BAE Systems Applied Intelligence Limited

Annual report and financial statements

31 December 2016

Registered number: 01337451

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Strategic Report

Review of business

Overview

Revenue for the year amounted to £385 million (2015: £326 million) and the loss for the year after taxation and exceptional items amounted to £52 million (2015: £18 million). Loss before finance income/expenditure and tax was £53 million (2015: £17 million).

The year ended 31 December 2016 has seen further year on year revenue growth, with the continuing expansion of the organisation's national security business and its offerings to government customers. It has also seen a year on year decline in profitability, as the Applied Intelligence business increases its investment in its cyber products and its sales and marketing activities in line with its growth strategy.

The Directors do not recommend payment of a final dividend in respect of the year ended 31 December 2016 (2015: £nil).

The Directors have a positive outlook for the year ahead with a strong order book and a positive pipeline that will be supported by the release of new products into the market, combined with its continued investment in its Cyber products and ongoing growth in other areas.

Strategy overview

BAE Systems Applied Intelligence ("Applied Intelligence") creates solutions which protect and enhance the connected world for our customers. The business solves complex and mission-critical problems through a combination of IT software, hardware and professional services, in four domains of expertise: cyber security, financial crime, communications & cyber intelligence and digital transformation. Applied Intelligence's strategic priorities are to:

- Maintain leadership in the UK services market by reducing the cost of delivering and maintaining close customer relationships;
- Grow in the international, large-scale security market by leveraging Government relationships and differentiated relationships; and
- Outperform in adjacent commercial cyber and financial crime markets by leveraging our business defence technology and brand.

Key performance indicators

The directors consider revenue and operating profit/loss as the principal key performance indicators to assess progress towards achieving the Company's strategy. This information for the current and prior periods is set out in the Company's Income Statement on page 8.

Principal risks and uncertainties

The significant high level risks identified by the Board have not changed substantially over the last 12 months and are as follows:

Global economic climate
As with all technology businesses, Applied Intelligence is exposed to any downturn in technology spending that may result from instability in the global economy caused, for example, by rising commodity prices, acts of terrorism or significant pressure on selected government spending programmes.

We believe that the diversified markets covered by the business and, in particular, Applied Intelligence's focus on the counter threat agenda and intellectual property led solutions to provide clients with greater value for money, provide some mitigation against this risk. In addition, we maintain staff base flexibility in order that we can move resources to those sectors where demand is greatest.

Recruitment market
The current market sees a strong demand for the best people. This has been particularly the case for people with advanced technical skills and those with UK government clearances. We address the risk of a competitive recruitment market through a portfolio of measures, including a strengthened HR recruitment team, attractive staff reward schemes such as flexible benefits, and through new career development programmes.

Strategic Report *(continued)*

Pricing pressure from off-shore providers

Low-cost providers in off-shore locations continue to exert pressure on pricing in some sectors of the organisations markets. Applied Intelligence operate a UK delivery centre in Leeds, a similar centre in Poland and a larger global delivery centre in Malaysia to provide more efficient and cost-effective offerings to our clients. Some of Applied Intelligence's work is unsuitable for off-shore resourcing for security reasons, which is a constraint the organisation has sought to address by investing in secure facilities in our UK locations.

Delivery risk

Applied Intelligence has, over many years, built a track record of very strong project management and technical delivery of the most complex and business-critical programmes. Any failure to meet client expectations and/or Applied Intelligence's contractual obligations could damage the organisation's reputation in the marketplace. We manage this risk through rigorous bid approval controls, peer review of technical solutions and project plans and regular monitoring of high risk projects by project boards.

Security

Much of Applied Intelligence's work relies on its reputation for strong security, in particular that for the national security community, where the Company is subject to particular rules applied by national governments. Security breaches could materially damage Applied Intelligence's business. Security matters are therefore carefully managed and are overseen by a Director-level Security Committee, which ensures that the business systematically embeds rigorous security practice in its everyday operations. Applied Intelligence is investing to ensure its own security keeps pace with the evolving threat environment.

Each of the identified risks is regularly reviewed and actively managed by the Board.

On behalf of the Board

J F Cracknell

Director

24 May 2017

Directors' Report

Company registration

BAE Systems Applied Intelligence Limited is a private company, limited by shares and registered in England and Wales with the registered number 01337451.

Going concern

The Company's business activities, strategy and principal risks which may affect its future development, performance and position are set out in the Strategic Report. In addition the Directors' Report and notes to the accounts include the Company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities.

The Company had a positive cash balance at the end of the year and continues to participate in BAE Systems plc group's centralised treasury arrangements. The ultimate parent company, BAE Systems plc, has indicated that for at least 12 months from the date of approval of these financial statements, it will continue to make available such funds as are needed by the Company to meet its liabilities as they fall due.

The directors consider that this should enable the Company to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Indemnity insurance

The Directors of the Company have been indemnified against liability in respect of proceedings brought by third parties, subject to the conditions set out in the Companies Act 2006. Such qualifying third party indemnity provision was in force during the period and continues to be in force as at the date of this report. Directors and Officers' liability insurance has been purchased in order to minimise the potential impact of such proceedings.

Employees

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

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

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

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

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

The Company is committed to giving full and fair consideration to applications for employment from disabled people who meet the requirements for the Company's roles, and making available training opportunities and appropriate accommodation to disabled people employed by the Company.

Research and development

The company performs both customer funded research and development as well as investing in internal research and development activities. The total internal research and development cost can be seen in note 2 of the accounts.

Financial instruments

The global nature of the Company's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Company's policy is to hedge all material firm transactional exposures.

Directors' Report *(continued)*

Directors and their interests

The Directors who served during the year and at the date of this report were as follows:

B N Raychawdhuri	Resigned: 14 July 2016
K B Taylor	
N S Medley	Resigned: 30 June 2016
A G Lazarus	Appointed: 14 July 2016, Resigned: 22 May 2017
A D Leggetter	Appointed: 18 July 2016
J F Cracknell	Appointed: 22 May 2017
M S Watson	Appointed: 22 May 2017

The Board is not aware of any contract of significance in relation to the Company in which any director has, or has had, a material interest.

