1.1 GROUP MANAGEMENT REPORT

1.1.1 Report on operations and results

In 2013, Thales achieved all its objectives. Whilst sales were stable, as expected, the Group achieved a substantial improvement in operating profitability, with a strengthened financial situation, and a strong growth of order intake, particularly in emerging markets.

1.1.1.1 Key figures (adjusted)

(€ million)	2013	2012[(a)]	Total change	Organic change[(b)]
Order intake	14,168	13,285	+7%	+10%
Order book[(c)]	29,527	29,849	-1%	+0%
Sales	14,194	14,158	+0%	+3%
EBIT[(d)]	1,003	927	+8%	+11%
in % of sales	*7.1%*	*6.5%*		
Adjusted net income, Group share[(d)]	644	570	+13%	
Adjusted net income per share *(in euros)*[(d)]	3.20	2.86	+12%	
Net income, Group share	573	586	-2%	
Dividend per share *(in euros)*[(e)]	1.12[(e)]	0.88	+27%	
Free operating cash flow[(d)]	466	669		
Net cash	1,666	1,528		

(a) Restated to take into account IAS19 R first adoption (see note 1-a of the notes to the consolidated financial statements).
(b) In this report, "organic" means "on a like-for-like basis and at constant exchange rates".
(c) In 2013, the Group revised the rules for valuing the order book, especially in civil avionics, so that the approach provides a better reflection of the economic reality.
(d) Non-GAAP measure, see definition below in the section "Presentation of financial information".
(e) Total amount proposed to the AGM on 14 May 2014, including the interim dividend of €0.27 paid in December 2013.

1.1.1.2 Presentation of financial information

Accounting policies

The consolidated financial statements of the Thales group are prepared in accordance with IFRS (International Financial Reporting Standards) as approved by the European Union at 31 December 2013.

These principles, described in note 23, are consistent with those applied for the year ended 31 December 2012, except for the following elements: IAS 19 revised (Employee Benefits), IFRS 13 (Fair value measurement) and the amendment to IFRS 7 (Disclosures and Offsetting Financial Assets and Financial Liabilities). Annual Improvements to IFRS, published in May 2012, has no significant impact for the Group.

Non-GAAP financial measures

In order to enable better monitoring and benchmarking of its operating and financial performance, the Group presents two main non-GAAP indicators, excluding non-operating and non-recurring items. They are determined as follows:

- **EBIT**, an adjusted operating metric, equivalent to income from operations excluding the amortisation of intangible assets acquired (purchase price allocation, "PPA") recorded as part of important business combinations.

  Starting from 1 January 2014 and the start of application of the new IFRS 10 and IFRS 11 standards, EBIT will also include share in net income (loss) of equity affiliates.
- **Adjusted net income** refers to net income, excluding (i) amortisation of intangible assets acquired, (ii) disposal of assets and others, (iii) change in fair value of derivative foreign exchange instruments (recorded in "other financial results" in the consolidated accounts), (iv) actuarial gains or losses on long-term benefits (accounted within the "finance costs on pensions and employee benefits" in the consolidated accounts, net of the corresponding tax effects.

For reminder, only the consolidated financial statements are audited by the statutory auditors, including the EBIT set out in note 3 to the consolidated financial statements "Segment information". Adjusted financial data other than provided in note 3 "Segment Information", is subject to the verification procedures applicable to all of the information provided in this report.

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The impact of these adjustments on the income statement is shown below:

▶ IMPACT OF ADJUSTMENT ENTRIES ON INCOME STATEMENT – 2013

		Adjustments			
(€ million)	**Consolidated income statement 2013**	**Amortisation of intangible assets (PPA)**	**Gain (loss) on disposal of assets and others**	**Change in fair value of derivative exchange instruments**	**Adjusted income statement 2013**
Sales	**14,194**				**14,194**
Cost of sales	(10,845)				(10,845)
R&D	(673)				(673)
Selling, general and administrative expenses	(1,554)				(1,554)
Restructuring costs	(119)				(119)
EBIT	**N/A**				**1,003**
Amortisation of intangible assets acquired (PPA)	(98)	98			-
Income from operations	**905**	**98**			**N/A**
Impairment of non current operating assets	(4)				(4)
Disposal of assets, change in scope of consolidation and other	12		(12)		-
Income of operating activities	**913**	**98**	**(12)**		**999**
Cost of net financial debt	*(1)*				*(1)*
Other financial income (expense)	*(50)*			*29*	*(21)*
Net financial expense	(51)			29	(22)
Finance costs on pensions and other employee benefits	(72)				(72)
Income tax	(237)	(34)		(10)	(281)
Share in net income (loss) of equity affiliates	20				20
Net income	**573**	**64**	**(12)**	**19**	**644**

