends received from equity accounted investments	(47)	(25)	(72)
Foreign exchange adjustments	5	(12)	(7)
At 31 December 2017	210	174	384

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of its equity accounted investments.

12. Trade and other receivables

Trade receivables are stated at their cost less provision for bad debts. A provision for bad debt is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

A loss on provision for bad debt is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Amounts due from customers for contract work includes long-term contract balances and amounts due from contract customers, less attributable progress payments.

Long-term contract balances are stated at cost less provision for any anticipated losses. Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of long-term contract balances for that portion of the work which has already been completed, and the remainder is included as amounts due to long-term contract customers within trade and other payables. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Progress payments are amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery and are credited, as progress payments, against any expenditure incurred for the particular contract. Any unexpended balance in respect of progress payments is held in trade and other payables as customer stage payments or, if the amounts are subject to advance payment guarantees unrelated to Group performance, as cash received on customers' account.

Amounts due from contract customers represent unbilled income and are stated at cost, plus attributable profit.

US deferred compensation plan assets are measured at fair value in accordance with IAS 19, Employee Benefits.

	2017 £m	2016 £m
Non-current		
Prepayments and accrued income	5	35
US deferred compensation plan assets	302	296
Other receivables ¹	80	20
	387	351
Current		
Long-term contract balances	2,506	3,128
Deduct Attributable progress payments	(1,706)	(2,282)
Amounts due from contract customers	422	435
Amounts due from customers for contract work	1,222	1,281
Trade receivables	1,688	1,437
Amounts owed by equity accounted investments (note 30)	86	69
Prepayments and accrued income	284	256
Other receivables ¹	306	262
	3,586	3,305

1. Includes £89m which is reimbursable in respect of reorganisation costs incurred in 2017 (non-current £45m; current £44m).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2017 is estimated to be £26.8bn (2016 £27.5bn).

Trade receivables are disclosed net of a provision for bad debts. Disclosures relating to the ageing of trade receivables and movements in the provision for bad debts are provided in note 28.

Notes to the Group accounts

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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 and those interest rate exposures where hedge accounting can be achieved.

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 do not qualify for hedge accounting are recognised in the income statement for the period.

Cash flow hedges

Where a derivative financial instrument is designated as a hedge of cash flows relating to a highly probable forecast transaction (income or expense), the effective portion of any change in the fair value of the instrument is recognised in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement immediately.

Fair value hedges

Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

	2017		2016	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	147	(114)	138	(102)
Other foreign exchange/interest rate contracts	–	(19)	93	–
Debt-related derivative financial instruments – assets ¹	79	–	114	–
	226	(133)	345	(102)
Current				
Cash flow hedges – foreign exchange contracts	77	(48)	151	(184)
Other foreign exchange/interest rate contracts	12	(37)	53	(28)
Debt-related derivative financial instruments – liabilities	–	(19)	–	–
	89	(104)	204	(212)

1. Includes fair value hedges of £nil (2016 £4m).

Cash flow hedges

The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts credited to the hedging reserve in respect of cash flow hedges were £61m (2016 £87m), including £24m (2016 £74m) on reclassification to profit and loss and £37m (2016 £13m credit) on contracts held at 31 December 2017.

Fair value hedges

The loss arising in the income statement on fair value hedging instruments was £4m (2016 £3m). The gain arising in the income statement on the fair value of the underlying hedged items was £4m (2016 £1m).

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 19). These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

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 new 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 21).

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	
	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m
Property, plant and equipment	16	20	(94)	(119)	(78)	(99)
Intangible assets	13	18	(14)	(28)	(1)	(10)
Provisions and accruals	224	343	–	–	224	343
Goodwill	–	–	(275)	(428)	(275)	(428)
Pension/retirement schemes:						
Deficits	710	1,212	–	–	710	1,212
Additional contributions and other ¹	100	149	(1)	–	99	149
Share-based payments	14	23	–	–	14	23
Financial instruments	–	–	(11)	(5)	(11)	(5)
Other items	27	39	(1)	–	26	39
Rolled over capital gains	–	–	(10)	(11)	(10)	(11)
Capital losses carried forward	10	11	–	–	10	11
Trading losses carried forward	12	17	–	–	12	17
Deferred tax assets/(liabilities)	1,126	1,832	(406)	(591)	720	1,241
Set off of tax	(402)	(581)	402	581	–	–
Net deferred tax assets/(liabilities)	724	1,251	(4)	(10)	720	1,241

1. Includes deferred tax assets on US deferred compensation plans.

Notes to the Group accounts

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14. Deferred tax continued

Movement in temporary differences during the year

	At 1 January 2017 £m	Foreign exchange adjustments £m	Recognised in income ¹ £m	Recognised in equity ² £m	At 31 December 2017 £m
Property, plant and equipment	(99)	9	12	–	(78)
Intangible assets	(10)	(1)	10	–	(1)
Provisions and accruals	343	(22)	(97)	–	224
Goodwill	(428)	31	122	–	(275)
Pension/retirement schemes:					
Deficits	1,212	(17)	28	(513)	710
Additional contributions and other ³	149	(12)	(38)	–	99
Share-based payments	23	–	(1)	(8)	14
Financial instruments	(5)	–	5	(11)	(11)
Other items	39	–	(13)	–	26
Rolled over capital gains	(11)	–	1	–	(10)
Capital losses carried forward	11	–	(1)	–	10
Trading losses carried forward	17	–	(5)	–	12
	1,241	(12)	23	(532)	720
	At 1 January 2016 £m	Foreign exchange adjustments £m	Recognised in income £m	Recognised in equity £m	At 31 December 2016 £m
Property, plant and equipment	(85)	(16)	2	–	(99)
Intangible assets	(17)	–	7	–	(10)
Provisions and accruals	299	54	(10)	–	343
Goodwill	(326)	(67)	(35)	–	(428)
Pension/retirement schemes:					
Deficits	908	45	26	233	1,212
Additional contributions and other ³	112	24	13	–	149
Share-based payments	15	–	4	4	23
Financial instruments	10	1	1	(17)	(5)
Other items	35	6	(2)	–	39
Rolled over capital gains	(12)	–	1	–	(11)
Capital losses carried forward	12	–	(1)	–	11
Trading losses carried forward	21	1	(5)	–	17
	972	48	1	220	1,241

1. Includes a credit of £39m recognised in income in respect of tax rate adjustments.

2. Includes a debit of £83m recognised in equity in respect of tax rate adjustments.

3. Includes deferred tax assets on US deferred compensation plans.

Unrecognised deferred tax assets and liabilities

Deferred tax assets have not been recognised in respect of the following items:

	2017		2016	
	Gross amount £m	Unrecognised deferred tax asset £m	Gross amount £m	Unrecognised deferred tax asset £m
Deductible temporary differences, including tax credits	1	1	2	2
Capital losses carried forward	207	36	165	30
Trading and other losses carried forward	389	38	415	39
	597	75	582	71

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 £237m (2016 £274m) 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.

14. Deferred tax continued

Future changes in tax rates

The US federal tax rate has been reduced from 35% to 21% with effect from 1 January 2018, while the estimated state tax rate has increased from 5% to 6%. This will reduce future US current tax charges accordingly. Recognised US deferred tax balances as at 31 December 2017 have been calculated at a combined federal and state tax rate of 27% (2016 40%).

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 2017 have been calculated at a blended rate of 17.5% (2016 18%).

15. Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

	2017 £m	2016 £m
Short-term work-in-progress	377	416
Raw materials and consumables	260	256
Finished goods and goods for resale	86	72
	723	744

The Group recognised £9m (2016 £10m) 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.

	2017 £m	2016 £m
Tax provisions	(351)	(365)
Research and development expenditure credits receivable	131	105
Other	(65)	(46)
	(285)	(306)

Represented by:

Current tax assets	20	5
Current tax liabilities	(305)	(311)
	(285)	(306)

Tax provisions of £351m (2016 £365m) are in respect of known tax issues, of which £292m (2016 £325m) relates to non-UK jurisdictions. Whilst there is inherent uncertainty regarding the timing of any resolution of tax positions, the Group does not consider that there is a significant risk of material change in 2018.

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.

	2017 £m	2016 £m
Cash	913	419
Money market funds	899	869
Short-term deposits	1,459	1,483
	3,271	2,771
Deduct Cash and cash equivalents (included within assets held for sale)	–	(2)
	3,271	2,769

Notes to the Group accounts

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18. Geographical analysis of assets

Analysis of non-current assets by geographical location

Asset location	Notes	2017 £m	2016 £m
UK		2,711	2,755
Rest of Europe		590	586
US		9,283	9,864
Saudi Arabia		438	443
Australia		459	474
Rest of Asia and Pacific		5	6
Non-current segment assets		13,486	14,128
Retirement benefit surpluses	21	302	223
Other financial assets	13	315	549
Tax	14,16	744	1,256
Inventories	15	723	744
Current trade and other receivables	12	3,586	3,305
Cash and cash equivalents	17	3,271	2,769
Assets held for sale		26	2
Consolidated total assets		22,453	22,976

19. Loans and overdrafts

Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at either amortised cost or, where hedge accounting has been adopted, fair value in respect of the hedged risk. Any difference between the amount initially recognised and the redemption value is recognised in the income statement over the period of the borrowings.

	2017 £m	2016 £m
Non-current		
Albertville Hangar bond, repayable 2018	–	8
US\$1bn 6.375% bond, repayable 2019	741	810
US\$500m 2.85% bond, repayable 2020	368	403
US\$500m 4.75% bond, repayable 2021	369	404
£400m 4.125% bond, repayable 2022	398	398
US\$800m 3.8% bond, repayable 2024	590	649
US\$750m 3.85% bond, repayable 2025	548	598
US\$500m 7.5% bond, repayable 2027	368	402
US\$400m 5.8% bond, repayable 2041	292	320
US\$550m 4.75% bond, repayable 2044	395	433
	4,069	4,425
Current		
Albertville Hangar bond, repayable 2018	7	–
Overdrafts	7	–
	14	–

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 2017 of 6.2%.

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 2018 and give an effective rate during 2017 of 2.5%.

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 2017 of 3.5%. 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 2017 of 4.0%.

19. Loans and overdrafts continued

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 7.6%.

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 2017 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 2017 of 4.2%.

20. Trade and other payables

Trade and other payables are stated at their cost.

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.

	2017 £m	2016 £m
Non-current		
Amounts due to long-term contract customers	808	173
Amounts due to other customers	16	10
Amounts owed to equity accounted investments (note 30)	15	24
Accruals and deferred income ¹	446	300
US deferred compensation plan liabilities	318	326
Other payables	119	194
	1,722	1,027
Current		
Amounts due to long-term contract customers	2,147	3,084
Amounts due to other customers	148	169
Trade payables	638	707
Amounts owed to equity accounted investments (note 30)	912	726
Other taxes and social security costs	239	206
Accruals and deferred income	1,946	1,406
Other payables	292	242
	6,322	6,540
Included above:		
Amounts due to long-term contract customers, including contract losses	2,955	3,257
Advances from long-term contract customers	2,880	3,133
Advances from other customers	164	179

1. Includes £344m (2016 £209m) of funding received from the UK government for property, plant and equipment at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme.