Disclosure of information to auditor

The directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditor is unaware; and each director has taken all the steps that he ought to have taken to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

Auditor

The auditor, KPMG LLP, has indicated its willingness to continue in office and in accordance with section 487(2) of the Companies Act 2006, has been reappointed.

On behalf of the Board

J F Cracknell

Director

24 May 2017

Registered office:

BAE Systems Applied Intelligence Limited

Surrey Research Park

Guildford

Surrey

GU2 7YP

United Kingdom

Statement of directors' responsibilities in respect of the strategic report and directors' report and the financial statements

The Directors are responsible for preparing the Strategic Report, the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice), including 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 Company and of the profit or loss of the company for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements;

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the company and to prevent and detect fraud and other irregularities.

Independent auditor's report to the members of BAE Systems Applied Intelligence Limited

We have audited the financial statements of BAE Systems Applied Intelligence Limited for the year ended 31 December 2016 set out on pages 8 to 34. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice), including FRS 101 *Reduced Disclosure Framework*.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 6, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2016 and of its loss for the year then ended;
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year is consistent with the financial statements.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the Strategic Report and the Directors' Report:

- we have not identified material misstatements in those reports; and.
- in our opinion, those reports have been prepared in accordance with the Companies Act 2006.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements 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.

John Costello (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
24 May 2017

KPMG LLP
15 Canada Square
London
E14 5GL

Income statement
for the year ended 31 December 2016

	Notes	2016 £'000	2015 £'000
Revenue		**385,256**	326,277
Operating costs	2	**(438,540)**	(342,713)
~~Operating costs - exceptional~~	3	-	(142)
Other income	6	**521**	-
Operating loss		**(52,763)**	(16,578)
Financial income	7	**7**	-
Financial expense	7	**(665)**	(644)
Loss before taxation		**(53,421)**	(17,222)
Taxation income/(expense)	8	**1,316**	(492)
Loss for the year		**(52,105)**	(17,714)

Statement of comprehensive income
for the year ended 31 December 2016

	2016 £'000	2015 £'000
Loss for the year	**(52,105)**	(17,714)
Other comprehensive income		
Items that will not be reclassified to the income statement:		
Actuarial gains and losses on defined benefit pension schemes	**(8,600)**	(2,300)
Tax on items that will not be reclassified to the income statement	**1,400**	130
Items that may be reclassified to the income statement:		
Amounts credited to hedging reserve	**4,083**	-
Tax on items that may be reclassified to the income statement	**(694)**	-
Total other comprehensive income for the year (net of tax)	**(3,811)**	(2,170)
Total comprehensive income for the year	**(55,916)**	(19,884)

The notes on pages 11 to 34 form part of the financial statements.

The results for 2016 and 2015 arise from continuing activities.

Balance sheet

as at 31 December 2016

	Notes	2016 £'000	2015 £'000
Non-current assets			
Intangible assets	9	**21,196**	27,637
Property, plant and equipment	10	**37,548**	42,617
Investments	11	**180**	180
Other financial assets	12	**2,917**	-
		61,841	70,434
Current assets			
Deferred tax assets	13	**7,532**	5,439
Inventories	14	**10,447**	16,615
Trade and other receivables	15	**153,825**	164,571
Other financial assets	12	**1,172**	-
Cash and cash equivalents		**282**	283
		173,258	186,908
Total assets		**235,099**	257,342
Non-current liabilities			
Trade and other payables	16	**(1,602)**	(8,080)
Retirement benefit obligations	17	**(22,700)**	(14,000)
Other financial liabilities	12	**(5)**	-
Provisions	18	**-**	(63)
		(24,307)	(22,143)
Current liabilities			
Trade and other payables	16	**(251,384)**	(221,893)
Other financial liabilities	12	**(1)**	-
Provisions	18	**(348)**	(611)
		(251,733)	(222,504)
Total liabilities		**(276,040)**	(244,647)
Net (liabilities)/assets		**(40,941)**	12,695
Capital and reserves			
Issued share capital	19	**125**	125
Share premium		**587**	587
Other reserves	19	**16,801**	11,056
Retained (deficit) / earnings		**(58,454)**	927
Total (deficit) / equity		**(40,941)**	12,695

Approved by the Board on 24 May 2017 and signed on its behalf by:

J F Cracknell
Director

Registered number: 01337451

Statement of changes in equity

for the year ended 31 December 2016

	Notes	Issued share capital £'000	Share premium £'000	Other reserves £'000	Retained earnings £'000	Total equity £'000
At 1 January 2015		125	587	10,714	20,757	32,183
Loss for the year		-	-	-	(17,714)	(17,714)
Total other comprehensive income for the year		-	-	(54)	(2,116)	(2,170)
Share-based payments	19	-	-	396	-	396
At 31 December 2015		125	587	11,056	927	12,695
Loss for the year		-	-	-	(52,105)	(52,105)
Total other comprehensive income for the year		-	-	3,465	(7,276)	(3,811)
Share-based payments	20	-	-	2,280	-	2,280
At 31 December 2016		**125**	**587**	**16,801**	**(58,454)**	**(40,941)**

Notes to the accounts

1 Accounting policies

Basis of preparation

These financial statements were prepared in accordance with Financial Reporting Standard (FRS) 101 Reduced Disclosure Framework. Amendments to FRS 101 (2014/15 cycle and other minor amendments) and Amendments to FRS 101 (2015/16 cycle), both effective for periods beginning on or after 1 January 2016, have been applied.

In preparing these financial statements, the Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards (IFRS) as adopted by the EU (EU-adopted IFRS), but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of the FRS 101 disclosure exemptions has been taken:

- the requirements of paragraphs 45(b) and 46 to 52 of IFRS 2, Share-based Payment;
- the requirements of 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.

The Company intends to continue to prepare its financial statements in accordance with FRS 101.

The Company is exempt under section 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements as it and its subsidiary undertakings are included by full consolidation in the consolidated financial statements of its ultimate parent, BAE Systems plc, a company registered in England and Wales. Accordingly, these financial statements present information about the Company as an individual undertaking and not as a group.