▶ **IMPACT OF ADJUSTMENT ENTRIES ON INCOME STATEMENT – 2012**

		Adjustments				
(€ million)	**Consolidated income statement 2012[(a)]**	**Amortisation of intangible assets (PPA)**	**Gain (loss) on disposal of assets and others**	**Change in fair value of derivative exchange instruments**	**Actuarial gains/losses on other long-term benefits**	**Adjusted income statement 2012**
Sales	**14,158**					**14,158**
Cost of sales	(10,868)					(10,868)
R&D	(687)					(687)
Selling, general and administrative expenses	(1,558)					(1,558)
Restructuring costs	(118)					(118)
EBIT	**N/A**					**927**
Amortisation of intangible assets acquired (PPA)	(112)	112				-
Income from operations	**816**	**112**				**N/A**
Impairment of non current operating assets	(15)					(15)
Disposal of assets, change in scope of consolidation and other	123		(123)			-
Income of operating activities	**923**	**112**	**(123)**			**913**
Cost of net financial debt	*(13)*					*(13)*
Other financial income (expense)	*(53)*			*26*		*(27)*
Net financial expense	(66)			26		(40)
Finance costs on pensions and other employee benefits	(99)				15	(84)
Income tax expense	(197)	(39)	8	(9)	(5)	(242)
Share in net income (loss) of equity affiliates	24					24
Net income	**586**	**73**	**(115)**	**17**	**10**	**570**

(a) Restated to take into account IAS19 R first adoption (see note 1-a of the notes to the consolidated financial statements).

1.1.1.3 Order intake

(€ million)	**2013**	**2012**	**Total change**	**Organic growth**
ORDER INTAKE				
Aerospace	**4,130**	**4,051**	**+2%**	**+9%**
Transport	**1,492**	**1,653**	**-10%**	**-8%**
Defence & Security	**7,661**	**6,748**	**+14%**	**+17%**
DCNS (at 35%)	**795**	**758**	**+5%**	**+5%**
Others and discontinued activities	90	75		
TOTAL	**14,168**	**13,285**	**+7%**	**+10%**

New orders booked in 2013 amounted to **€14,168m**, a **7%** increase compared to 2012 (+10% at constant exchange rates and scope). At 31 December 2013 **the consolidated order book** stood at **€29,527m**, representing more than two years of sales. The book-to-bill ratio (order intake to sales) amounted to 1.00 for the full year 2013.

Nineteen significant **orders over €100m unit value** were registered in 2013, compared to ten[(1)] in 2012.

(1) Including two contracts booked by DCNS.

Ten of these major 2013 contracts are for emerging market customers, compared to two in 2012:

- in **Aerospace**, the Group won several major contracts: in Avionics, a UK A400M aircrew training and simulation service contract and in Space, a contract with the European Space Agency (ESA) as prime contractor for the 2016 and 2018 missions of the Exomars scientific programme, as well as several contracts for satellites, including a dual-use communication satellite for Brazil, an observation satellite for an African country and a new tranche of the European Meteosat programme;

- in **Transport**, two major main line rail signalling orders were signed in South Africa and Egypt.
- in **Defence & Security**, the Group booked several large orders: in France, with the second tranche of the Contact software defined radio programme, the Atlantique 2 maritime patrol aircraft renovation and the new F3R standard Rafale (laser targeting pod, electronic systems). In the United Kingdom, Thales was awarded a sensor system support contract for the Royal Navy. In emerging markets, several major contracts were captured in Defence & Security, particularly in the Middle East (Saudi frigates upgrade, air defence radars in the United Arab Emirates, optronics and critical infrastructure security).

Orders for a unit value of less than €10m represent almost half of the order intake in terms of value.

New orders in emerging markets recorded a sharp rise (+30%) compared to 2012, at **€4,566m**, and amounted to **32%** of total order intake, compared to 26% over the same period in 2012. This growth was particularly significant in the Middle East, where the Group order intake nearly doubled compared to 2012.

New orders for **Aerospace** amounted to **€4,130m**, compared to €4,051m for 2012. Excluding the impact due to the disposal of activities in 2012 (civil fixed-wing aircraft simulation, Diehl Aircabin), Avionics order intake remained generally stable, as the continued growth in on-board avionic activities, both original equipment and support, and helicopters avionics compensated lower orders in in-flight entertainment, tubes and imaging (after the high level of orders witnessed in 2012). Space activities saw major growth in orders, particularly in observation and exploration satellites (Exomars, Meteosat, Cosmo-Skymed programmes), whereas the Telecom segment was down, despite the signature of the above-mentioned contract for a dual-use communication satellite contract in Brazil.

In the **Transport** segment, new orders amounted to **€1,492m**, compared to €1,653m in 2012 (during which several high unit value contracts were notified: mainline rail network in Denmark, Singapore urban rail). However, 2013 witnessed several significant commercial successes, particularly in emerging markets: mainline rail signalling contracts in South Africa (Cape region) and in Egypt (Cairo-Alexandria line), and metros in China (Hong Kong, Guangzhou, Nanjing) and in Latin America (Santiago).