Notes to the Group accounts continued

21. 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 178. 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 2017.

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 the equity accounted investments is included in the balance sheet within equity accounted investments.

21. 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 Main Scheme and the BAE Systems 2000 Pension Plan (2000 Plan) which, in aggregate, represent 81% (2016 69%) of the total IAS 19 defined benefit obligation at 31 December 2017. The schemes in other countries are primarily defined contribution schemes.

At 31 December 2017, the weighted average durations of the UK and US defined benefit pension obligations were 18 years (2016 19 years) and 12 years (2016 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	31	16	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 2017.

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.

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

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21. 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 178 to 183.

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 178. 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 valuation will have an effective date of no later than 31 March 2020.

In November, the 2017 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 funding valuations have resulted in a significantly lower deficit than under IAS 19.

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 are based on prudent levels of expected returns for the assets held by each of the schemes. The discount rates are curves which provide a different rate for each year into the future. The discount rates used in the 2014 valuation were based on a traditional gilts yield plus a margin which varied by scheme and over time. The discount rates used in the 2017 valuation are directly based on prudent return assumptions for the assets held by the schemes, reflecting the planned investment strategies and maturity profiles of each scheme.

The inflation assumptions are 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 deficit is approximately £3bn lower than the accounting deficit of the equivalent UK schemes prepared under IAS 19, using like-for-like mortality assumptions and asset values at 31 December 2017, 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 held in the schemes, which are expected 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 will be no change 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 2017.

21. Retirement benefits 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 2017, total contributions to the Group's pension schemes were £433m (2016 £461m), including amounts funded by equity accounted investments of £31m (2016 £50m), and included approximately £209m and £62m of deficit recovery payments in respect of the UK and US schemes, respectively.

Based on the new funding valuations, current annual deficit recovery payments to the UK schemes, including amounts funded by equity accounted investments, will increase to £220m a year from 1 April 2018. Deficit contributions will further increase in line with any percentage growth in dividend payments made by the Group. Under the new deficit recovery plans, these annual payments would subsequently fall by £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.

Based on the latest valuations of the Group's US pension schemes, contributions are expected to remain at a level consistent with 2017 through to 2022.

In 2018, the Group expects to make total contributions to its pension schemes of £0.5bn.

Risk management

The defined benefit pension schemes expose the Group to actuarial risks, including market (investment) risk, interest rate risk, inflation risk and longevity risk.

Risk	Mitigation
Market (investment) risk Asset returns may not move in line with the liabilities and may be subject to volatility.	The investment portfolios are highly diversified, investing in a wide range of assets, in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. To reduce volatility, certain assets are held in a matching portfolio, which largely consists of index-linked bonds, gilts and swaps, designed to mirror movements in corresponding liabilities. Some 47% (2016 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 has a long-dated equity option strategy protecting £1.4bn of assets against a significant fall in equity markets.
Interest rate risk Liabilities are sensitive to movements in interest rates, with lower interest rates leading to an increase in the valuation of liabilities.	In addition to investing in bonds as part of the matching portfolio, 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

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21. 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		
	2017	2016	2015	2017	2016	2015
Financial assumptions						
Discount rate – past service (%)	2.6	2.7	3.9	3.7	4.2	4.5
Discount rate – future service (%)	2.7	2.7	3.9	3.7	4.2	4.5
Retail Prices Index (RPI) inflation (%)	3.1	3.2	3.2	n/a	n/a	n/a
Rate of increase in salaries (%)	3.1	3.2	3.2	n/a	n/a	n/a
Rate of increase in deferred pensions (%)	2.1/3.1	2.2/3.2	2.3/3.2	n/a	n/a	n/a
Rate of increase in pensions in payment (%)	1.6 – 3.7	1.7 – 3.7	1.8 – 3.6	n/a	n/a	n/a
Demographic assumptions						
Life expectancy of a male currently aged 65 (years)	86 – 88	86 – 89	87 – 89	87	87	87
Life expectancy of a female currently aged 65 (years)	88 – 90	89 – 90	89 – 90	89	89	89
Life expectancy of a male currently aged 45 (years)	88 – 90	88 – 91	89 – 91	87	87	87
Life expectancy of a female currently aged 45 (years)	90 – 92	91 – 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 175.

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% (2016 RPI inflation of 3.2%), plus a promotional scale. From 1 January 2013, employees in the US schemes no longer accrue salary-related benefits.

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on Consumer Prices Index (CPI) inflation of 2.1% (2016 CPI inflation of 2.2%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.1% (2016 RPI inflation of 3.2%). For all UK schemes, the rate of increase in deferred pensions is subject to inflation caps.

Rate of increase in pensions in payment

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

Life expectancy

For its UK pension schemes, the Group has used the Self-Administered Pension Schemes S2 mortality tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of scheme members and information on the demographic profile of the scheme's membership. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2016 tables (published by the Institute of Actuaries) have been used (in 2016, the Continuous Mortality Investigation 2015 tables were used), with an assumed long-term rate of future annual mortality improvements of 1.25% (2016 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 2017 are a blend of the fully generational RP-2014 Aggregate table and the RP-2014 White Collar table, both projected using Scale MP-2017. The IRS have approved the new mortality tables to be adopted for funding valuation purposes from 2018.

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 2017. These valuations were rolled forward to reflect the information at 31 December 2017. 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% (2016 4.8%) based on the assumptions that the increases are 7.8% in 2017 reducing to 4.5% by 2026 and 4.5% each year thereafter for pre-retirement, and 8.5% in 2017 reducing to 4.5% by 2026 and 4.5% each year thereafter for post-retirement.

21. Retirement benefits continued

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total net IAS 19 deficit at 1 January 2017	(5,778)	(792)	(6,570)
Actual return on assets excluding amounts included in net interest expense	1,082	444	1,526
Increase in liabilities due to changes in financial assumptions	(242)	(291)	(533)
Decrease in liabilities due to changes in mortality assumptions	971	24	995
Decrease in liabilities due to changes in other demographic assumptions	202	–	202
Experience gains/(losses)	136	(29)	107
Contributions in excess of service cost	98	53	151
Past service cost – plan amendments	(2)	–	(2)
Net interest expense	(147)	(32)	(179)
Foreign exchange adjustments	–	55	55
Movement in US healthcare schemes	–	2	2
Total net IAS 19 deficit at 31 December 2017	(3,680)	(566)	(4,246)
Allocated to equity accounted investments	326	–	326
Group's share of net IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments at 31 December 2017	(3,354)	(566)	(3,920)

The decrease in liabilities due to changes in mortality assumptions in the UK schemes reflects updated assumptions, both to base tables and future improvements.

Contributions in excess of service cost on an IAS 19 accounting basis of £151m are lower than on a funding basis (£271m) because the service cost is higher on an IAS 19 accounting basis.

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.

	2017				2016			
	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m	UK defined benefit pension schemes £m	US and other pension schemes £m	US healthcare schemes £m	Total £m
Present value of unfunded obligations	(49)	(146)	–	(195)	(74)	(153)	–	(227)
Present value of funded obligations	(26,071)	(4,803)	(168)	(31,042)	(27,099)	(4,981)	(169)	(32,249)
Fair value of scheme assets	22,440	4,352	199	26,991	21,395	4,313	198	25,906
Total net IAS 19 (deficit)/surplus	(3,680)	(597)	31	(4,246)	(5,778)	(821)	29	(6,570)
Allocated to equity accounted investments	326	–	–	326	516	–	–	516
Group's share of net IAS 19 (deficit)/surplus	(3,354)	(597)	31	(3,920)	(5,262)	(821)	29	(6,054)
Represented by:								
Retirement benefit surpluses	209	54	39	302	132	49	42	223
Retirement benefit obligations	(3,563)	(651)	(8)	(4,222)	(5,394)	(870)	(13)	(6,277)
	(3,354)	(597)	31	(3,920)	(5,262)	(821)	29	(6,054)
Group's share of net IAS 19 deficit of equity accounted investments	(126)	–	–	(126)	(193)	–	–	(193)

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £4.6bn (2016 £6.7bn).

Notes to the Group accounts

continued

21. 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 2016	20,209	3,452	166	23,827
Impact of sectionalisation of the Main Scheme	(1,779)	–	–	(1,779)
<i>Interest income</i>	710	166	8	884
<i>Actual return on assets excluding amounts included in interest income</i>	2,649	180	2	2,831
Actual return on assets	3,359	346	10	3,715
<i>Contributions by employer</i>	390	71	1	462
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	86	–	–	86
Total contributions by employer	476	71	1	548
Members' contributions	9	–	–	9
Administrative expenses	–	(17)	–	(17)
Foreign exchange translation	–	679	33	712
Benefits paid	(879)	(218)	(12)	(1,109)
Value of scheme assets at 31 December 2016	21,395	4,313	198	25,906
<i>Interest income</i>	568	169	8	745
<i>Actual return on assets excluding amounts included in interest income</i>	1,082	444	19	1,545
Actual return on assets	1,650	613	27	2,290
<i>Contributions by employer</i>	352	81	2	435
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	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	22,440	4,352	199	26,991

21. Retirement benefits continued

Assets of defined benefit pension schemes

	2017									
	UK			US and other			Total			Total
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	
Equities:										
UK ¹	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 ²	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 ³	–	1,648	1,648	–	129	129	–	1,777	1,777	
Derivatives ⁴	–	(1,011)	(1,011)	–	–	–	–	(1,011)	(1,011)	
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	4,996	22,440	4,220	132	4,352	21,664	5,128	26,792	
2016										
	UK			US and other			Total			Total
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m	
Equities:										
UK ¹	4,030	–	4,030	–	–	–	4,030	–	4,030	
Overseas	2,774	–	2,774	430	–	430	3,204	–	3,204	
Pooled investment vehicles ²	1,503	2,428	3,931	988	–	988	2,491	2,428	4,919	
Fixed interest securities:										
UK gilts	1,947	–	1,947	–	–	–	1,947	–	1,947	
UK corporates	2,389	145	2,534	–	–	–	2,389	145	2,534	
Overseas government	79	–	79	151	–	151	230	–	230	
Overseas corporates	1,069	230	1,299	2,509	–	2,509	3,578	230	3,808	
Index-linked securities:										
UK gilts	2,039	–	2,039	–	–	–	2,039	–	2,039	
UK corporates	1,046	546	1,592	–	–	–	1,046	546	1,592	
Property ³	–	1,460	1,460	–	147	147	–	1,607	1,607	
Derivatives ⁴	–	(708)	(708)	–	–	–	–	(708)	(708)	
Cash:										
Sterling	345	–	345	–	–	–	345	–	345	
Foreign currency	32	26	58	79	–	79	111	26	137	
Other	–	15	15	–	9	9	–	24	24	
Total	17,253	4,142	21,395	4,157	156	4,313	21,410	4,298	25,708	

1. Includes £33m (2016 £32m) of the Company's own ordinary shares.
2. Primarily invested in equities. The amounts classified as unquoted primarily comprise investments in private equity, valued in accordance with International Private Equity and Venture Capital Valuation Guidelines.
3. 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 £243m (2016 £229m) of property occupied by Group companies.
4. Includes interest rate, inflation and longevity swaps. The valuations are based on valuation techniques using underlying market data and discounted cash flows.