The following paragraphs summarise the main accounting policies of the Company and have, unless otherwise stated, been applied consistently to all periods presented in these financial statements.

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). The going concern basis has been applied in these accounts.

Revenue and profit recognition

Revenue derived from professional fees billed to clients on a time and materials or fixed-price basis represents the value of work completed, including attributable profit, based on the stage of completion achieved on each project. For time and materials projects, revenue is recognised as services are performed. For fixed-price projects, revenue is recognised on completion of milestones as set out in our terms of engagement.

Revenue from the sale of products is recognised on delivery of the equipment to customers. Revenue derived from licence sales is recognised where there is persuasive evidence that an arrangement exists, delivery has occurred and no significant vendor obligations remain, the fee is fixed or determined and collectability is probable. Revenue from maintenance and support contracts is spread evenly over the period of the support contract.

Notes to the accounts *(continued)*

1 Accounting policies *(continued)*

Revenue and profit recognition

In accordance with paragraph 8 of IAS 18 Revenue to the extent that the Company acts as principal in the transaction, revenue from recharging to clients the cost of specialist managed subcontractors, the purchase of software or hardware for client assignments and staff expenses incurred in the performance of client assignments, together with associated mark-up (if applicable), is recognised as these costs are incurred. Where the Company acts as agent in the transaction, only the commission is recognised as Company revenue.

Income is accrued where these revenue recognition policies result in the recognition of revenue before invoices are sent to clients.

Sales and profits on intercompany trading are determined on an arm's length basis.

Lease costs

Payments, including any incentives, made under operating leases are recognised in the income statement on a straight-line basis over the lease term.

Research and development

The Company undertakes research and development activities either on its own behalf or on behalf of customers.

Company-funded expenditure on both research and development activities not meeting the conditions for capitalisation is written off as incurred and charged to the income statement.

Customer-funded expenditure on research and development activities is held in long-term contract balances as a contract cost within trade and other receivables and recognised in the income statement in accordance with the Company's revenue recognition policy.

Dividends

Dividends received and receivable are credited to the Company's Income Statement. Equity dividends paid on ordinary share capital are recognised as a liability in the period in which they are declared.

Intangible assets

Intangible assets are carried at cost or valuation, less accumulated amortisation and impairment losses.

– Computer software licences acquired for use within the Company are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software;

– Software development costs that are directly associated with the production of identifiable and unique software products controlled by the Company, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Company-funded expenditure associated with enhancing or maintaining computer software programs for sale is recognised as an expense as incurred;

– Research and development expenditure funded by the Company on development activities applied to a plan or design for the production of new or substantially improved products is capitalised as an internally generated intangible asset if certain conditions are met. The expenditure capitalised includes the cost of materials, direct labour and related overheads.

Goodwill

Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill is not amortised, but is tested annually for impairment. This is not in accordance with The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 which require that all goodwill is amortised. The Directors consider that this would fail to give a true and fair view of the profit for the year and that the economic measure of performance in any period is properly made by reference only to any impairment that may have arisen.

Notes to the accounts *(continued)*

1 Accounting policies *(continued)*

Amortisation

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of the intangible assets.

For programme-related intangibles, amortisation is set on a programme-by-programme basis over the life of the individual programme. Amortisation for customer-related intangibles is also set on an individual basis. The Company has no indefinite life intangible assets other than goodwill.

The estimated useful lives are as follows:

Programme and customer-related	Up to 15 years
Computer software licences acquired	2 to 5 years
Software development costs	2 to 5 years
Research and development expenditure	Up to 10 years
Patents, trademarks and licenses	Up to 20 years
Other intangibles	Up to 10 years

Impairment

The carrying amounts of the Company's intangible assets are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, Impairment of Assets. If any such indication exists, the asset's recoverable amount is estimated. For intangible assets that are not yet available for use, impairment testing is performed annually.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

The recoverable amount is the greater of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate. For an asset that does not generate largely independent cash flows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Impairment losses are recognised in the Income Statement.

An impairment loss in respect of 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.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the Income Statement.

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.

Depreciation

Depreciation is provided on a straight-line basis, to write off the cost of property, plant and equipment over their estimated useful lives to any estimated residual value, using the following rates:

Leasehold premises	Over the period of the lease
Office furniture and equipment	20%
Computers, ancillary equipment and electronic test equipment	20-33%

Notes to the accounts *(continued)*

1 Accounting policies *(continued)*

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 Company's property, plant and equipment are reviewed, at each balance sheet date to determine whether there is any indication of impairment. The treatment of any resulting impairment is as described above.

Investments

Fixed asset investments in shares in subsidiary undertakings and in shares in participating interests are stated at cost less provision for impairment.

Inventories

Inventories are stated at the lower of cost, including all relevant overhead expenditure, and net realisable value.

Trade and other receivables

Trade and other receivables are stated at their cost less provision for bad debts. A provision for bad debt is established when there is objective evidence that the Company 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 company performance, as cash received on customers' account.

Amounts due from contract customers represent unbilled income and are stated at cost, plus attributable profit.

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call and term deposits, and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value.

Trade and other payables

Trade and other payables are stated at their cost.

Notes to the accounts *(continued)*

1 Accounting policies *(continued)*

Tax

Income tax expense comprises current and deferred tax. Current and deferred tax is recognised in the Income Statement 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.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority and they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

Provisions

A provision is recognised in the balance sheet when the Company 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.

Legal, contractual and environmental

The Company holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period. These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Other

Other provisions include provisions for onerous contracts, which are recognised when the expected benefits to be derived by the Company from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

Notes to the accounts *(continued)*

1 Accounting policies *(continued)*

Retirement benefit obligations

Defined contribution pension schemes

A defined contribution pension scheme is a post-employment benefit plan under which the Company pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further amounts.

Obligations for contributions are recognised as an expense in the income statement as incurred.

Defined benefit pension schemes

The cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Remeasurements, including actuarial gains and losses, are recognised in the 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 Company's Balance Sheet represents 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 27. 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.

The Company participates in a number of group and multi-employer schemes administered by its ultimate parent company, BAE Systems plc. A share of the IAS 19, Employee Benefits, pension deficit has been allocated to all participating employers. This allocation is 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 BAE Systems plc'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 Company considers the likelihood of this event arising as remote.