Defence & Security order intake stood at **€7,661m** versus €6,748m in 2012, which represented an organic growth of **14%**. This evolution reflects the sharp rise in orders for Defence Mission Systems, driven in particular by the UK Royal Navy sensor system support contract, the new F3R standard Rafale and the French Atlantique 2 maritime patrol aircraft renovation and the Sawari I Saudi frigates upgrade. Orders for Secure Communications and Information Systems recorded a strong increase, particularly in radio-communications (new tranche of the French Contact software defined radio contract), in military communications networks (France, NATO), as well as in cybersecurity. Order intake for Land and Air Systems was mainly stable, with successes in air defence, optronics and weapons systems in the Middle East or in air traffic management in the Philippines, Brazil and Africa.

DCNS order intake (at 35%) totalled **€795m** in 2013, compared to €758m in 2012. The key orders booked during the period were the Sawari I frigates upgrade contract for Saudi Arabia, as well as amendments to the French FREMM frigates and submarine programmes.

1.1.1.4 Sales

(€ million)	**2013**	2012	Total change	Organic change
SALES				
Aerospace	**4,451**	**4,417**	**+1 %**	**+6 %**
Transport	**1,481**	**1,535**	**-4 %**	**-2 %**
Defence & Security	**6,988**	**7,081**	**-1 %**	**+1 %**
DCNS (at 35%)	**1,176**	**1,027**	**+14 %**	**+14 %**
Others and discontinued activities	98	98		
TOTAL	**14,194**	**14,158**	**+ 0 %**	**+ 3 %**

Group sales totalled **€14,194m** at 31 December 2013, which is almost identical to the 2012 figures[1].

In **Aerospace**, sales amounted to **€4,451m**, a **1%** increase compared to 2012 (+6% at constant exchange rates and scope). Avionics activities continued their strong progression, driven by flight avionics systems (Airbus, Bombardier), in-flight entertainment and military simulation activities (A400M). Tubes and imaging activities also made a positive contribution to sales. Space sales increased slightly, both in observation and exploration activities (Cosmo-Skymed, Exomars) and in Telecom (Iridium, Eutelsat and Arabsat programmes).

Sales for **Transport** segment recorded **€1,481m**, compared to €1,535m at end of 2012 (**-2%** at constant exchange rates and scope). Signalling activity sales were slightly up due to recent order intake while only partially offsetting lower sales in ticketing due to some major contracts coming to an end.

(1) The foreign exchange impact on sales was -€227m, mainly because of the appreciation of the euro against the Australian dollar, the Pound sterling and the American dollar.

Defence & Security sales came to **€6,988m**, down **1%** (+1% at constant exchange rates and scope). Secure Communications and Information Systems sales were slightly down over the period, despite the increase of radio communications (ramp up of the Contact contract in France) and of cybersecurity. Land and Air Systems recorded slightly lower sales in 2013, particularly in armaments and air defence activities. At the same time, sales of Defence Mission Systems saw a major increase over the period, mainly driven by the French Rafale programme, the Indian Mirage 2000 upgrade, as well as electronic warfare and sonar activities.

DCNS sales (at 35%) amounted to **€1,176m** at 31 December 2013, a **14%** increase compared to 31 December 2012. This evolution reflects a good progress of the programmes in France (FREMM frigates, Barracuda submarines) and internationally (submarines in India and Brazil, Mistral-class projection and command ship for Russia).

1.1.1.5 Adjusted results

► **EBIT**

(€ million)	**2013**	**2012**	**Total change**	**Organic growth**
EBIT				
Aerospace	370	297	+24%	+26%
in % of sales	*8.3%*	*6.7%*		
Transport	97	95	+3%	+7%
in % of sales	*6.5%*	*6.2%*		
Defence & Security	518	504	+3%	+5%
in % of sales	*7.4%*	*7.1%*		
DCNS (at 35%)	63	79	-20%	-15%
in % of sales	*5.4%*	*7.7%*		
Others and discontinued activities	(45)	(48)		
TOTAL	**1 003**	**927**	**+ 8%**	**+ 11%**
in % of sales	***7.1%***	***6.5%***		

In 2013, the Group's EBIT came to **€1,003m**, or **7.1%** of sales compared to €927m (6.5% of sales) en 2012. This **8% increase** in EBIT (+11% in organic terms) reflects ongoing performance improvement measures.

The **Aerospace** segment's EBIT continues to grow, reaching **€370m** (8.3% of sales), compared to €297m (6.7% of sales) in 2012. In Avionics, the marked growth in results, boosted by the civil avionics activities and in-flight entertainment, is due to a favourable volume impact and improved project execution. Space activities also recorded improved EBIT in 2013, thanks to more efficient project management and reduced restructuring costs.

The **Transport** segment posted an EBIT of **€97m** (6.5% of sales), stable compared to 31 December 2012 (€95m, or 6.2% of sales). This stable profit level over 2013 reflects a more efficient execution of contracts during the second half-year, despite an unfavourable mix and volume effect.

The EBIT of **Defence & Security** increased in 2013 and totalled **€518m** (7.4% of sales), compared to €504m in 2012 (7.1% of sales). Thanks to good contract execution and efficient indirect cost control, Secure Communications and Information Systems showed an increasing EBIT in 2013. Defence Mission Systems recorded a slight increase in EBIT compared to last year, despite higher restructuring costs, which offset the project execution improvement. By contrast, EBIT for Land and Air Systems was lower, mainly due to an unfavourable volume effect during the period.