Notes to the Group accounts

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21. 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 2016	(25,033)	(4,203)	(145)	(29,381)
Impact of sectionalisation of the Main Scheme	2,446	–	–	2,446
<i>Current service cost</i>	(180)	(11)	(1)	(192)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(86)	–	–	(86)
Total current service cost	(266)	(11)	(1)	(278)
Members' contributions	(9)	–	–	(9)
Past service cost – plan amendments	(7)	(4)	(1)	(12)
Actuarial loss due to changes in financial assumptions	(4,815)	(170)	(5)	(4,990)
Actuarial gain due to changes in demographic assumptions	250	40	3	293
Experience gains	242	10	1	253
Interest expense	(860)	(200)	(7)	(1,067)
Foreign exchange translation	–	(814)	(26)	(840)
Benefits paid	879	218	12	1,109
Defined benefit obligations at 31 December 2016	(27,173)	(5,134)	(169)	(32,476)
<i>Current service cost</i>	(254)	(12)	(1)	(267)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(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	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)

Amounts recognised in the income statement after allocation to equity accounted investments

	2017				2016			
	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	(228)	(12)	(1)	(241)	(161)	(11)	(1)	(173)
Past service cost – plan amendments	(2)	–	(1)	(3)	(7)	(4)	(1)	(12)
	(230)	(12)	(2)	(244)	(168)	(15)	(2)	(185)
Administrative expenses	–	(16)	–	(16)	–	(17)	–	(17)
	(230)	(28)	(2)	(260)	(168)	(32)	(2)	(202)
Included in net finance costs:								
Net interest (expense)/income on retirement benefit obligations	(134)	(32)	1	(165)	(136)	(34)	1	(169)
Group defined benefit schemes included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	(12)	–	–	(12)	(10)	–	–	(10)
Group's share of equity accounted investments' finance costs	(5)	–	–	(5)	(5)	–	–	(5)

The Group incurred a charge of £193m (2016 £189m restated) in relation to defined contribution schemes for employees.

21. Retirement benefits continued

Sensitivity analysis

The sensitivity information has been derived using scenario analysis from the actuarial assumptions as at 31 December 2017 and keeping all other assumptions as set out on page 178.

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	(0.5)	0.2
0.1 percentage point decrease	0.5	(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	(1.5)
0.5 percentage point decrease	1.5
1.0 percentage point increase	(3.1)
1.0 percentage point decrease	2.8

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 177), 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.

Notes to the Group accounts

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22. Provisions

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

Warranties and after-sales service

Warranties and after-sales service are provided in the normal course of business with provisions for associated costs being made based on an assessment of future claims with reference to past experience. A provision for warranties is recognised when the underlying products and services are sold. The provision is based on historical warranty data and a weighting of possible outcomes against their associated probabilities.

Reorganisations

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Future operating costs are not provided for.

Legal, contractual and environmental

The Group holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period. 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 £m	Other £m	Total £m
Non-current	59	1	280	32	372
Current	43	22	131	38	234
At 1 January 2017	102	23	411	70	606
Created	55	190	66	21	332
Utilised	(37)	(16)	(36)	(10)	(99)
Acquisitions	–	–	–	2	2
Reclassified between categories	–	–	3	(3)	–
Released ¹	(13)	(6)	(51)	(8)	(78)
Net present value adjustments	–	–	17	2	19
Foreign exchange adjustments	(5)	–	(16)	(3)	(24)
At 31 December 2017	102	191	394	71	758
Represented by:					
Non-current	51	73	259	30	413
Current	51	118	135	41	345
	102	191	394	71	758

1. There are no individual provision releases in excess of £10m.

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 £89m which is reimbursable in respect of reorganisation costs incurred in 2017 (see note 12).

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 reliably estimated.

Other

There are no individually significant provisions included within other provisions.

23. Share capital and other reserves

Share capital

	Equity		Non-equity		Total Nominal value £m	
	Ordinary shares of 2.5p each		Special Share of £1			
	Number of shares m	Nominal value £m	Number of shares	Nominal value £		
Issued and fully paid						
At 1 January 2016, 31 December 2016 and 31 December 2017	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 2017, 281,232,739 (2016 291,449,361) ordinary shares of 2.5p each with an aggregate nominal value of £7,030,818 (2016 £7,286,234) were held in treasury. During 2017, 10,216,622 (2016 10,358,742) treasury shares were used to satisfy awards and options under the Share Incentive Plan, International Share Incentive Plan, Performance Share Plan, Restricted Share Plan and Executive Share Option Plan.

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems Employee Share Option Plan (ESOP) Trust, are recognised as a deduction from retained earnings.

BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. 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 2017.

At 31 December 2017, the ESOP held 1,680,035 (2016 1,327,731) ordinary shares of 2.5p each, with a market value of £10m (2016 £8m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was also in operation for the dividends paid in June and November 2017 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.

	2017 £m	2016 £m
Prior year final 12.7p dividend per ordinary share paid in the year (2016 12.5p)	404	397
Interim 8.8p dividend per ordinary share paid in the year (2016 8.6p)	280	273
	684	670

After the balance sheet date, the directors proposed a final dividend of 13p per ordinary share. The dividend, which is subject to shareholder approval, will be paid on 1 June 2018 to shareholders registered on 20 April 2018. The ex-dividend date is 19 April 2018.

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 2018.

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23. 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 2016	4,589	202	10	3	(62)	535	5,277
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	1,284	1,284
Amounts credited to hedging reserve	–	–	–	–	96	–	96
Tax on other comprehensive income	–	–	–	–	(17)	–	(17)
Equity accounted investments (net of tax)	–	–	–	–	(7)	52	45
At 31 December 2016	4,589	202	10	3	10	1,871	6,685
Subsidiaries:							
Currency translation on foreign currency net investments	–	–	–	–	–	(620)	(620)
Amounts credited to hedging reserve	–	–	–	–	59	–	59
Tax on other comprehensive income	–	–	–	–	(11)	–	(11)
Equity accounted investments (net of tax)	–	–	–	–	1	(16)	(15)
At 31 December 2017	4,589	202	10	3	59	1,235	6,098

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 2017, the Group's capital was £4,725m (2016 £3,454m), which comprises total equity of £4,784m (2016 £3,464m), excluding amounts accumulated in equity relating to cash flow hedges of £59m (2016 £10m). Net debt was £752m (2016 £1,542m).

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.

24. 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

	2017 £m	2016 £m
Net cash flow from operating activities	1,897	1,229
Add back Taxation paid	227	187
<i>Purchase of property, plant and equipment, and investment property</i>	(389)	(408)
<i>Purchase of intangible assets</i>	(87)	(82)
<i>Proceeds from sale of property, plant and equipment, and investment property</i>	34	45
<i>Proceeds from sale of intangible assets</i>	1	–
<i>Equity accounted investment funding</i>	(3)	(5)
Net capital expenditure and financial investment	(444)	(450)
Dividends received from equity accounted investments	72	38
Operating business cash flow	1,752	1,004

Reconciliation of operating business cash flow to net cash flow from operating activities by reporting segment

	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	
	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m
Electronic Systems	450	469	(3)	(2)	122	101	569	568
Cyber & Intelligence	116	83	–	–	11	23	127	106
Platforms & Services (US)	222	58	(8)	(9)	72	80	286	129
Platforms & Services (UK)	427	199	(9)	(3)	189	189	607	385
Platforms & Services (International)	671	435	(52)	(19)	50	57	669	473
HQ	(134)	(240)	–	(5)	–	–	(134)	(245)
	1,752	1,004	(72)	(38)	444	450	2,124	1,416
Taxation paid ¹							(227)	(187)
Net cash flow from operating activities							1,897	1,229

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

Notes to the Group accounts

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25. Movement in assets and liabilities arising from financing activities

	2016 £m	Cash (inflow)/ outflow £m	Non-cash movements	2017 £m
			Foreign exchange movements £m	Fair value and other movements £m
Non-current assets				
Other financial assets	345	–	–	(119) 226
Current assets				
Other financial assets	204	(164)	–	49 89
Non-current liabilities				
Loans	(4,425)	–	350	6 (4,069)
Other financial liabilities	(102)	6	–	(37) (133)
Cash collateral (reported in other payables)	(32)	15	–	– (17)
Current liabilities				
Loans	–	–	–	(7) (7)
Other financial liabilities	(212)	241	–	(133) (104)
	98	350	(241)	
Interest paid	204			
Net purchase of own shares	1			
Equity dividends paid	684			
Dividends paid to non-controlling interests	8			
Net cash flow from financing activities	995			

26. 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	2017 £m	2016 £m
Cash and cash equivalents	17	3,271	2,769
Debt-related derivative financial instrument assets – non-current	13	79	114
Loans – non-current	19	(4,069)	(4,425)
Loans and overdrafts – current	19	(14)	–
Debt-related derivative financial instrument liabilities – current	13	(19)	–
Net debt		(752)	(1,542)

27. Fair value measurement

Fair value of financial instruments

Certain of the Group's financial instruments are held at fair value.

The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date.

The fair values of financial instruments held at fair value have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair values of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates; and
- 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.

Due to the variability of the valuation factors, the fair values presented at 31 December may not be indicative of the amounts the Group would expect to realise in the current market environment.

Fair value hierarchy

The fair value measurement hierarchy is as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

Carrying amounts and fair values of certain financial instruments

	Notes	2017		2016	
		Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m

Financial instruments measured at fair value:

Non-current

Available-for-sale financial assets		6	6	6	6
Other financial assets	13	226	226	345	345
Other financial liabilities	13	(133)	(133)	(102)	(102)

Current

Other financial assets	13	89	89	204	204
Other financial liabilities	13	(104)	(104)	(212)	(212)

Financial instruments not measured at fair value:

Non-current

Loans ¹	19	(4,069)	(4,478)	(4,425)	(4,805)
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Current

Cash and cash equivalents	17	3,271	3,271	2,769	2,769
Loans and overdrafts	19	(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 interest rate risk on the bond, 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 of the 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. 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.

Notes to the Group accounts

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28. Financial risk management

Interest rate risk

The Group's objective is to manage its exposure to interest rate fluctuations on borrowings through varying the proportion of fixed rate debt relative to floating rate debt with derivative instruments, including interest rate and cross-currency swaps.

The Group's interest rate management policy is that a minimum of 50% (2016 50%) and a maximum of 90% (2016 90%) of gross debt is maintained at fixed interest rates. At 31 December 2017, the Group had 82% (2016 81%) of fixed rate debt and 18% (2016 19%) of floating rate debt based on a gross debt of £4.0bn, including debt-related derivative financial assets (2016 £4.3bn).

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	Less than one year £m	Between one and two years £m	More than two years £m
Cash and cash equivalents	3,271	—	—
Loans and overdrafts	(746)	(739)	(661)

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 2017, the Group had a total of \$1.0bn (2016 \$1.0bn) of this type of swap outstanding with a weighted average duration of 5.6 years (2016 2.6 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 9.5 years (2016 11.6 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 4.6% (2016 4.1%) on US dollars. The cost of the fixed rate debt was 4.9% (2016 4.8%).