Share-based payments

BAE Systems plc issues equity-settled share options to employees of the Company. In accordance with the requirements of IFRS 2, Share-based Payment, the Company has recognised a charge for the equity-settled share options issued to its employees.

Equity-settled share options and long term incentive plan arrangements are measured at fair value at the date of grant using an option pricing model.

The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of the number of shares that will actually vest.

Financial instruments

Derivative financial instruments and hedging activities

The global nature of the Company's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Company's policy is to hedge all material firm transactional exposures. The Company aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures.

In accordance with its treasury policy, the Company does not hold derivative financial instruments for trading purposes.

Derivative financial instruments are recognised initially at fair value. Subsequent to initial recognition, such instruments are stated at fair value at the balance sheet date. Gains and losses on derivative financial instruments that do not qualify for hedge accounting are recognised in the Income Statement for the period.

Cash flow hedges

Where a derivative financial instrument is designated as a hedge of cash flows relating to a highly probable forecast transaction (income or expense), the effective portion of any change in the fair value of the instrument is recognised in other comprehensive income and presented in the hedging reserve in equity. Amounts recognised in equity are reclassified from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the Income Statement immediately.

Notes to the accounts *(continued)*

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.

2 Operating costs

Included within operating costs are the following expenses:	2016 £'000	2015 £'000
Staff costs (note 4)	**207,935**	173,613
Intercompany market support expense/(operating income) [1]	**13,160**	(9,565)
Intercompany expense [2]	**22,783**	15,767
Depreciation, amortisation and impairment	**20,955**	16,467
Loss on disposal of property, plant and equipment	**1,045**	193
Operating lease rental costs	**6,307**	4,540

[1] Relates to certain operating arrangements with fellow wholly owned subsidiaries.
[2] Represents charges from fellow wholly owned subsidiaries in respect of product licences and research and development activities.

The remuneration of the auditor for the year ended 31 December 2016 for statutory audit work was £144k (2015: £142k) and £nil (2015: £nil) in respect of non-audit work.

Included within operating costs are £35,571k (2015: £23,881k) relating to the Company's research and development activities.

3 Exceptional costs

	2016 £'000	2015 £'000
Leasehold surrender property costs	**-**	142

In 2011 the Company entered into an agreement to surrender a operating lease to the landlord in exchange for a monetary incentive. The Company recognised the receipt over the period from the date of the agreement to the date of vacation. As a result of the decision to vacate the above property, as well as entering into an agreement to lease another property, the Company has incurred additional property costs of £nil (2015: £142k). These costs are included in operating costs in the year.

4 Employees

The average number of Company employees was as follows:

	2016	2015
Staff numbers	**2,849**	2,408

The aggregate staff costs of Company employees were as follows:

	2016 £'000	2015 £'000
Wages and salaries	**169,331**	142,982
Social security costs	**19,319**	15,728
Pension costs – defined contribution plans (note 17)	**13,136**	11,879
Pension costs – defined benefit plans (note 17)	**3,869**	2,628
Share-based payments (note 19)	**2,280**	396
	207,935	173,613

Notes to the accounts *(continued)*

5 Directors emoluments

Three of the directors did not receive any remuneration from the Company during the year. The directors were employed by other BAE Systems plc group companies and were remunerated through those companies. In 2015 such remuneration was included in amounts recharged from other group companies for directors services. In 2016 their remuneration has been presented within the relevant remuneration and contributions to pension scheme classifications.

The disclosures below represent an allocation of the emoluments received by the directors to reflect their qualifying services to the Company.

	2016	2015
	£'000	£'000
Directors' remuneration	**1,132**	753
Company contributions to money purchase pension schemes	**2**	88
Company contributions to defined benefit pension schemes	**122**	-
Compensation for loss of office	**55**	-
Amounts recharged from other group companies for directors services	**-**	1,015
	1,311	1,856

The number of directors for whom retirement benefits were accruing in respect of qualifying services under money purchase pension schemes amounted to 2 (2015: 2) and under defined benefit schemes amounted to 1 (2015: 1).

The amounts in respect of the highest paid director were as follows:

	2016	2015
	£'000	£'000
Remuneration	**450**	497
Company contributions to money purchase pension schemes	**-**	34
Company contributions to defined benefit pension schemes	**80**	-
	530	531

The highest paid director's defined benefit accrued pension and accrued lump sum at 31 December 2016 was £226k (2015 £211k) and £nil (2015 £nil), respectively.

6 Other income

	2016	2015
	£'000	£'000
Rental income from operating leases	**521**	-

7 Financial income and expense

	2016	2015
	£'000	£'000
Interest income	**7**	-
Financial income	**7**	-
Net present value adjustments	**65**	44
Net interest expense on retirement benefit obligations (note 17)	**600**	600
Financial expense	**665**	644

Notes to the accounts *(continued)*

8 Taxation expense

Taxation expense	**2016 £'000**	2015 £'000
Current taxation		
Overseas:		
Current tax	**71**	90
	71	90
Deferred taxation		
Origination and reversal of temporary differences	**(1,288)**	35
Adjustments in respect of prior years	**(344)**	59
Tax rate adjustment[1]	**245**	308
	(1,387)	402
Taxation (income)/expense	**(1,316)**	492

Total tax reconciliation

The following reconciles the expected tax expense, using the UK corporation tax rate, to the reported tax expense:

	2016 £'000	2015 £'000
Profit before taxation	**(53,421)**	(17,222)
UK corporation tax rate	**20%**	20.25%
Expected tax (income)/expense	**(10,684)**	(3,487)
Expenses not tax effected	**491**	430
Income not subject to tax	**82**	(185)
Research and development expenditure credits	**(238)**	(476)
Property, plant and equipment	**(604)**	480
Effect of tax rates in foreign jurisdictions	**71**	90
Provisions and accruals	**(7)**	191
Pensions	**2**	190
Share based payments	**(54)**	(277)
Imputed interest	**(288)**	(303)
Losses surrendered to/(received from) group companies	**10,012**	3,472
Adjustments in respect of prior years	**(344)**	59
Tax rate adjustment	**245**	308
Taxation (income)/expense	**(1,316)**	492