The EBIT for **DCNS** (at 35%) reached **€63m** at 31 December 2013, significantly lower than in 2012 (-20%) despite strong sales growth. The deterioration of operating profitability is due to difficulties in the execution of civil nuclear projects.

Adjusted income of operating activities

Adjusted **operating income came** to **€999m** compared with €913m in 2012 (+9%), in line with the increase in EBIT, as impairment on intangible assets was limited at -€4m compared with -€15m in 2012.

Adjusted financial income

Adjusted net financial expense, came to **-€22m** compared to -€40m in 2012, mostly due to the fall in financial costs following the refinancing of the 2013 bond at favourable market conditions. **Adjusted finance costs on pensions and other employee benefits**[1] dropped to **-€72m** compared to -€84m[1] in 2012, thanks to the fall in interest costs.

(1) Restated to take into account IAS19 R first adoption (see note 1-a of the notes to the consolidated financial statements).

Adjusted net income

Share in net income of equity affiliates recorded a slight decrease at **€20m**, compared to €24m last year.

Thus, 2013 closed with an **adjusted net profit, Group share**[1] of **€644m**, representing an increase of **13%** compared to 2012, after adjusted net income tax[1] of -€281m against -€242m[1], giving an effective tax rate of 31%, which is similar to last year. **Adjusted net income per share**[1] was **€3.20** compared to €2.86[1] in 2012, up 12%.

1.1.1.6 Consolidated results

Income from operations

Consolidated EBIT came to **€905m** compared to €816m in 2012 representing an increase of +11%. This increase reflects the changes mentioned above (cf. paragraph "EBIT" in the section "Adjusted Results"), as well as the decline in the effect of amortisation of intangible assets acquired ("PPA"), which came to -€98m in 2013 compared to -€112m the previous year, mainly linked to acquisitions of Alcatel's Space and Transport activities in 2007 and the entry (2007) then increase of equity interest (2011) in DCNS.

Income of operating activities

Consolidated income of operating activities came to **€913m**, broadly stable compared to the previous year, with the progression in EBIT in 2013 offset by the capital gains registered in 2012 from the disposals of the civil simulation activity in the United Kingdom and the 49% participation in Diehl Aircabin in Germany.

Financial result

Financial expense was **-€51m** compared to -€66m in 2012, mainly due to the decrease in financial costs following the refinancing of the 2013 bond payment at favourable market conditions. The **other components of pension charge** declined to **-€72m** against -€99m in 2012, thanks to the reduction in interest expense.

Net income

Consolidated net profit, Group share, reduced slightly to €573m compared to €586m during the previous year, with a tax expense of -€237m compared to -€197m in 2012.

1.1.1.7 Financial position at 31 December 2013

Free operating cash flow[2] was **€466m** compared to €669m in the previous year, during which the Group had received significant payments at the end of the year.

(€ million)	2013	2012
Operating cash flows	**1,415**	**1,346**
Change in working capital requirements and in reserves for contingencies	(275)	13
Payment of contributions/pension benefits	(126)	(113)
Financial interest paid	(24)	(37)
Income tax paid	(91)	(125)
Net operating cash flow[(a)]	**899**	**1,084**
Net operating investments	(433)	(415)
Free operating cash flow	**466**	**669**
Net (acquisitions)/disposals	(89)	156
Deficit payments on pensions in the United Kingdom	(64)	(64)
Dividends	(181)	(155)
Foreign exchange and others	6	17
Change in net cash	**138**	**623**

(a) Excluding deficit payments on pensions in the United Kingdom.

Due to increased dividend payments and net (acquisitions)/disposals of -€89m in 2013, compared to a positive balance of €156m in 2012 thanks to different disposals of assets, **net cash** amounted to **€1,666m** up €138m compared to year-end 2012.

Equity, Group share, was **€3,911m** compared to €3,541m[1] at year-end 2012, which takes into account a consolidated net income of €573m.

(1) Restated to take into account IAS19 R first adoption (see note 1-a of the notes to the consolidated financial statements)..
(2) Operating cash flow + changes in working capital requirement (WCR) and in reserves for contingencies – net financial interests paid – payment of pension benefits (excluding deficit payments on pensions in the United Kingdom) – tax – net operating investments.

1.1.1.8 Proposed dividend

At the Annual General Meeting on 14 May 2014, the Board of directors will recommend the distribution to shareholders of a **dividend** of **€1.12** per share, up 27%. This corresponds to an increase in the payout ratio to 35% of the adjusted net income, compared to 30% last year.

If approved, the ex-dividend date will be 27 May 2014 and the payment date 30 May 2014. The dividend will be paid entirely in cash and will total €0.85 per share, after deducting the interim dividend of €0.27 per share already paid in December 2013.