A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £7m (2016 £8m).

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 £14m (2016 £14m).

Liquidity risk

Contractual cash flows on financial liabilities

The contracted cash flows on loans and overdrafts, and derivative financial instruments at the reporting date are shown below, classified by maturity. The cash flows are shown on a gross basis, are not discounted and include estimated interest payments where applicable.

	31 December 2017					31 December 2016				
	Contracted cash flow					Carrying amount £m	Contracted cash flow			Total £m
	Less than one year £m	Between one and five years £m	More than five years £m	Total £m	Less than one year £m	Between one and five years £m	More than five years £m			
Loans and overdrafts	(4,083)	(213)	(2,474)	(3,217)	(5,904)	(4,425)	(217)	(2,354)	(4,055)	(6,626)
Purchase/(sale) contracts:										
US dollar	401	358	33	792		(396)	23	30	(343)	
Euro	397	90	(17)	470		466	225	18	709	
Sterling	(796)	(567)	(21)	(1,384)		(333)	(307)	(55)	(695)	
Other	(1)	118	6	123		255	58	7	320	
Cash flow hedges – foreign exchange contracts	63	1	(1)	1	1	3	(8)	(1)	–	(9)
Purchase/(sale) contracts:										
US dollar	821	–	–	821		1,809	–	–	1,809	
Euro	771	–	–	771		620	–	–	620	
Sterling	(1,867)	11	–	(1,856)		(2,624)	–	–	(2,624)	
Other	275	(11)	–	264		195	–	–	195	
Interest rate contracts	9	25	(2)	32		7	106	–	113	
Other foreign exchange/interest rate contracts	(45)	9	25	(2)	32	118	7	106	–	113
Debt-related derivative financial instruments	60	8	50	92	150	114	10	29	147	186
Other financial assets and liabilities	78	18	74	91	183	235	9	134	147	290

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

28. Financial risk management continued

Borrowing facilities

The Group's objective is to maintain adequate undrawn committed borrowing facilities.

At 31 December 2017, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2016 £2bn). The RCF is contracted until 2018 at £2bn and from 2018 to 2020 at £1.9bn. The RCF was undrawn throughout the year. The RCF also acts as a back stop to Commercial Paper issued by the Group. At 31 December 2017, the Group had no Commercial Paper in issue (2016 £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 2017 of £3,271m (2016 £2,769m) was invested with 33 (2016 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 and the Group aims, where possible, to apply hedge accounting to these transactions.

The Group is exposed to movements in foreign currency exchange rates in respect of the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group does not hedge the translation effect of exchange rate movements on the income statements or balance sheets of foreign subsidiaries and equity accounted investments it regards as long-term investments.

The estimated impact on foreign exchange gains and losses in net finance costs of a ten cent movement in the closing US dollar exchange rate on the retranslation of US dollar-denominated bonds held by BAE Systems plc is approximately £49m (2016 £59m).

Credit risk

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, a provision for bad debts has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk, and no one counterparty constitutes more than 2% of the balance (2016 11%).

The ageing of trade receivables is detailed below:

	2017			2016		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due and not impaired	1,143	–	1,143	850	–	850
Up to 180 days overdue and not impaired	369	–	369	466	–	466
Past 180 days overdue and not impaired	176	–	176	76	–	76
Past 180 days overdue and impaired	35	(35)	–	85	(40)	45
	1,723	(35)	1,688	1,477	(40)	1,437

Movements on the provision for bad debts are as follows:

	2017 £m	2016 £m
At 1 January	40	34
Created	16	15
Utilised	(1)	(2)
Released	(19)	(13)
Foreign exchange adjustments	(1)	6
At 31 December	35	40

Notes to the Group accounts

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29. 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 96 to 115.

Expense in year

	2017 £m	2016 £m
Executive Share Option Plan	6	6
Performance Share Plan	12	11
Restricted Share Plan	6	5
	24	22

The Group also incurred a charge of £37m (2016 £33m) in respect of the equity-settled all-employee Free Shares and Matching Partnership Shares elements of the Share Incentive Plan.

Executive Share Option Plan

	2017		2016	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	34,315	4.59	32,165	4.26
Granted during the year	9,816	6.48	10,981	5.02
Exercised during the year	(7,491)	3.92	(6,255)	3.81
Expired during the year	(3,733)	4.86	(2,576)	4.28
Outstanding at the end of the year	32,907	5.28	34,315	4.59
Exercisable at the end of the year	5,835	3.81	5,961	3.56
			2017	2016
Range of exercise price of outstanding options (£)			3.01 – 6.49	3.01 – 5.56
Weighted average remaining contracted life (years)			8	8
Weighted average fair value of options granted (£)			0.88	0.65

Performance Share Plan, Share Matching Plan and Restricted Share Plan

	Performance Share Plan		Share Matching Plan		Restricted Share Plan	
	2017 Number of shares '000	2016 Number of shares '000	2017 Number of shares '000	2016 Number of shares '000	2017 Number of shares '000	2016 Number of shares '000
Outstanding at the beginning of the year	22,992	19,662	–	2,252	3,328	2,847
Granted during the year	6,979	8,638	–	–	1,463	1,393
Exercised during the year	(456)	(361)	–	–	(766)	(699)
Expired during the year	(8,757)	(4,947)	–	(2,252)	(256)	(213)
Outstanding at the end of the year	20,758	22,992	–	–	3,769	3,328
Exercisable at the end of the year	38	81	–	–	–	–
	2017	2016	2017	2016	2017	2016
Weighted average remaining contracted life (years)	5	5	–	–	5	5
Weighted average fair value of awards granted (£)	5.36	4.09	–	–	6.49	5.01

The exercise price for the Performance Share Plan and Restricted Share Plan is £nil (2016 £nil).

29. 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

	2017	2016
Range of share price at date of grant (£)	6.05 – 6.49	4.99 – 5.56
Expected option/award life (years)	3 – 10	3 – 10
Volatility (%)	19	20
Risk free interest rate (%)	0.2	0.1 – 0.4

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 £6.11 (2016 £5.24).

30. 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 21).

Transactions occur with the equity accounted investments in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

Related party	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party ¹		Management recharges ¹	
	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m	2017 £m	2016 £m
Advanced Electronics Company Limited	86	27	158	95	24	–	5	–	–	–
CTA International SAS	8	6	–	–	3	4	–	–	–	–
Eurofighter Jagdflugzeug GmbH	1,004	997	–	3	47	41	49	126	–	–
FADEC International LLC	95	79	–	–	–	–	–	–	–	–
FAST Training Services Limited	2	–	–	–	–	–	–	–	–	–
Gripen International KB	–	–	–	–	–	18	–	16	–	–
MBDA SAS ²	28	24	199	199	9	2	873	608	16	16
Panavia Aircraft GmbH	48	64	51	79	3	4	–	–	–	–
	1,271	1,197	408	376	86	69	927	750	16	16

1. Also relates to disclosures under IAS 24, Related Party Disclosures, for the parent company, BAE Systems plc. At 31 December 2017, £884m (2016 £631m) was owed by BAE Systems plc and £43m (2016 £119m) by other Group subsidiaries.

2. Amounts owed to related party in 2016 excludes £285m included within amounts due to long-term contract customers.

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 96 to 115. Total emoluments for directors and key management personnel charged to the Consolidated income statement were:

	2017 £'000	2016 £'000
Short-term employee benefits	16,878	19,389
Post-employment benefits	1,661	1,931
Share-based payments	5,123	5,744
	23,662	27,064

Notes to the Group accounts continued

31. 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 22).

The Group has no individually significant contingent liabilities.

32. Commitments

Operating lease commitments

The Group leases various offices, factories and shipyards under non-cancellable operating lease agreements. The leases have varying terms, including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2017 £m	2016 £m
Payments due:		
Not later than one year	251	255
Later than one year and not later than five years	769	699
Later than five years	626	802
	1,646	1,756
Total of future minimum sublease income under non-cancellable subleases	101	115

Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2017 £m	2016 £m
Property, plant and equipment ¹	310	429
Intangible assets	18	19
	328	448

1. Includes £100m (2016 £158m) at Barrow-in-Furness, UK, relating to the Dreadnought submarine programme funded by the UK government.

33. 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 2017 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, LLC²²
4219-120 Lafayette Center Drive, Chantilly VA 20151, United States

Aerosystems International Limited
Lupin Way, Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Alvis Pension Scheme Trustees Limited

Alvis Limited

Alvis Vickers Limited

Armor Holdings Inc.⁶
2000 North 15th Street, 11th Floor, Arlington VA 22201, United States

Armstrong Whitworth Aircraft Limited¹

Australian Marine Engineering Corporation (Finance) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Avro International Aerospace Limited¹

BAE Systems (Al Diriyah C4i) Limited¹

BAE Systems (Aviation Services) Limited

BAE Systems (Canada) Inc.
220 Laurier Avenue West, Suite 1200, Ottawa ON K1P 5Z9, Canada

BAE Systems (Combat and Radar Systems) Limited
PO Box 727, St. Paul's Gate, Nev Street, St. Helier JE4 8ZB, Jersey

BAE Systems (Consultancy Services) Limited

BAE Systems (Corporate Air Travel) Limited

BAE Systems (CS&SI – Qatar) Limited¹

BAE Systems (Defence Systems) Limited

BAE Systems (Dynamics) Limited

BAE Systems (Farnborough 1) Limited

BAE Systems (Farnborough 2) Limited

BAE Systems (Farnborough 3) Limited

BAE Systems (Finance) Limited

BAE Systems (Funding Three) Limited

BAE Systems (Funding Two) Limited

BAE Systems (Gripen Overseas) Limited

BAE Systems (Hawk Synthetic Training) Limited

BAE Systems (Holdings) Limited¹

BAE Systems (Insurance) Limited

BAE Systems (International) Limited

BAE Systems (Kazakhstan) Limited

BAE Systems (Land and Sea Systems) Limited¹¹

BAE Systems (Malaysia) Sdn Bhd
16th Floor, Wisma Sime Darby, Jalan Raja Laut, 50350 Kuala Lumpur, Malaysia

BAE Systems (MEH) Limited

BAE Systems (Military Air) Overseas Limited

BAE Systems (Moose Jaw) Inc.^{1,5}
LeBlanc Nichols, The Chambers, 1000-300 Terry Fox Drive, Ottawa ON K2K 0E3, Canada

BAE Systems (Nominees) Limited¹

BAE Systems (Oman) Limited

BAE Systems (Operations) Limited¹⁰

BAE Systems (Operations) Singapore Pte Limited
One Marina Boulevard #28-00, Singapore 018989, Singapore

BAE Systems (Overseas Holdings) Limited

BAE Systems (Poland) Sp. z o.o.
ul. Abp. A. Baraniaka 88, 61-131 Poznan, Poland

BAE Systems (Projects) Limited

BAE Systems (Property Investments) Limited

BAE Systems (Sweden) AB¹⁷
c/o Advokattfirman DLA Nordic KB, Box 7315, SE-103 90 Stockholm, Sweden

BAE Systems (Vehicles and Equipment) Limited

BAE Systems 2000 Pension Plan Trustees Limited¹

BAE Systems AB¹³
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Al Diriyah Programme Limited¹