Notes to the accounts *(continued)*

8 Taxation expense *(continued)*

Tax recognised in other comprehensive income

	2016			2015		
	Before tax	Tax benefit/ (expense)	Net of tax	Before tax	Tax benefit/ (expense)	Net of tax
	£'000	£'000	£'000	£'000	£'000	£'000
Items that will not be reclassified to the income statement:						
Remeasurements on retirement benefit schemes	(8,600)	1,548	(7,052)	(2,300)	460	(1,840)
Share-based payments	-	92	92	-	(34)	(34)
Tax rate adjustment[1]	-	(240)	(240)	-	(296)	(296)
Items that may be reclassified to the income statement:						
Amounts credited to hedging reserve	4,083	(735)	3,348	-	-	-
Tax rate adjustment[1]		41	41	-	-	-
	(4,517)	706	(3,811)	(2,300)	130	(2,170)

	2016			2015		
	Other reserves	Retained earnings	Total	Other reserves	Retained earnings	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Deferred tax						
Pensions	-	1,548	1,548	-	460	460
Share based payments	92	-	92	(34)	-	(34)
Financial instruments	(735)	-	(735)	-	-	-
Tax rate adjustment[1]	25	(224)	(199)	(20)	(276)	(296)
Tax on other comprehensive income	(618)	1,324	706	(54)	184	130

[1] The UK corporation tax rate was reduced from 20% to 19% with effect from 1 April 2017, and will be reduced to 17% with effect from 1 April 2020. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from the prior year's enacted tax rate of 18% to 17%, creating a rate adjustment in 2016 which is partly reflected in the income statement and partly in the statement of other comprehensive income.

9 Intangible assets

	Goodwill £'000	Software £'000	Other £'000	Total £'000
Cost				
At 1 January 2016	27,531	25,205	14,635	67,371
Additions	-	1,825	-	1,825
Transfers	-	6,437	-	6,437
Transfers to other group subsidiaries	-	(580)	-	(580)
At 31 December 2016	**27,531**	**32,887**	**14,635**	**75,053**
Amortisation				
At 1 January 2016	27,531	11,788	415	39,734
Amortisation charge	-	12,664	1,459	14,123
At 31 December 2016	**27,531**	**24,452**	**1,874**	**53,857**
Net book value				
At 31 December 2016	**-**	**8,435**	**12,761**	**21,196**
At 31 December 2015	-	13,417	14,220	27,637

Notes to the accounts *(continued)*

10 Property, plant and equipment

	Short leasehold premises £'000	Office furniture and equipment £'000	Computers and ancilliary equipment £'000	Electronic test equipment £'000	Assets in the course of construction £'000	Total £'000
Cost or valuation						
At 1 January 2016	25,600	3,467	25,763	2,978	16,260	74,068
Additions	1,953	260	1,783	92	8,170	12,258
Disposals	(259)	(9)	(350)	(36)	(739)	(1,393)
Transfers	1,669	-	1,812	736	(10,654)	(6,437)
Transfers to other group subsidiaries	(392)	-	(1,553)	(378)	(690)	(3,013)
At 31 December 2016	**28,571**	**3,718**	**27,455**	**3,392**	**12,347**	**75,483**
Depreciation and impairment						
At 1 January 2016	12,128	624	15,871	2,828	-	31,451
Depreciation charge for the year	3,072	666	2,524	570	-	6,832
Disposals	(249)	(7)	(57)	(35)	-	(348)
At 31 December 2016	**14,951**	**1,283**	**18,338**	**3,363**	**-**	**37,935**
Net book value						
At 31 December 2016	**13,620**	**2,435**	**9,117**	**29**	**12,347**	**37,548**
At 31 December 2015	13,472	2,843	9,892	150	16,260	42,617

Capital commitments

Capital expenditure contracted for but not provided for in full in the accounts is £8,400k (2015: £2,844k).

Operating lease commitments

The Company leases various land and buildings and other assets 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 are as follows:

	2016 £'000	2015 £'000
Payments due:		
Not later than one year	**5,852**	5,815
Later than one year and not later than five years	**19,457**	19,493
Later than five years	**645**	4,929
	25,954	30,237
Total of future minimum sublease income under non-cancellable subleases	**434**	-

Operating lease commitments above include £650k (2015: £1,159k) relating to commitments under onerous operating leases which have been fully provided for within provisions.

Notes to the accounts *(continued)*

11 Investments

Carrying value	**£'000**
At 1 January 2016 and 31 December 2016	**180**

Subsidiary undertakings at 31 December 2016

In accordance with Section 409 of the Companies Act 2006, the subsidiary as at 31 December 2016 is disclosed below. The subsidiary undertaking is owned directly by BAE Systems Applied Intelligence Limited and has a financial year end of 31 December.

Company name	**Class of shares**	**Proportion of class (%)**
BAE Systems Applied Intelligence Malaysia SDN BHD c/o RDL Corporate Services Sdn. Bhd., 16th Floor, Wisma Sime Darby, Jalan Raja Laut, Kuala Lumpur, 50340, Malaysia	Ordinary shares of RM1	99.9999

12 Other financial assets

	2016		2015	
	Assets	**Liabilities**	Assets	Liabilities
	£'000	**£'000**	£'000	£'000
Non-current				
Cash flow hedges – foreign exchange contracts	**2,917**	**(5)**	-	-
Current				
Cash flow hedges – foreign exchange contracts	**1,172**	**(1)**	-	-

Cash flow hedges

Amounts credited to the hedging reserve in respect of cash flow hedges were £4,083k (2015: nil).