1.1.1.9 Outlook for 2014

Order intake in emerging markets should continue to increase, with double-digit growth expected for 2014, allowing to offset the expected fall of order intake from mature countries, particularly in defence markets.

Sales should remain stable.

A continuing drive to improve performance should enable the Group to post a further increase in EBIT, which should increase by 5 to 7% compared to 2013.

1.1.2 Risk factors

Thales is exposed to a number of risks and uncertainties which could materially affect its business, reputation, financial position, results or ability to achieve its objectives. The risks described below are not the only ones that Thales faces. Other risks, unknown to Thales on this date, or which presently appear to be non-significant, could also have an unfavourable impact on the business, profitability and financial position of the Group or its ability to achieve its objectives.

Generally, Thales may be faced with a number of financial, legal, operational and strategic risks.

1.1.2.1 Financial risks

1.1.2.1.1 Liquidity

Thales' liquidity risk corresponds to its level of exposure to changes in the main market indicators that could lead to an increase in the cost of credit or even to a temporary limitation of access to external sources of financing.

The Group manages this risk by trying to anticipate its cash needs and ensures that these are covered by the Group's short-term and long-term financial resources as follows:

- shareholders' equity, listed by heading in note 14 to the consolidated financial statements;
- gross debt, listed by maturity in note 11 to the consolidated financial statements;
- committed, undrawn credit facilities granted by banks as backup to the commercial paper programme and acting as a financial reserve. These are described in more detail in note 21 to the consolidated financial statements.

The principle of centralising the entities' short-term assets and liabilities (cash pooling) *is* applied to the combination of entities in the same currency zone (euro zone, sterling zone, dollar zone and Australian dollar zone, etc.) and, in some cases, in the same country.

Through the consolidation and centralisation of cash requirements and surpluses of its units, the Group is in a position to:

- simplify cash management and match the cash positions of units to produce a single consolidated position that is easier to manage; and
- gain prime access to financial markets through the parent company's financing programmes, rated by Standard & Poor's and Moody's (see below).

At 31 December 2013, cash recorded under consolidated assets amounted to €3,023.8m (compared with €2,518.3m at end-2012), including:

- €2,051.7m held by the parent company and available for immediate use (€1,721.8m in 2012);
- €501.8m in the bank credit balances of subsidiaries (€392.8m in 2012), most of them outside of France. This figure includes, *inter alia*, payments received in the last few days of the financial year and subsequently transferred to the corporate treasury account;
- €470.3m in cash held directly by the companies in joint ventures (prorated by Thales' interest in each joint venture), including €218.5m for DCNS for which Group cash pooling cannot be used in certain cases (€403.7m in 2012, of which €191.3m for DCNS).

Cash at bank and equivalents at year-end is solely invested in bank deposits, in very short-term bank certificates of deposit with first-tier banks or in money market funds. At the date of publication, Thales' credit risk ratings were as follows:

	Moody's	Standard & Poor's
Medium and long-term loans	A2	BBB+
Outlook	Negative	Positive
Commercial paper & short-term loans	Prime-1	A2

The decrease of Thales' credit risk rating doesn't place at risk financial covenants included in financing contracts. The coming into effect of the unique clauses providing for accelerated repayment would only apply in the event that the State no longer held its golden share and, simultaneously, the ratio of consolidated net financial debt to EBITDA (earnings before interest, taxes, depreciation and amortisation) were to exceed 3.

A lower rating would result in an increase (capped) in the margins applicable to the committed credit facility of €1.5bn (described in note 21 to the consolidated financial statements); at the same time, these margins would be improved (with a minimum threshold) in the event of a rating upgrade.

1.1.2.1.2 Interest rates

Thales is exposed to interest rate volatility and in particular its impact on the conditions associated with variable-rate financing. To limit this risk, Thales operates an active policy of interest rate hedging.

The Corporate Financing and Treasury Department consolidates data on Thales' exposure to interest rate risk and uses the appropriate financial instruments to hedge those risks.

Thales policy is to control interest rate and counterparty risks and to optimise its funding and banking operations by consolidating and pooling the cash surpluses and requirements of all its units.

The breakdown of Thales' debt by type of interest rate is described in note 21 to the consolidated financial statements. The table below summarises the Group's exposure to interest rate risk before and after hedging. Based on the Group's average net cash (taking into account hedging instruments), a 1% rise in interest rates would decrease financial expense in 2013 by €12m (compared to €11.1m in 2012).