BAE Systems Applied Intelligence (Asia Pacific) Pte Limited
United Square, 101 Thomson Road, #25-03/04, 307591, Singapore

BAE Systems Applied Intelligence (Australia) Pty Limited
Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia

BAE Systems Applied Intelligence (Belgium) NV
Geldekaaksebaan 329, B-3001, Heverlee, Leuven, Belgium

BAE Systems Applied Intelligence Canada Inc.
1959 Upper Water Street, Suite 900, Halifax NS B3J 2X2, Canada

BAE Systems Applied Intelligence (Connect) A/S
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BAE Systems Applied Intelligence GCS Inc.⁶
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BAE Systems Applied Intelligence (Germany) GmbH
Mainzer Landstrasse 50, 60325 Frankfurt am Main, Germany

BAE Systems Applied Intelligence (Integration) Limited
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BAE Systems Applied Intelligence (International) Limited
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BAE Systems Applied Intelligence (Japan) KK
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1 Boulevard de la Foire, L-1528 Luxembourg, Luxembourg

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BAE Systems Applied Intelligence New Zealand Limited
c/o Russell McVeagh, Vero Centre, 48 Shortland Street, Auckland Central, 1140, New Zealand

BAE Systems Applied Intelligence Pty Limited
Level 12, 16-20 Bridge Street, Sydney NSW 2000, Australia

BAE Systems Applied Intelligence US Corp⁶
440 Wheelers Farms Road, Suite 202, Milford CT 06461, United States

BAE Systems Australia Datagate Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Defence Holdings Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Defence Pty Limited¹⁴
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (Electronic Systems) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (NSW) Holdings Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (NSW) Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia (Singapore) Pte Limited²⁰
60 Paya Lebar Road, #08-43 Paya Lebar Square, 409051, Singapore

BAE Systems Australia Holdings Limited¹
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Logistics Pty Limited¹⁰
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Australia Sea Sentinel Project Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

BAE Systems Avionics Singapore Pte Limited
One Marina Boulevard, #28-00, Singapore 018989, Singapore

BAE Systems Bofors AB
SE-691 80 Karlskoga, Sweden

BAE Systems Bofors Holdings Sdn Bhd
Level 21, Suite 21.01, The Gardens South Tower, Mid Valley City, Lingkaran Syed Putra, 59200 Kuala Lumpur, Malaysia

BAE Systems China (Exports) Limited

BAE Systems C-ITS AB
Box 5676, SE-114 86 Stockholm, Sweden

BAE Systems Communications Limited¹

BAE Systems Communications Solutions, LLC²²
Knowledge Oasis, Building 4, Second Floor, O402-Z427, Knowledge Oasis Muscat, PO Box 16, Postal Code 135, Muscat, Oman

BAE Systems Controls Inc.⁵
1098 Clark Street, Endicott NY 13760, United States

BAE Systems Creole Inc.⁷
3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States

BAE Systems Datagate Limited

BAE Systems Datagate Holdings Limited

BAE Systems Defence Limited¹

BAE Systems Deployed Systems Limited²

BAE Systems Display Technologies Limited

BAE Systems do Brasil Ltda
SCN Quadra 5 Bloco A, Ed. Brasilia Shopping, Torre Norte, Sala 426, Brasilia, DF CEP:70715-900, Brazil

BAE Systems Electronic Systems (Overseas) Limited

BAE Systems Electronics Limited

Notes to the Group accounts

continued

33. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Enterprises Limited	BAE Systems International Inc. ⁵ 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems Rokar International Limited PO Box 45059, 11 Hartom Street, Mount Hotzvim, 91450 Jerusalem, Israel
BAE Systems Executive Pension Scheme Trustees Limited ¹	BAE Systems Jacksonville Ship Repair LLC ²² 8500 Heckscher Drive, Jacksonville FL 32226, United States	BAE Systems S&S Holdings Inc. ⁷ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
BAE Systems Finance (Ireland) Unlimited Company ²³ Level 5, Block 4, Dundrum Town Centre, Sandyford Road, Dundrum, Dublin 16, D16 A4W6, Ireland	BAE Systems Land & Armaments Holdings LLC ⁶ 2000 North 15th Street, 11th Floor, Arlington VA 22201, United States	BAE Systems S&S Operations Inc. ⁶ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
BAE Systems Finance B.V. c/o SGG Netherlands N.V., Hoogoordeel 15, 1101 BA Amsterdam, Netherlands	BAE Systems Land & Armaments Inc. ⁶ 2000 North 15th Street, 11th Floor, Arlington VA 22201, 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 Finance Inc. ⁶ 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems Land & Armaments L.P. ²² 2000 North 15th Street, 11th Floor, Arlington VA 22201, United States	BAE Systems Saudi Limited PO Box 1732, Riyadh 11441, Saudi Arabia
BAE Systems Flight Training (Australia) Pty Limited ¹⁰ Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia	BAE Systems Land Systems ATF Limited	BAE Systems Saudi America Limited Business Gate Building 7, Floor 1, Riyadh 11482, Saudi Arabia
BAE Systems Funds Management ^{1,23}	BAE Systems Land Systems (Finance) Limited	BAE Systems Saudi Arabia (Maintenance and Equipment Services) Limited PO Box 1732, Riyadh 11441, Saudi Arabia
BAE Systems Global Combat Systems Bridging Limited	BAE Systems Land Systems FMTV International Inc. ⁷ 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems Saudi Arabia (Vehicles and Equipment Holdings) Limited ¹
BAE Systems Global Combat Systems Limited	BAE Systems Land Systems (Investments South Africa) Limited	BAE Systems Saudi Arabia (Vehicles and Equipment Nominees) Limited ¹
BAE Systems Global Combat Systems Munitions Limited	BAE Systems Land Systems (Investments) Limited	BAE Systems Serviços de Aviônicos Ltda. Rua Boa Vista, No. 254, 13th Floor, Suite 15, Centro, São Paulo, São Paulo 01014-907, Brazil
BAE Systems Global Tactical Systems LLC ²² 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States	BAE Systems Land Systems (Logistics) Limited	BAE Systems Shared Services Inc. ⁶ 11215 Rushmore Drive, Charlotte NC 28277, United States
BAE Systems Hägglunds AB SE-691 80, Karlskoga, Sweden	BAE Systems Land Systems Pinzgauer Limited	BAE Systems Shared Services (Overseas) Limited
BAE Systems Hawaii Shipyards Inc. ⁶ 3049 Alena Street, Suite 915, Honolulu HI 96819, United States	BAE Systems Land Systems Pinzgauer (Holdings) Limited	BAE Systems Share Plans Trustee Limited ¹
BAE Systems Holdings (South Africa) (Pty) Limited Central Office Park No. 5, 257 Jean Avenue, Centurion, Gauteng, 0157, South Africa	BAE Systems Land Systems (Ranges) Limited	BAE Systems Ship Repair Inc. ⁶ 750 West Berkley Ave., Norfolk VA 23523, United States
BAE Systems Holdings B.V. c/o SGG Netherlands N.V., Hoogoordeel 15, 1101 BA Amsterdam, Netherlands	BAE Systems Land Systems (Singapore Investments) Limited	BAE Systems Southeast Shipyards Alabama LLC ²² 8500 Heckscher Drive, Jacksonville FL 32226, United States
BAE Systems Holding GmbH ¹⁷ Hauptstrasse 48, 82433 Bad Kohlgrub, Germany	BAE Systems Logistica Ltda SCN Quadra 5 Bloco A, Ed. Brasilia Shopping, Torre Norte, Sala 426, Brasilia, DF CEP:70715-900, Brazil	BAE Systems Southeast Shipyards AMHC Inc. ^{6,22} 8500 Heckscher Drive, Jacksonville FL 32226, United States
BAE Systems Holdings Inc. ⁵ 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems MAI Turkey Hava Sistemleri A.Ş Kızılırmak Mahallesi, 1445. Sok No: 2, The Paragon B Blok K: 23, iç Kapı No: 113 Çukurambar, Çankaya, Ankara, Turkey	BAE Systems Surface Ships (Holdings) Limited
BAE Systems Holdings International LLC ²² 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems Marine (Holdings) Limited	BAE Systems Surface Ships Limited
BAE Systems IAP Research, Inc. ⁶ CT Corporation System, 4400 Easton Commons Way, Ste 125, Columbus OH 43219, United States	BAE Systems Marine (YSL) Limited	BAE Systems Surface Ships (Projects) Limited
BAE Systems Imaging Solutions Inc. ⁵ 1841 Zanker Road, Suite 50, San Jose CA 95112, United States	BAE Systems Marine Limited	BAE Systems Surface Ships Intermediate Holdings Limited
BAE Systems, Inc. ⁶ 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems Norfolk Ship Repair Inc. ⁶ 750 West Berkley Avenue, Norfolk VA 23523, United States	BAE Systems Surface Ships Integrated Support Limited
BAE Systems India (Services) Private Limited ¹⁸ 2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India	BAE Systems Oman LLC ²² PO Box 74, Postal Code 111, Seeb, Oman	BAE Systems Surface Ships International Limited ¹³
BAE Systems India (Homeland Security) Private Limited ¹⁸ 2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India	BAE Systems Ordnance Systems Inc. ⁶ 4509 West Stone Drive, Kingsport TN 37660-9982, United States	BAE Systems Surface Ships Maritime Limited
BAE Systems India (Technology) Private Limited ¹⁸ 2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India	BAE Systems Overseas Inc. ⁶ 1101 Wilson Blvd, Ste 2000, Arlington VA 22209, United States	BAE Systems Surface Ships Portsmouth Limited ¹³
BAE Systems India (Ventures) Private Limited ¹⁸ 2nd Floor, Hotel Le-Meridien Commercial Tower, Raisina Road, New Delhi 110001, India	BAE Systems PAMCO Services International Inc. ⁷ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States	BAE Systems Surface Ships Projects (Malaysia) Sdn Bhd Level 14, West Block, Wisma Selangor Dredging, 142-C, Jalan Ampang, 50450 Kuala Lumpur, Malaysia
BAE Systems Information and Electronic Systems Integration Inc. ⁶ 65 Spit Brook Road, Nashua NH 03061, United States	BAE Systems Pension Funds CIF Trustees Limited ¹	BAE Systems Surface Ships Property Services Limited
BAE Systems Insurance (Isle of Man) Limited Tower House, Loch Promenade, Douglas, IM1 2LZ, Isle of Man, United Kingdom	BAE Systems Pension Funds Investment Management Limited ^{1,19}	BAE Systems Surface Ships Support Limited ¹⁰
BAE Systems Integrated System Technologies (KSA) Limited	BAE Systems Pension Funds Trustees Limited ¹	BAE Systems Surface Ships (Overseas) Limited
BAE Systems Integrated System Technologies (Overseas) Limited	BAE Systems Project Services Limited	BAE Systems SWS Defence AB SE-691 80 Karlskoga, Sweden
BAE Systems Integrated System Technologies GmbH Hans-Stießberger-Str. 2b, 85540 Haar, Germany	BAE Systems Projects (Canada) Limited	BAE Systems Tactical Vehicle Systems LP ²² 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
BAE Systems Integrated System Technologies Limited	BAE Systems Properties Limited	BAE Systems Technology Solutions & Services Inc. ⁶ 520 Gaither Road, Rockville, MD 20850, United States
	BAE Systems Quest Limited ¹	BAE Systems Training Services Limited
	BAE Systems Regional Aircraft (Japan) KK ⁶ Minami Azabu T&F Building 8th Floor, 4-11-22 Minami Azabu, Minato-ku, Tokyo, Japan	BAE Systems TVS Holdings Inc. ⁶ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
	BAE Systems Regional Aircraft Colombia SAS c/o Brigard & Urrutia, Calle 70 A No. 4-41, Bogota, Colombia	BAE Systems TVS Holdings LLC ²² 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
	BAE Systems Resolution Inc. ⁷ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States	BAE Systems TVS Inc. ⁷ 3701 Outlet Ctr. Drive, Suite 15, Sealy TX 77474-4904, United States
	BAE Systems RO Defense Inc. ⁶ 1801 Electronics Drive, Anniston AL 36207, United States	