Notes to the accounts *(continued)*

13 Deferred tax

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2016	2015	**2016**	2015	**2016**	2015
	£'000	£'000	**£'000**	£'000	**£'000**	£'000
Property, plant and equipment	**3,223**	2,028	**-**	-	**3,223**	2,028
Provisions and accruals	**615**	547	**-**	-	**615**	547
Pension/retirement schemes:						
Deficits	**3,859**	2,520	**-**	-	**3,859**	2,520
Share-based payments	**529**	344	**-**	-	**529**	344
Financial instruments	**-**	-	**(694)**	-	**(694)**	-
Deferred tax assets/(liabilities)	**8,226**	5,439	**(694)**	-	**7,532**	5,439
Set off of tax	**(694)**	-	**694**	-	**-**	-
Net deferred tax assets/(liabilities)	**7,532**	5,439	**-**	-	**7,532**	5,439

Movement in temporary differences

	At 1 January 2016 £'000	Recognised In income £'000	Recognised In equity £'000	**At 31 December 2016 £'000**
Property, plant and equipment	2,028	1,195	-	**3,223**
Provisions and accruals	547	68	-	**615**
Pensions/retirement schemes: deficits	2,520	15	1,324	**3,859**
Share-based payments	344	109	76	**529**
Financial instruments	-	-	(694)	**(694)**
	5,439	1,387	706	**7,532**

	At 1 January 2015 £'000	Recognised In income £'000	Recognised In equity £'000	At 31 December 2015 £'000
Property, plant and equipment	2,089	(61)	-	2,028
Provisions and accruals	757	(210)	-	547
Pension schemes: deficits	2,260	76	184	2,520
Pension schemes: additional contributions	189	(189)	-	-
Share-based payments	416	(18)	(54)	344
	5,711	(402)	130	5,439

Future changes in tax rates

The UK corporation tax rate was reduced from 20% to 19% with effect from 1 April 2017, and will be reduced to 17% with effect from 1 April 2020. In line with this change, the rate applying to UK deferred tax assets and liabilities has been reduced from the prior year's enacted tax rate of 18% to 17%, creating a rate adjustment in 2016 which is partly reflected in the income statement and partly in the statement of other comprehensive income.

Notes to the accounts *(continued)*

14 Inventories

	2016 £'000	2015 £'000
Short-term work in progress	**10,447**	16,615

The Company recognised £1,004k (2015: £1,401k) as a write down of inventories to net realisable value.

15 Trade and other receivables

	2016 £'000	2015 £'000
Current		
Amounts due from customers for contract work	**13,165**	14,770
Trade receivables	**64,484**	49,626
Amounts owed by group companies	**29,899**	63,214
Prepayments and accrued income	**45,297**	36,524
Other receivables	**980**	437
	153,825	164,571

16 Trade and other payables

	2016 £'000	2015 £'000
Non Current		
Amounts owed to group companies	**1,602**	8,080
	1,602	8,080
Current		
Trade payables	**5,028**	8,553
Customer stage payments	**15,111**	12,306
Amounts owed to group companies	**175,938**	144,422
Other taxes and social security costs	**17,131**	14,000
Accruals and deferred income	**38,097**	42,279
Other payables	**78**	333
	251,383	221,893

Notes to the accounts *(continued)*

17 Retirement benefit obligations

Background

BAE Systems plc operates pension schemes for qualifying employees in the UK, US and other countries. The principal schemes in the UK are funded defined benefit schemes and the assets are held in separate trustee-administered funds. The two largest funded defined benefit schemes are the BAE Systems Pension Scheme (Main Scheme) and the BAE Systems 2000 Pension Plan (2000 Plan).

At 31 December 2016, the weighted average durations of the UK defined benefit pension obligations were 19 years (2015 18 years).

The Company participates in the following BAE Systems plc schemes: Main Scheme, 2000 Plan and Executive Pension Scheme.

The split of the defined benefit pension liability on a funding basis between active, deferred and pensioner members for the Main Scheme and 2000 Plan is set out below:

	Active %	Deferred %	Pensioner %
Main Scheme[1]	32	19	49
2000 Plan[2]	14	29	57

1. Source: Main Scheme actuarial valuation report as at 31 March 2014.

2. Source: 2000 Plan actuarial valuation report as at 31 March 2014.

Regulatory framework

The funded UK schemes are registered and subject to the statutory scheme specific-funding requirements outlined in UK legislation, including the payment of levies to the Pension Protection Fund as set out in the Pension Act 2004. These schemes were established under trust and the responsibility for their governance lies jointly with the trustees and BAE Systems plc.

Benefits

The UK defined benefit schemes provide benefits to members in the form of a set level of pension payable for life based on members' final salaries. The benefits attract inflation-related increases both in deferment and payment. All UK defined benefit schemes are closed to new entrants, with benefits for new employees being provided through a defined contribution scheme. The normal retirement age for active members of the Main Scheme and 2000 Plan is 65. Specific benefits applicable to members differ between schemes. Further details on the benefits provided by each scheme are provided on the BAE Systems Pensions website: www.baesystemspensions.com.

Funding

The majority of the UK defined benefit pension schemes are funded by BAE Systems plc'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, whilst the liabilities are determined based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The separate actuarial valuations for funding purposes include assumptions which differ from the actuarial assumptions used for IAS 19 accounting purposes shown on page 27. The latest valuations of the Main Scheme and 2000 Plan were performed as at 31 March 2014 and showed a funding deficit of £2.6bn. The total net funding deficit in respect of all of the UK schemes was £2.7bn. Deficit recovery plans agreed with the trustees of the relevant schemes run until 2026.

The next UK triennial funding valuations, as at 31 March 2017, commenced in April 2017 and, in conjunction with the trustees of the schemes and other stakeholders, BAE Systems plc will be looking at various options with a focus on the longer-term view. The results of future triennial valuations and associated funding requirements will be impacted by the future performance of investment markets, and interest and inflation rates.

The total Company contributions made to the defined benefit schemes in the year ended 31 December 2016 were £3,869k (2015: £2,628k) in line with the schedule of contributions. In 2017, the Company expects to make contributions at a similar level to the recurring contributions and deficit funding as made in 2016.

The Company incurred a charge of £13,136k (2015: £11,879k) in relation to defined contribution schemes for employees.

Notes to the accounts *(continued)*

17 Retirement benefit obligations *(continued)*

Risk management

The defined benefit pension schemes expose BAE Systems plc 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 of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of market risk.
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.
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.
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.