	< 1 year		> 1 year		Total	
(€ million)	**Fixed**	**Variable**	**Fixed**	**Variable**	**Fixed**	**Variable**
Financial liabilities	(70.0)	(387.2)	(1,447.1)	(77.9)	(1,517.1)	(465.1)
Financial assets		3,648.5			0.0	3,648.5
Net exposure before taking account of derivatives	**(70.0)**	**3,261.3**	**(1,447.1)**	**(77.9)**	**(1,517.1)**	**3,183.4**
Derivatives	(20.6)	20.6	950.0	(950.0)	929.4	(929.4)
NET EXPOSURE AFTER TAKING ACCOUNT OF DERIVATIVES	**(90.6)**	**3,281.9**	**(497.1)**	**(1,027.9)**	**(587.7)**	**2,554.0**

1.1.2.1.3 Foreign exchange

Due to the international nature of its business, Thales is exposed to the risk of exchange rate fluctuations.

a) Business-related currency risk

Business-related currency risk occurs when some of the business is billed in a currency other than that of the related costs.

a. As a general rule, Thales is structurally immune to exchange rate fluctuations for a significant part of its business activity. More than 40% of Thales' sales are generated in the euro zone, which is also where most of its industrial operations are located. More generally, the reinforcement of the Group's international industrial footprint allows the Company to manufacture and invoice in local currency, thereby eliminating exchange rate risk on local sales.

b. The accounts of Thales subsidiaries located in countries where the official currency is not the euro are translated into euros in the Group's consolidated financial statements. A fall in these currencies against the euro is likely to have a negative impact on the accounts. Its impact on profitability is limited, however, since the cost base of these subsidiaries is essentially in the same currency as their sales. The main currencies are the Pound sterling, the US dollar, the Canadian dollar and the Australian Dollar.

c. For certain Group businesses (civil avionics and tubes, civil space, etc.), the US dollar ("USD") is the reference transaction currency. For business activities outside the dollar zone (the in-flight entertainment business is based essentially in the United States and is therefore largely immune to this risk), a specific currency risk hedging policy is implemented.

- For equipment transactions (avionics and tubes), this policy is defined on the basis of sales forecasts in USD, after accounting for corresponding purchases in USD. For these transactions, net exposure to dollar risk represents around 3% of the Group's total sales for 2013.
- For longer-term programmes in markets traditionally denominated in USD (primarily in civil space and simulators), each bid is examined for profitability in the light of the effect of currency fluctuations, after accounting for corresponding purchases in USD, and, if necessary, is specifically hedged through market transactions (forward exchange-rate contracts and options).

  Where necessary, a similar approach is adopted for other Thales activities if a customer specifically requires a contract denominated in USD on an *ad hoc* basis.

  Overall, net exposure represented around 4% of the Group's total sales for 2013.
- As well as this direct dollar risk, which concerned around 7% in total of consolidated sales at end-2013, the Group is also exposed to an "indirect" dollar risk on contracts denominated in currencies other than the dollar. This occurs when it is bidding against companies that benefit from a cost base in dollars. Analysis by product line and region shows that approximately one quarter of total sales may be exposed to this "indirect" dollar risk.

The "dollar risk" is thus the main currency risk that Thales needs to hedge. The figures corresponding to the hedging of business-related dollar risk are as follows:

- USD 2,795m, the amount of financial instruments hedging net firm commitments (USD risk against Euro, Canadian dollar and Pound sterling) at 31 December 2013 compared to USD 3,102m at 31 December 2012;

- USD 281m, the amount of financial instruments hedging bids in USD against the Euro, Canadian dollar and Pound sterling at 31 December 2013 compared to USD 238m at 31 December 2012.

Operating receivables and payables denominated in foreign currency are exchange-rate hedged and therefore not exposed to currency risk.

The change in value of financial instruments (forward transactions) used as cash flow hedges is recognised in shareholders' equity. A decrease (increase) of 5% in the US dollar compared to the Euro, Pound sterling and Canadian dollar, would have increased (decreased) shareholder's equity by approximately €103m at 31 December 2013 compared to €118m at 31 December 2012. The premium/discount component is not eligible to cash flow hedge accounting and is recognised through profit and loss. In 2013, the change in market value of the discount/ premium was -€11m.

The change in value of financial instruments matched with portfolios of sales offers which are not eligible for hedge accounting is recognised in profit and loss. A decrease (increase) of 5% in the US dollar compared to the Euro, Pound sterling and Canadian dollar, would have increased (decreased) the result by approximately €2m at 31 December 2013 compared to €5m at 31 December 2012.

Foreign currency-denominated financial debt does not generate any exposure in profit and loss, as it is either denominated in the functional currency of the entity in which it is recognised, or is used as a net foreign investment hedge.

b) Management of risks relating to foreign currency-denominated assets

Thales hedges a very limited part of its foreign currency-denominated assets, mainly those likely to be disposed of at a future date. The main criteria for determining whether or not a given foreign currency-denominated asset should be hedged are as follows:

- the nature of the business involved;
- the structure of Thales' commitment with respect to jointly-held companies, in particular the specific features of the shareholders' agreement in each joint venture.

In general, hedging is achieved by loans or currency swaps in the same currency as the assets to be hedged. The actual application of this policy also depends on:

- the objective of optimising hedges in the light of market conditions (availability of foreign currency, interest rates, hedging rate, etc.);
- the risks inherent in the future value of the assets being hedged and the nature of the business of the corresponding subsidiaries.