33. Information about related undertakings continued

Subsidiaries – wholly-owned continued

BAE Systems Zephyr Corporation⁵
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 Corporation⁵
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 Corporation⁵
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 Corporation⁵
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 Corporation⁵
c/o The Corporation Trust Company, Corporation Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle DE 19801, United States

Brabazon Limited

British Aerospace (Far East) Limited²¹
Level 54, Hopewell Centre, 183 Queen's Road East, Hong Kong

British Aerospace (Malaysia) Sdn Bhd²¹
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) Limited¹

British Aircraft Corporation Limited¹

Buckfield Properties Limited

Cashhold Limited^{1,10}

CPS International, Inc.⁷

c/o Benedetti & Benedetti, Comosa Building, 21st Floor, Ave. Samuel Lewis, PO Box 850120, Panama 5, Panama

Creole (Nigeria) Limited¹⁰

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 Limited¹³
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 Limited¹

Granada Enterprises Limited
PO Box 1732, Riyadh 11441, Saudi Arabia

Hadrian Trustees Limited^{1,18}

Hadrian Holdings, Inc.¹⁸
521 Fifth Avenue, New York NY 101075, United States

Hägglunds Vehicle GmbH

Ernst-Grote Strasse 13, 30916 Isernhagen, Germany

Hawker Siddeley Aviation Limited¹

Hawker Siddeley Dynamics Limited¹

H-B Utveckling, H-B Development AB
Nybrogatan 7, SE-114 34 Stockholm, Sweden

Hertfordshire Estates Limited¹⁰

HSA/HSD Pension Fund Trustees Limited¹

Hunter Aerospace Corporation Pty Limited
Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

International Military Sales Limited

Jetstream Aircraft Limited¹
Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Kalamind Limited

Lemacrown Limited¹²

MES Holdco Limited
PO Box 727, St. Paul's Gate, New Street, St. Helier JE4 8ZB, Jersey

MES Interco²³

Meslink Limited

Muiden Chemie International B.V.
c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Newcombe Properties Limited

PAMCO Servicios Internationales de Mexico, S. de R.L. de C.V.⁷
c/o Gonzalez Calvillo y Forastieri, S.C., Centro Empresarial Lomas, Monte Peloux No. 111, Piso 5, Lomas de Chapultepec, 11000 D.F., Mexico

Piper Group plc

Pitch Technologies AB
Repslagaregatan 25, SE-582 22 Linköping, Sweden

Pitch Technologies Limited

Sweden House, 5 Upper Montagu Street, London W1H 2AG, United Kingdom

Port Solent Limited

Port Solent Marina Limited

PT. BAE Systems Services⁵

Wisma 46, Kota BNI, 34th Floor, Suite 34.01.A, Jl. Jenderal Sudirman Kawling 71, Jakarta 10220, Indonesia

Reflectone UK Limited¹⁶

15 Canada Square, London E14 5GL, United Kingdom

Representaciones SSTS, CA⁷

Ave Francisco de Miranda, Centro Lido El Rosal Oficina 71B, Caracas, Venezuela

Royal Ordnance B.V.

c/o SGG Netherlands N.V., Hoogoorddreef 15, 1101 BA Amsterdam, Netherlands

Royal Ordnance (Crown Service) Pension Scheme Trustees Limited

Royal Ordnance Senior Staff Pension Scheme Trustees Limited

Royal Ordnance Speciality Metals Limited¹

RWT Limited¹

Salford Electrical Instruments Limited

Scentcivil Limited

Scottish Aviation Limited¹

Prestwick International Airport, Prestwick, Ayrshire KA9 2RW, United Kingdom

Sepia, LLC²²

4219-120 Lafayette Center Drive, Chantilly VA 20151, United States

Shipbuilding (MSF) Pty Limited

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Shipbuilding (VIC) Pty Limited

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Stephen Howe Systems Limited

Alvington, Yeovil, Somerset BA22 8UZ, United Kingdom

Stewart & Stevenson Operations (Nigeria) Limited⁷

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^{17,22}

House No. 145, Street No. 1, Qtr. 611, Al Andalous Area, Al Mansour, Baghdad, Iraq

TDS International Pty Limited

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

TDS International Holdings Pty Limited⁸

Evans Building, Taranaki Road, Edinburgh Parks, Edinburgh SA 5111, Australia

Tenix Philippines Inc.^{17,20}

Unit 702, 7th Floor, Philippine AXA Life Centre, 1286 Sen, Gil Puyat Avenue, Makati City, 1200, Philippines

The Blackburn Aeroplane & Motor Co Limited¹

The Bristol Aviation Company Limited¹

The British & Colonial Aeroplane Co. Limited¹

The Leeds Partnership Limited¹⁰

The Supermarine Aviation Works Limited^{11,11}

Thomas Sopwith Aviation Company Limited¹

VSEL Birkenhead Limited

Warship Design Services Limited

Westover Controls Incorporated⁶

1098 Clark Street, Endicott NY 13760, United States

Notes to the Group accounts

continued

33. Information about related undertakings continued

Subsidiaries – not wholly-owned

Aircraft Accessories & Components Co Limited (82.2%)
PO Box 13532, Jeddah 21434, Saudi Arabia

Aircraft Research Association Limited (87.1%)¹
Manton Lane, Bedford MK41 7PF, United Kingdom

ARA Pension Fund Trustees Limited (87.1%)¹
Manton Lane, Bedford MK41 7PF, United Kingdom

BAE Systems Saudi Development and Training Company Limited (95%)³
PO Box 67775, Riyadh 11517, Saudi Arabia

BAE Systems SDT (UK) Limited (95%)

Flight Control System Management GmbH (66.6%)⁴
PO Box 801109, 81663 Munich, Germany

Hadrian Properties, Inc. (95%)¹⁸
521 Fifth Avenue, New York NY 101075, United States

International Systems Engineering Company Limited (86.9%)
PO Box 54002, Riyadh 11514, Saudi Arabia

Overhaul and Maintenance Company Limited (95.9%)
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%)¹
PO Box 1732, Riyadh 11441, Saudi Arabia

SMSCMC (UK) Limited (51%)

U.S. Munitions, LLC (51%)²²
1713 Burdette Crossing, Blue Springs MO 64015, United States

Equity accounted investments

Abercromby Property International (20.42%)

Advanced Electronics Company Limited (48%)
PO Box 90916, Riyadh 11623, Saudi Arabia

Air Astana (49%)⁵
Zakarpatskaya Str 4A, 050039 Almaty, Kazakhstan

AMSH B.V. (50%)⁹
Weena 210-212, 3012 NJ Rotterdam, Netherlands

BAeHAL Software Limited (40%)^{1,18}
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 Sudut Putra, 59200 Kuala Lumpur, Malaysia

BAE (Consultancy Services) Malaysia Sdn Bhd (49%)
Tkt.11, Wisma Damansara, Damansara Heights, 50490 Kuala Lumpur, Malaysia

Canadian Naval Support Limited (50%)¹⁵
3099 Barrington Street, Halifax NS B3K 5M7, Canada

CTA International SAS (50%)
13 Route De La Miniere, 78000 Versailles, France

Data Link Solutions L.L.C. (50%)^{21,22}
400 Collins Ave, Cedar Rapids IA 52498, United States

Eurofighter Aircraft Management GmbH (33%)^{1,17}
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Eurofighter Jagdflugzeug GmbH (33%)¹
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

European Aerosystems Limited (50%)^{1,8}

FADEC International LLC (50%)²²
1098 Clark Street, Endicott NY 13760, United States

FAST Holdings Limited (50%)^{8,18}

FAST Training Services Limited (50%)¹⁸

FBV Designs Limited (50%)^{8,18}
33 Wigmore Street, London W1U 1QX, United Kingdom

FNSS Savunma Sistemleri A.S (49%)⁸
PK 37, Golbasi 06830, Ankara, Turkey

Gripen International KB (50%)²²
SE-581 88 Linköping, Sweden

MBDA Holdings SAS (25%)
1 Avenue Réaumur, 92350 Le Plessis-Robinson, France

Nobeli Business Support AB (34%)
SE-691 80 Karlskoga, Sweden

Nurol BAE Systems Hava Sistemleri Anonim Şirketi (49%)⁹
Universiteler Mah, 1605.Cad, No:3/1-3, 06800, Ankara, Turkey

Panavia Aircraft GmbH (42.5%)¹
Am Soldnermoos 17, 85399 Hallbergmoos, Germany

Patria Hägglunds Oy (50%)
Naulakatu 3, FI-33100 Tampere, Finland

Reaction Engines Limited (20%)⁹
Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom

Saab-BAE Systems Gripen AB (50%)¹
SE-581 88 Linköping, Sweden

Saab Bofors Test Center AB (30%)
SE-691 80 Karlskoga, Sweden

Sealand Support Services Limited (33.3%)¹⁴
MoD Sealand, Welsh Road, Sealand, Deeside, Flintshire CH5 2LS, United Kingdom

Seele-Alvis Fenestration Limited (43.5%)^{8,20}
Unit A33, Jack's Place, 6 Corbett Place, London E1 6NN, United Kingdom

SIKA International Limited (50%)⁸

Spectrum Technologies Limited (20%)^{1,18}
Western Avenue, Bridgend Industrial Estate, Bridgend, Mid Glamorgan CF31 3RT, United Kingdom

Tirs Mateen & Co LLC (50%)^{16,22}
PO Box 3369, Postal Code 111, Seeb, Oman

Winner Developments Limited (33.3%)

Notes

1. Directly owned by BAE Systems plc.
2. 40% owned by BAE Systems plc.
3. 1% owned by BAE Systems plc.
4. 33.3% owned by BAE Systems plc.
5. Ownership held in common stock.
6. Ownership held in common shares.
7. Ownership held in authorized shares.
8. Ownership held in class of A shares.
9. Ownership held in class of B shares.
10. Ownership held in class of A shares and B shares.
11. Ownership held in class of A shares, B shares and preference shares.
12. Ownership held in ordinary shares and class of A shares.
13. Ownership held in ordinary shares and preference shares.
14. Ownership held in ordinary shares and redeemable preference shares.
15. Ownership held in common shares and B Preferred shares.
16. In members' voluntary liquidation.
17. In liquidation.
18. Year end 31 March.
19. Year end 5 April.
20. Year end 30 June.
21. Year end 30 September.
22. Unincorporated entity for which the address given is the principal place of business.
23. Unlimited company.