Notes to the accounts *(continued)*

17 Retirement benefit obligations *(continued)*

Principal actuarial assumptions

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the long-term nature of the obligation covered, may not necessarily occur in practice.

	2016	2015	2014
Financial assumptions			
Discount rate (%)	**2.7**	3.9	3.6
Inflation (%)	**3.2**	3.2	3.2
Rate of increase in salaries (%)	**3.2**	3.2	3.2
Rate of increase in deferred pensions (%)	**2.2/3.2**	2.3/3.2	2.3/3.2
Rate of increase in pensions in payment (%)	**1.7-3.7**	1.8 – 3.6	1.8 – 3.6
Demographic assumptions			
Life expectancy of a male currently aged 65 (years)	**86 – 89**	87 – 89	87 – 89
Life expectancy of a female currently aged 65 (years)	**89 – 90**	89 – 90	89 – 90
Life expectancy of a male currently aged 45 (years)	**88 – 91**	89 – 91	89 – 91
Life expectancy of a female currently aged 45 (years)	**91 – 92**	91 – 92	91 – 92

Discount rate

The discount rate assumptions are derived through discounting the projected benefit payments of the principal schemes using a third-party AA corporate bond yield curve to produce a single equivalent discount rate. This inherently captures the maturity profile of the expected benefit payments. Further information on the duration of the schemes is detailed on page 25.

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.

Rate of increase in salaries

The rate of increase in salaries for the UK schemes is assumed to be Retail Prices Index (RPI) inflation of 3.2% (2015 RPI inflation of 3.2%), plus a promotional scale.

Rate of increase in pensions in payment

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

Rate of increase in deferred pensions

The rate of increase in deferred pensions for the UK schemes is based on CPI inflation of 2.2% (2015 CPI inflation of 2.3%), with the exception of the 2000 Plan, which is based on RPI inflation of 3.2% (2015 RPI inflation of 3.2%). The rate of increase in deferred pensions is subject to inflation caps.

Life expectancy

The Company has used the Self-Administered Pension Schemes S2 mortality tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of scheme members. In addition, to allow for future improvements in longevity, the Continuous Mortality Investigation 2015 tables (published by the Institute of Actuaries) have been used, with an assumed long-term rate of future annual mortality improvements of 1.25% (2015 1.25%), for both pensioner and non-pensioner members.

Notes to the accounts *(continued)*

17 Retirement benefit obligations *(continued)*

The disclosures below relate to post-retirement benefit schemes in the UK which are accounted for as defined benefit schemes in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries as updated to take account of the requirements of IAS 19 to assess the deficits of the schemes at 31 December each year. In 2015, the Company presented the total fair value of scheme assets and the total present value of the defined benefit obligations for the schemes in which the Company participated, together with reconciliation to the Company's share of the net deficit. For 2016, the Company has presented the Company's share of the fair value of scheme assets and the present value of the defined benefit obligations and, therefore, the 2015 disclosures have been re-presented on this basis. This provides more relevant information since only those assets, obligations and associated movements relating to the Company's share of the schemes in which it participates are now presented.

Summary of movements in retirement benefit obligations

	£m
Company's share of IAS 19 deficit at 1 January 2016	(14)
Actual return on assets excluding amounts included in interest expense	20.2
Increase in liabilities due to changes in assumptions and experience	(28.8)
Contributions in excess of service cost	0.5
Net interest expense	(0.6)
Company's share of IAS 19 deficit at 31 December 2016	**(22.7)**

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.

	2016 £m	2015 £m
Present value of funded obligations	**(102.6)**	(72.8)
Fair value of scheme assets	**79.9**	58.8
Company's share of IAS 19 (deficit), net	**(22.7)**	(14)
Represented by:		
Retirement benefit surpluses	**-**	-
Retirement benefit obligations	**(22.7)**	(14)
	(22.7)	(14)

Notes to the accounts *(continued)*

17 Retirement benefit obligations *(continued)*

Changes in the fair value of scheme assets after allocation to other participating employers

	UK defined benefit pension schemes £m
Company's value of scheme assets at 1 January 2015	35.6
Interest income	2.1
Actual return on assets excluding amounts included in interest income	22.3
Actual return on assets	24.4
Contributions by employer	1.1
Contributions by employer in respect of employee salary sacrifice arrangements	0.2
Total contributions by employer	1.3
Benefits paid	(2.5)
Company's value of scheme assets at 31 December 2015	58.8
Interest income	2.7
Actual return on assets excluding amounts included in interest income	20.2
Actual return on assets	22.9
Contributions by employer	1.3
Contributions by employer in respect of employee salary sacrifice arrangements	0.3
Total contributions by employer	1.6
Benefits paid	(3.4)
Company's value of scheme assets at 31 December 2016	**79.9**

Assets of defined benefit pension schemes

	2016			2015[4]		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equities:						
UK	**17.4**	**0.0**	**17.4**	14.4	0.0	14.4
Overseas	**12.5**	**0.0**	**12.5**	10.7	0.0	10.7
Pooled investment vehicles[1]	**2.2**	**7.6**	**9.8**	1.0	4.8	5.8
Fixed interest securities:						
UK gilts	**5.9**	**0.0**	**5.9**	5.3	0.0	5.3
UK corporates	**8.9**	**0.6**	**9.5**	7.2	0.8	8.0
Overseas government	**0.4**	**0.0**	**0.4**	0.0	0.0	0.0
Overseas corporates	**4.1**	**1.1**	**5.2**	0.1	0.9	1.0
Index-linked securities:						
UK gilts	**6.1**	**0.0**	**6.1**	3.9	0.0	3.9
UK corporates	**4.5**	**2.4**	**6.9**	3.0	1.8	4.8
Property[2]	**0.0**	**5.6**	**5.6**	0.0	4.8	4.8
Derivatives[3]	**0.0**	**(1.0)**	**(1.0)**	0.0	(0.7)	(0.7)
Cash:						
Sterling	**1.3**	**0.0**	**1.3**	0.6	0.0	0.6
Foreign currency	**0.1**	**0.1**	**0.2**	0.2	0.0	0.2
Other	**0.1**	**0.0**	**0.1**	0.0	0.0	0.0
Company total	**63.5**	**16.4**	**79.9**	46.4	12.4	58.8

1. 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.
2. 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.
3. Includes interest rate, inflation and longevity swaps. The valuations are based on valuation techniques using underlying market data and discounted cash flows.
4. Restated following reinterpretation of the classifications, including the allocation between quoted and unquoted assets.