SUMMARY OF ASSET RISKS AT 31 DECEMBER 2013 FOR MAIN CURRENCIES

(€ million)	GBP	USD	AUD
Assets	1,795.2	938.8	733.4
Liabilities	1,752.7	434.0	407.5
Net position before management	**42.5**	**504.8**	**325.9**
Off-balance-sheet position	(39.4)		
NET POSITION AFTER MANAGEMENT	**3.1**	**504.8**	**325.9**

1.1.2.1.4 Shares

Thales was not exposed to any significant equity risk at end-2013, excluding the risk on treasury shares.

At 31 December 2013, Thales held 2,490,177 treasury shares, representing 1.21% of the share capital.

1.1.2.1.5 Off-balance-sheet commitments

a) Pension commitments

Defined-benefit pension plans are in place for certain Thales employees, mainly in the United Kingdom and the Netherlands, and are externally funded by the Company under the provisions of the applicable national legislation.

At 31 December 2013, Thales' commitments in the United Kingdom and the Netherlands toward current employees (access to these plans has been closed to new employees in the UK), former employees and retired employees amounted to €4,314m for both countries, hedged by €3,512m in investments, representing an underlying shortfall of €802m. At 31 December 2013, these investments consisted of:

- 38% in equities;
- 37% in fixed-rate bonds;
- 8% in inflation linked bonds;
- 7% in alternative liquid investments;
- 6% in alternative long-term investments (e.g. real estate, infrastructure, etc.);
- 4% in cash.

Changing market parameters could affect the amount of the shortfall and the annual costs of defined-benefit plans. At 31 December 2013, the main risk variables were as follows, listed in order of importance:

- a reduction or increase in the discount rate applied to liabilities, which could increase or reduce the unfunded status; this variable is partly offset by changes in the value of fixed-rate hedging bonds held as plan assets and interest rate swaps;
- changes in the total return on investments in equities and other assets;

- changes in the forecast inflation rate;
- a substantial change in mortality tables;
- exchange rate fluctuations (mainly sterling against the euro).

Thales has introduced quarterly reporting on its pension plan positions and makes regular projections measuring the sensitivity of unfunded status to possible changes in market parameters taking into account correlation factors. In some countries, such as the UK and the Netherlands, Thales is committed to defined-benefit pension schemes, but plan assets are managed by trustees in accordance with the applicable regulations and in consultation with the Group. Plan assets are allocated with regard to the long-term nature of the commitments they cover.

b) Parent company guarantees

Thales, as the parent company, issues guarantees on commitments undertaken by its subsidiaries on commercial contracts. These guarantees are centralised by the Group Corporate Financing & Treasury Department.

Guarantees are issued out of an envelope of €3bn dedicated each year to the Chairman and Chief Executive Officer by the Board of directors. Prior to each renewal of the authority granted to the Chairman & Chief Executive Officer, the Group's Treasury and Funding Department reports to the Board of directors on the level of use of this envelope, based on the monitoring carried out by the Group Corporate Financing & Treasury Department.

At 31 December 2013, outstanding guarantees issued by the parent company in support of its subsidiaries stood at €10,884m. This figure includes all commitments given in relation to Thales Alenia Space (matched by a counter-guarantee from Finmeccanica in proportion to its 33% interest in Thales Alenia Space).

Thales manages risks connected to these parent company guarantees and optimises the financial conditions of the transactions guaranteed. The main objectives of this risk management policy are as follows:

- to limit risks to those corresponding to normal commitments on commercial contracts, particularly in terms of volume and duration;
- to limit the issue of guarantees to commitments made by wholly-owned subsidiaries, with guarantees on commitments by consortia or joint ventures only in proportion to the Group's equity interest or counter-guaranteed by the other shareholder in proportion to its interest;
- to enable its subsidiaries to benefit, when appropriate, from the credit rating of the parent company by controlling the financial conditions of the transactions guaranteed.

1.1.2.1.6 Client credit

Credit risk relates to the risk that a party to a contract will default on its commitments or fail to pay what it owes.

a) Risk relating to failure of a private-sector customer

Non-governmental customers (aircraft manufacturers, airlines, private infrastructure operators and industry) account for approximately 25% of Thales' sales. These customers may encounter major and/or prolonged financial difficulties that could lead to payment defaults or order cancellations. Such occurrences could have a negative impact on Thales' sales, profitability and financial position.

To mitigate these risks, Thales conducts regular analysis of the ability of customers to meet their obligations. When necessary, Thales may request bank guarantees or corporate guarantees, or may use credit insurers.

b) Credit risk relating to public-sector customers

Public, Government and institutional customers account for around 75% of Thales' sales. Thales works with a large number of countries. Some of these could present a significant credit risk which could, for example, lead them to suspend an order in production, or make them be unable to pay on delivery, as agreed under the terms of the contract. To limit its exposure to these risks, Thales takes out insurance with export credit agencies (such as Coface in France) or private insurers.

At 31 December 2013, only two customers accounted for annual sales for Thales in excess of €500m: the French State (around €3bn, including one third related to DCNS) and the British State (approx. €1bn). At 31 December 2013, these two countries still have first-class or high quality ratings (France AA by S&P's and Aa1 by Moody's – UK AAA by S&P's and Aa1 by Moody's).