34. Adoption of IFRS 15, Revenue from Contracts with Customers

Adoption of IFRS 15

From 1 January 2018, the Group will adopt IFRS 15, Revenue from Contracts with Customers. The standard replaces IAS 11, Construction Contracts, IAS 18, Revenue, and all other existing revenue accounting requirements within IFRS. It applies to all revenue arising from contracts with customers unless the contracts are within the scope of other existing standards, such as IAS 17, Leases.

IFRS 15 outlines principles for the measurement and recognition of revenue from contracts with customers, with the core principle being that revenue should be recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for the transfer of goods and services to the customer. In order to achieve this objective, the standard sets out a five-step model:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognise revenue when (or as) the entity satisfies a performance obligation.

The standard also covers the accounting for the incremental costs of obtaining a contract and the costs to fulfil a contract, together with presentation and disclosure requirements.

The Group will adopt IFRS 15 fully retrospectively in accordance with paragraph C3 (a). Comparatives for the year ended 31 December 2017 will be restated.

Impact of adoption of IFRS 15

Revenue recognition

- Revenue on the majority of contracts, currently being recognised based on the completion of milestones or deliveries, will cumulatively be recognised earlier.

Under IAS 11, revenue under long-term contracts is recognised when a separately identifiable phase (milestone) has been completed. Under IAS 18, revenue from the sale of goods not under long-term contracts is recognised when the significant risks and rewards of ownership have been transferred to the customer, for example, upon delivery.

The Group has determined that the performance obligations identified in the majority of its contracts will satisfy the criteria in IFRS 15 for recognition over time rather than at a point in time. In order to qualify for revenue recognition over time, the Group's performance must not create assets with alternative uses and it must have an enforceable right to payment for performance completed to date. The majority of the Group's products are designed and/or manufactured under contract to the customer's individual specifications. The Group is, therefore, limited in its ability to sell its products to alternative customers due to the substantial rework costs involved.

Under IAS 11, the recognition of revenue over time based on milestones gives rise to work-in-progress in respect of costs expended in pursuit of milestones which have not been completed at the balance sheet date. Under IFRS 15, it is not deemed appropriate to recognise significant work-in-progress as an asset on the Group's balance sheet when revenue is recognised over time as the Standard considers the control of the work-in-progress to have been transferred to the customer. Consequently, under IFRS 15, the Group will recognise revenue based on costs incurred reflecting the continuous transfer of the benefit of the Group's performance to the customer.

The adoption of IFRS 15 will not impact contracts for the provision of services currently accounted for on the basis of the stage of completion measured on the basis of either direct expenses incurred or labour hours delivered as these have already been determined to meet the criteria for over time revenue recognition.

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 and the business has the right to payment.

Notes to the Group accounts

continued

34. Adoption of IFRS 15, Revenue from Contracts with Customers continued

Profit recognition

- Profit on contracts will continue to be recognised progressively as risks have been mitigated or retired.
- Profit will be recognised earlier on shorter-term contracts in the Group's US businesses.
- On contracts for both development and production in the Group's MBDA joint venture, there will be lower profit recognised during the development phase.

On the majority of the Group's contracts, profit is calculated by reference to reliable estimates of contract revenue and costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. No profit is recognised until the outcome of a contract can be reliably estimated. Profit is recognised progressively as risks have been mitigated or retired. Forecast losses are recognised immediately in full.

On adoption of IFRS 15, profit on these contracts will continue to be recognised progressively on this basis.

In the Group's Platforms & Services (UK) and Platforms & Services (International) businesses, contracts are typically longer-term in nature than in the Group's other businesses. Whilst the recognition of revenue is accelerated under IFRS 15 as a result of the measure of progress being based on costs incurred, there is less impact on the timing of recognition of profit as, operationally, the next risk retirement point will still not have been achieved on the contract. Conversely, in the Group's US businesses, contracts are typically shorter-term, with cumulative profit to date traded at close to out-turn margin. Accordingly, the acceleration of revenue recognised under IFRS 15 will accelerate profit recognition on the Group's US contracts.

The Group's MBDA joint venture is undertaking a number of significant contracts which include both development and production elements. Under IAS 11, MBDA has previously recognised profit on contracts with both development and production elements at a single blended out-turn profit margin. Under IFRS 15, the development and production elements of the contract represent separate performance obligations, with development satisfied over time and production, typically, satisfied at a point in time. The development activity on these contracts has a lower margin than the subsequent production activity and, therefore, under IFRS 15, less profit is allocated to development, with more allocated to production.

Licence revenue

- Some licence revenue in Applied Intelligence originally recognised upfront under IAS 18 will be deferred and recognised over the licence term under IFRS 15.

BAE Systems Applied Intelligence generates revenue from the sale of licences of its intellectual property. The licences have varying terms and conditions and can be provided for a fixed term or in perpetuity. Under IAS 18, the Group recognises revenue in respect of software licences in line with the substance of those transactions, either on delivery to the customer or spread over the licence term (typically five years) or, in relation to perpetual licences, over the related customer relationship.

The Group has determined that, under IFRS 15, certain licences that qualified for upfront recognition under IAS 18 in its Applied Intelligence business represent the right to access the Group's intellectual property on the basis that the customers have an expectation that the Group will provide significant updates to the software during the licence term to ensure its continuing value to the customer. Accordingly, revenue relating to these licences is deferred and recognised over the licence term under IFRS 15 rather than being recognised upfront under IAS 18.

Financing

- No financing (as defined by IFRS 15) in the Group's contracts.

IFRS 15 states that the consideration in a contract must be adjusted for the time value of money if the timing of payments either explicitly or implicitly provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.

In the ordinary course of business, certain of the Group's businesses can receive down-payments from customers in advance of the delivery of the contracted products and services. Advances are not significant in the Group's US businesses. At 31 December 2017, advances from long-term contract customers totalled £2.9bn.

The advances received are typically utilised within 12 months of the balance sheet date. As such, the Group can apply the practical expedient in IFRS 15 by which revenue does not have to be adjusted for financing if the period between the down-payment and the recognition of the related revenue is one year or less.

The Group also had £1.7bn and £0.3bn of progress payments allocated to long-term and short-term work-in-progress, respectively, at 31 December 2017. On transition to IFRS 15, most of this work-in-progress, and associated progress payments, will be recognised as revenue.

Balance sheet

- Most balance sheet contract work-in-progress replaced with a contract receivable representing accrued revenue, based on costs incurred, and including attributable profit.

Under IAS 11, fulfilment costs incurred on the Group's contracts are carried in the balance sheet until the associated revenue is recognised upon achievement of performance milestones. Under IFRS 15, it is not appropriate to recognise significant work-in-progress as an asset on the Group's balance sheet when revenue is recognised over time. Accordingly, contract work-in-progress, both short-term and long-term, is replaced with a contract receivable representing accrued revenue, based on costs incurred, and including attributable profit. Inventories will include fulfilment costs incurred in advance of delivery in respect of contracts with customers which have been determined to fulfil the criteria for point in time revenue recognition, together with products manufactured to stock without contract cover.

Impact on reported results

The Group will adopt IFRS 15 fully retrospectively in accordance with paragraph C3 (a). Provisional comparatives for the year ended 31 December 2017 are shown in the following tables.

34. Adoption of IFRS 15, Revenue from Contracts with Customers continued

Consolidated income statement

	Year ended 31 December 2017		
	As previously reported £m	IFRS 15 adjustments £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)
EBITA	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 share¹	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.

Consolidated net assets

The following table shows the effect of adopting IFRS 15 on net assets in the Consolidated balance sheet at 31 December 2016 and 2017:

	£m
Increase in net assets at 31 December 2016	92
Decrease in profit for the year ended 31 December 2017	(27)
Decrease in total other comprehensive income for the year ended 31 December 2017 (net of tax)	(8)
Increase in net assets at 31 December 2017	57

Company statement of comprehensive income for the year ended 31 December

	2017 £m	2016 ¹ £m
Profit for the year	962	590
Other comprehensive income		
Items that will not be reclassified to the income statement:		
Remeasurements on retirement benefit schemes	142	(56)
Items that may be reclassified to the income statement:		
Amounts charged to hedging reserve	(2)	(13)
Total other comprehensive income for the year (net of tax)	140	(69)
Total comprehensive income for the year	1,102	521

1. Restated to recognise an increase in investments in subsidiary undertakings representing the cost of the Free and Matching elements of the Share Incentive Plan awarded to employees of subsidiary undertakings.

Company statement of changes in equity for the year ended 31 December

	Issued share capital £m	Share premium £m	Other reserves £m	Retained earnings ¹ £m	Total equity £m
At 1 January 2016 ²	87	1,249	218	2,209	3,763
Profit for the year ²	–	–	–	590	590
Total other comprehensive income for the year	–	–	(13)	(56)	(69)
Share-based payments	–	–	–	50	50
Net sale of own shares	–	–	–	3	3
Ordinary share dividends	–	–	–	(670)	(670)
At 31 December 2016 ²	87	1,249	205	2,126	3,667
Profit for the year	–	–	–	962	962
Total other comprehensive income for the year	–	–	(2)	142	140
Share-based payments	–	–	–	55	55
Net purchase of own shares	–	–	–	(1)	(1)
Ordinary share dividends	–	–	–	(684)	(684)
At 31 December 2017	87	1,249	203	2,600	4,139

1. The non-distributable portion of retained earnings is £649m (2016 £604m).
 2. Retained earnings restated to recognise an increase in investments in subsidiary undertakings representing the cost of the Free and Matching elements of the Share Incentive Plan awarded to employees of subsidiary undertakings.

Company balance sheet as at 31 December

	Notes	2017 £m	2016 ¹ £m
Non-current assets			
Intangible assets		38	34
Property, plant and equipment		29	31
Investments in subsidiary undertakings and participating interests	2	8,439	8,399
Other receivables		3	4
Retirement benefit surpluses	8	27	8
Other financial assets	4	280	385
		8,816	8,861
Current assets			
Trade and other receivables	3	2,653	3,038
Current tax		14	14
Other financial assets	4	145	347
Cash and cash equivalents		2,707	2,168
		5,519	5,567
Total assets		14,335	14,428
Non-current liabilities			
Loans	5	(1,059)	(1,122)
Other payables		(19)	(33)
Retirement benefit obligations	8	(186)	(308)
Other financial liabilities	4	(216)	(182)
Provisions	7	(101)	(97)
		(1,581)	(1,742)
Current liabilities			
Loans and overdrafts		(7)	–
Trade and other payables	6	(8,416)	(8,664)
Other financial liabilities	4	(172)	(332)
Provisions	7	(20)	(23)
		(8,615)	(9,019)
Total liabilities		(10,196)	(10,761)
Net assets		4,139	3,667
Capital and reserves			
Issued share capital		87	87
Share premium		1,249	1,249
Other reserves	9	203	205
Retained earnings ²		2,600	2,126
Total equity		4,139	3,667

1. Restated to recognise an increase in investments in subsidiary undertakings representing the cost of the Free and Matching elements of the Share Incentive Plan awarded to employees of subsidiary undertakings.
 2. The Company's profit for the year is £962m (2016 £590m¹).