Notes to the accounts *(continued)*

17 Retirement benefit obligations *(continued)*

Changes in the present value of the defined benefit obligations after allocation to other participating employers

	UK defined benefit pension schemes £m
Company's defined benefit obligations at 1 January 2015	(46.9)
Current service cost	(0.9)
Contributions by employer in respect of employee salary sacrifice arrangements	(0.2)
Total current service cost	(1.1)
Actuarial (loss) due to changes in assumptions and experience	(24.6)
Interest expense	(2.7)
Benefits paid	2.5
Company's defined benefit obligations at 31 December 2015	(72.8)
Current service cost	(0.8)
Contributions by employer in respect of employee salary sacrifice arrangements	(0.3)
Total current service cost	(1.1)
Actuarial (loss) due to changes in assumptions and experience	(28.8)
Interest expense	(3.3)
Benefits paid	3.4
Company's defined benefit obligations at 31 December 2016	**(102.6)**

Amounts recognised in the income statement after allocation to other participating employers

	2016 £m	2015 £m
Included in operating costs:		
Current service cost	**1.1**	1.1
Included in finance costs:		
Net interest expense on retirement benefit obligations	**(0.6)**	(0.6)

Notes to the accounts *(continued)*

17 Retirement benefit obligations *(continued)*

Financial assumptions

Changes in the following financial assumptions would have the following effect on the defined benefit pension obligation after allocation to other participating employers:

	(Increase)/ Decrease in pension obligation £m
Discount rate:	
0.1 percentage point increase	2
0.1 percentage point decrease	(2)
Inflation:	
0.1 percentage point increase	(2)
0.1 percentage point decrease	2

The sensitivity of the valuation of the liabilities to changes in the inflation assumption presented above assumes that a 0.1 percentage point change to expectations of future inflation results in a 0.1 percentage point change to all inflation-related assumptions used to value the liabilities. However, upper and lower limits exist on the majority of inflation-related benefits such that a change in expectations of future inflation may not have the same impact on the inflation-related benefits, and hence will result in a smaller change to the valuation of the liabilities. Accordingly, extrapolation of the above results beyond the specific sensitivity figures shown may not be appropriate. To illustrate this, the (increase)/decrease in the defined benefit pension obligation resulting from larger changes in the inflation assumption would be as follows:

	(Increase)/ Decrease in pension obligation £m
Inflation:	
0.5 percentage point increase	(7)
0.5 percentage point decrease	7
1.0 percentage point increase	(15)
1.0 percentage point decrease	13

Demographic assumptions

Changes in the life expectancy assumption would have the following effect on the total net IAS 19 deficit after allocation to other participating employers:

	(Increase)/ Decrease in net deficit £m
Life expectancy:	
One-year increase	(4)
One-year decrease	4

Notes to the accounts *(continued)*

18 Provisions

	Warranty £'000	Staff costs £'000	Onerous leases £'000	Contract loss £'000	Other £'000	Total £'000
At 1 January 2016	44	385	223	22	-	674
Created	5	3	-	-	130	138
Released	(44)	(5)	-	(21)	-	(70)
Utilised	-	(270)	(142)	-	-	(412)
Net present value adjustment	-	-	18	-	-	18
At 31 December 2016	**5**	**113**	**99**	**1**	**130**	**348**
Represented by:						
Non-current	-	-	-	-	-	-
Current	5	113	99	1	130	348
	5	**113**	**99**	**1**	**130**	**348**

Onerous leases

The provision on onerous leases has been created in order to satisfy the Company's remaining net rental obligations on a vacant property lease in London.

Staff costs

The staff costs provision has been created to provide for staff related costs such as rationalisation costs.

Notes to the accounts *(continued)*

19 Share capital and other reserves

Share capital

	£1 Ordinary shares	Nominal value £'000
Issued and fully paid		
At 1 January and 31 December 2016	**125,045**	**125**

Equity dividends

No dividends were paid in respect of the year ended 31 December 2016 or 31 December 2015.

The directors do not propose a final dividend for 2016.

Other reserves

	Capital redemption £'000	Share based payments reserve £'000	Hedging reserve £'000	Total £'000
At 1 January 2015	**31**	**10,683**	**-**	**10,714**
Other comprehensive income	-	(54)	-	(54)
Share based payment	-	396	-	396
At 31 December 2015	**31**	**11,025**	**-**	**11,056**
Other comprehensive income	-	76	3,389	3,465
Share based payment	-	2,280	-	2,280
At 31 December 2016	**31**	**13,381**	**3,389**	**16,801**

Share based payment reserve

The share based payment reserve represents the credit to reserves in relation to the share based payment expense recognised in the Company's Income Statement (note 4).

20 Share-based payments

Options over shares of the ultimate parent undertaking, BAE Systems plc, have been granted to employees of the Company under various plans. Details of the terms and conditions of each share-based payment plan are given in the Annual Remuneration Report of the BAE Systems plc Annual Report.

For options outstanding at the end of the year:

	2016		2015	
	Range of exercise price of outstanding options (£)	**Weighted average remaining contracted life (years)**	Range of exercise price of outstanding options (£)	Weighted average remaining contracted life (years)
Executive Share Option Plan	**3.01-5.56**	**8**	3.01-5.43	8
Performance Share Plan	**-**	**5**	-	5
Restricted Share Plan	**-**	**6**	-	-

The average share price in the year was £5.24 (2015: £4.07).

Notes to the accounts *(continued)*

21 Controlling parties

The Company's immediate parent company is Detica Group Limited, a company incorporated in Great Britain and registered in England and Wales.

The Company's ultimate parent company is BAE Systems plc, a company incorporated in Great Britain and registered in England and Wales.

The consolidated accounts of BAE Systems plc are available to the public and may be obtained from:

6 Carlton Gardens
London
SW1Y 5AD

Website: www.baesystems.com