Approved by the Board on 21 February 2018 and signed on its behalf by:

C N Woodburn
Chief Executive

P J Lynas
Group Finance Director

Notes to the Company accounts

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 81, 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 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.

2. Investments in subsidiary undertakings and participating interests

	£m
Cost	
At 1 January 2017 ¹	8,413
Additions	45
At 31 December 2017	8,458
Impairment provisions	
At 1 January 2017	14
Impairment charge	5
At 31 December 2017	19
Net carrying value	
At 31 December 2017	8,439
At 31 December 2016 ¹	8,399

1. Restated to recognise an increase in investments in subsidiary undertakings representing the cost of the Free and Matching elements of the Share Incentive Plan awarded to employees of subsidiary undertakings.

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.

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of relevant financial assets and financial liabilities (including derivative instruments).

Significant accounting policies

The significant accounting policies applied in the preparation of these individual financial statements are set out below. These policies have been applied consistently to all the years presented, unless otherwise stated.

Investments in subsidiary undertakings and participating interests

Fixed asset investments in shares in subsidiary undertakings and participating interests are stated at cost less provision for impairment.

Other significant accounting policies

Other significant accounting policies are consistent with the Group accounts and the table below references where they are disclosed.

Significant accounting policy	Page
Loans and overdrafts	172
Retirement benefits	174
Provisions	184

Prior year restatement

The Company has restated comparatives for the year ended 31 December 2016 to recognise a £250m increase in investments in subsidiary undertakings and a corresponding increase in non-distributable retained earnings, representing the cost of the Free and Matching elements of the Share Incentive Plan awarded to employees of subsidiary undertakings. The Company had previously recognised the cost of these awards in the income statement, with a corresponding credit in equity. Accordingly, investments and non-distributable retained earnings at 1 January 2016 have increased by £220m and profit for the year ended 31 December 2016 has increased by £30m.

3. Trade and other receivables

	2017 £m	2016 £m
Current		
Amounts owed by subsidiary undertakings	2,571	2,954
Amounts owed by Group joint ventures	5	–
Prepayments and accrued income	62	37
Other receivables	15	47
	2,653	3,038

4. Other financial assets and liabilities

	2017		2016	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	–	(1)	1	–
Other foreign exchange/interest rate contracts	201	(215)	274	(182)
Debt-related derivative financial instruments – assets	79	–	110	–
	280	(216)	385	(182)
Current				
Cash flow hedges – foreign exchange contracts	–	(1)	1	(2)
Other foreign exchange/interest rate contracts	145	(152)	346	(330)
Debt-related derivative financial instruments – liabilities	–	(19)	–	–
	145	(172)	347	(332)

The contractual cash flows on derivative financial instruments at the reporting date are shown below, classified by maturity.

	2017 £m	2016 £m
Less than one year	17	11
Between one and five years	76	136
More than five years	90	147
	183	294

Full disclosures relating to the Group's other financial assets and liabilities, and financial risk management strategies are given in notes 13, 27 and 28 to the Group accounts.

5. Loans

	2017 £m	2016 £m
Non-current		
US\$500m 4.75% bond, repayable 2021	369	404
£400m 4.125% bond, repayable 2022	398	398
US\$400m 5.8% bond, repayable 2041	292	320
	1,059	1,122

6. Trade and other payables

	2017 £m	2016 £m
Current		
Amounts owed to subsidiary undertakings	7,299	7,830
Amounts owed to Group joint ventures	884	631
Accruals and deferred income	120	121
Other payables	113	82
	8,416	8,664

Notes to the Company accounts continued

7. Provisions

	Contracts and other £m
Non-current	97
Current	23
At 1 January 2017	120
Created	4
Utilised	(8)
Released	(1)
Net present value adjustments	6
At 31 December 2017	121
Represented by:	
Non-current	101
Current	20
	121

The Company holds provisions for contractual costs that it expects to incur over an extended period. These costs are based on past experience of similar items and represent management's best estimate of the likely outcome.

8. Retirement 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 21 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.

	2017 £m	2016 £m
Present value of unfunded obligations	(33)	(39)
Present value of funded obligations	(1,326)	(1,429)
Fair value of scheme assets	1,200	1,168
Company's share of net IAS 19 deficit	(159)	(300)
Represented by:		
Retirement benefit surpluses	27	8
Retirement benefit obligations	(186)	(308)
	(159)	(300)

9. Share capital and other reserves

Share capital

Disclosures in respect of the Company's share capital are provided in note 23 to the Group accounts.

Other reserves

	Statutory reserve £m	Capital redemption reserve £m	Hedging reserve £m	Total £m
At 1 January 2016	202	3	13	218
Amounts credited to hedging reserve	–	–	(13)	(13)
At 31 December 2016	202	3	–	205
Amounts charged to hedging reserve	–	–	(2)	(2)
At 31 December 2017	202	3	(2)	203

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.

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 96 to 115.

	2017		2016	
	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 – 5.56	8
Performance Share Plan	–	5	–	5

The average share price in the year was £6.11 (2016 £5.24).

11. Employees

The total number of employees of the Company at 31 December 2017 was 1,134 (2016 1,101).

Total staff costs, excluding charges for share-based payments, were as follows:

	2017 £m	2016 £m
Wages and salaries	86	98
Social security costs	9	9
Pension costs – defined contribution plans	2	2
Pension costs – defined benefit plans	11	6
	108	115

12. Other information

Company audit fee

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £2,034,000 (2016 £1,776,000).

Related party transactions

Disclosures in respect of related party transactions are provided in note 30 to the Group accounts.

The Company also has amounts receivable from Aircraft Accessories and Co. Limited of £7m (2016 £nil) and Aircraft Research Association Limited of £4m (2016 £1m) which are not wholly-owned subsidiaries.

The Company also has a related party relationship with its directors and key management personnel, and pension schemes.

Directors' emoluments

Under Schedule 5 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (Schedule 5), total directors' emoluments, excluding Company pension contributions, were £8,748,961 (2016 £10,806,172); 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 2017 as at the date of exercise was £1,002,325 (2016 £158,125) and the net aggregate value of assets received by directors in 2017 from Long-Term Incentive Plans as calculated at the date of vesting was £1,016,511 (2016 £nil); these amounts are calculated on a different basis from the valuation of share plan benefits under Schedule 8 (2013) in the Annual remuneration report. Retirement benefits are accruing to 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 £3,010m (2016 £3,295m), 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 33 to the Group accounts.

Shareholder information

Registered office

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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 e-mail form, which will help to ensure your question is directed to the most appropriate team for a response. Alternatively, you can call the BAE Systems Helpline on 0371 384 2044 or, from outside the UK, +44 121 415 7058. Lines are open from 8.30am to 5.30pm Monday to Friday, excluding UK Bank holidays.

In addition, the following services are offered to shareholders:

- **Shareview** – online access to your shareholding, including balance movements, indicative share prices and information on recent payments
- **Dividend mandates** – have your dividends paid directly into either your UK bank/building society account or an overseas bank account
- **Dividend reinvestment plan (DRIP)** – have your dividend reinvested in shares purchased on the stock market

More information on all these services can be found on Equiniti's website (shareview.co.uk).

American Depository Receipts

BAE Systems plc American Depository Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares.

JPMorgan Chase Bank, N.A. is the depositary. If you should have any queries, please contact:

JPMorgan Chase & Co
PO Box 64504
St Paul
MN 55164-0854 USA
Email: jpmorgan.adr@wellsfargo.com

Telephone number for general queries: (800) 990 1135
Telephone number from outside the US: +1 651 453 2128

ShareGift

ShareGift, the share donation charity (registered charity number 1052686), accepts donations of small parcels of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at sharegift.org, by telephone on 020 7930 3737 or by e-mail: help@sharegift.org

Share price information

The middle market price of the Company's ordinary shares on 31 December 2017 was 573.0p and the range during the year was 535.5p to 677.0p.

For more information

Visit the Shareholder information section of our website:
investors.baesystems.com

FINANCIAL CALENDAR

Financial year end	31 December
Annual General Meeting	10 May 2018
2017 final ordinary dividend payable	1 June 2018
2018 half-yearly results announcement	1 August 2018
2018 interim ordinary dividend payable	30 November 2018
2018 full-year results:	
– preliminary announcement	February 2019
– Annual Report	March 2019
2018 final ordinary dividend payable	June 2019

BEWARE OF SHARE FRAUD

Fraudsters use persuasive and high-pressure tactics to lure investors into scams.

They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment. While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

Victims of share fraud lose an average of £20,000 to these scams, with as much as £200m being lost in the UK each year.

How to avoid share fraud

1. Keep in mind that firms authorised by the FCA are unlikely to contact you out of the blue with an offer to buy or sell shares.
2. Do not get into a conversation, note the name of the person and firm contacting you and then end the call.
3. Check the Financial Services Register from fca.org.uk to see if the person and firm contacting you is authorised by the FCA.
4. Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details.
5. Use the firm's contact details listed on the Register if you want to call it back.
6. Call the FCA on **0800 111 6768** if the firm does not have contact details on the Register or you are told they are out of date.
7. Search the list of unauthorised firms to avoid at scamsmart.fca.org.uk/warninglist
8. Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme.
9. Think seriously about getting independent financial and professional advice before you hand over any money.
10. **Remember:** if it sounds too good to be true, it probably is!

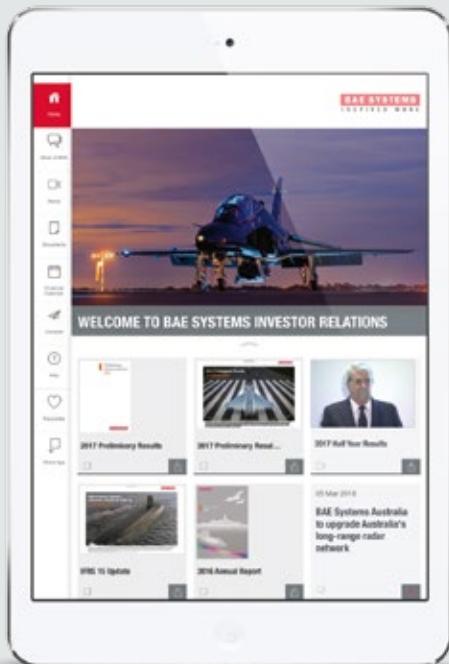
Report a scam

If you are approached by fraudsters please tell the FCA using the FCA Consumer Helpline on **0800 111 6768**, or the share fraud reporting form at fca.org.uk/scams, where you can also find out more about investment scams.

If you have already paid money to share fraudsters you should contact Action Fraud on **0300 123 2040** or online at actionfraud.police.uk

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The papers are the combination of 100% virgin fibre and 50% recycled fibre sourced from well managed, responsible, FSC® certified forests. The pulp for each is bleached using an Elemental Chlorine Free (ECF) process.

Designed and produced by Radley Yeldar.

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