1.1.2.2 Litigation

1.1.2.2.1 Compliance with laws and regulations

The Group operates its business in a strict and evolving complex legal and regulatory environment, both nationally and internationally.

The legal and regulatory framework in which Thales operates covers a broad range of areas, relating in particular to company law, financial market regulation, fiscal legislation, labour law, export control and measures to combat corruption and money laundering.

Thales is able to monitor developments within this legal and regulatory framework through its international network. The Company is not always able to foresee them, however, and in this respect its business could be affected.

Despite the steps taken by Thales as a company to comply with all applicable legislation, risks still exist due to their inherent nature, the interpretative powers of regulatory agents and changes in legal/judicial precedent and sanctioning powers.

In most cases, regulators in conjunction with the judicial authorities have the right to initiate legal proceedings, which could expose the Group or its employees to civil, administrative or criminal rulings. Such a ruling could, if applicable, involve a temporary ban on trading, which would in turn have an adverse impact on the Group's profitability and financial position.

To manage this complexity, Thales has set up a Risks & Internal Control Committee, which uses legal and regulatory risk-mapping to evaluate and monitor the implementation and continuous improvement of compliance plans at each unit. Compliance actions rely for these needs on networks of compliance officers who may be specialists (export control), on risk sponsors in charge of the prevention of each of the major risks identified and monitored by the Risks & Internal Control Committee, or on a dedicated organisation as regards international trade (cf. below).

The Risks & Internal Control Committee participates in the preparation of the annual audit plan and monitors the conclusions of the regular controls conducted by the Internal Audit Department in these compliance areas.

Regular reports are submitted to the Audit and Accounts Committee of the Thales Board of directors, which in turn may issue compliance audit directives within the entire Group.

a) Management of commercial activities

Because of its presence in more than 50 countries and the diversity of its markets and business segments, Thales is subject to national laws, particularly those resulting from the transposition of international conventions (OECD convention, UN convention to fight corruption, European Union convention, Council of Europe conventions, etc.) and to international norms and standards to fight corruption.

Infringement of these laws could have serious legal consequences for the individuals or entities concerned. It could also have a significant impact on the image and reputation of the Group as a whole.

In response to the regulatory requirements in terms of prevention of corruption and business ethics in general, Thales has for a number of years operated a strict international compliance and integrity programme. This programme is regularly assessed and readjusted according to changes in legislation and external risks (country risks, etc.), internal risks (areas for improvement identified by the internal audit, risks committee etc.) and the Group's commercial strategy.

It is implemented on the basis of a coherent set of directives that is included in the Group's reference system, dedicated units and independent control resources.

Business risks are addressed throughout all governance processes. From the preliminary phase of a project, these operating processes envisage action plans to mitigate business risks, focusing particularly on the prevention of corruption.

Thales strictly governs the use of agents and consultants through a very detailed procedure, which requires in-depth preliminary verifications (due diligence) – reinforced by the analysis of red flags or risk factors, as well as appropriate representations and engagements from these consultants. Designed by the Group's Ethics and Corporate Responsibility Department, this procedure, updated in early 2013, is regularly revised in consultation with the Group Legal Department and the Sales and Marketing Department.

In addition, to underpin its strategy of strengthening its presence internationally and its establishment in target countries, Thales vets and selects local industrial partners. The vetting and selection process is aimed at sealing long-term partnerships with local industrial companies that meet a series of criteria with regard to business integrity and ethics, competence and expertise. This scheme is part of the policy of deploying tailored and reasonable prior due diligence procedures for third parties.

An international, dedicated network, independent of the operational commercial structures, conducts the verifications required, enhanced by outside studies and diagnostics performed by companies that specialise in business intelligence – during the vetting and selection phases for agents, consultants and local industrial partners for Thales.

In addition, by relying on risk mapping and rigorous internal control procedures, Thales' Audit & Internal Control Department regularly conducts compliance and integrity audit missions which cover all processes to manage commercial risks.

Thales is particularly keen to make its employees aware of ethical business conduct as soon as they join the Group. Adherence and accountability are key to the awareness and training model designed by the Ethics and Corporate Responsibility Department. A broad array of tools (Code of Ethics, reference guide, best practice guides, etc.) and training sessions (face-to-face training and e-learning are now available in French, English and German) is available to staff throughout their professional lives. Special attention is paid to employees involved in the sales processes, project management and purchasing. The training plan for "Business Ethics and Preventing Corruption", which is world-wide in scope, is as a priority intended for this group of employees.

Thales also continues to disseminate and foster best practices among its suppliers and subcontractors, requiring them to subscribe to the terms of its Purchasing & Corporate Responsibility Charter. In this connection, in France in 2012 Thales received government recognition for responsible supplier relations. This is a three-year label given to French businesses that have demonstrated long-term balanced relations with their suppliers.

Thales also actively participates in national professional organisations (MEDEF, GIFAS, ADS[1], etc.) and international organisations (ASD[2], ICC[3], B20[4], etc.) dealing with business ethics, and within the working groups of intergovernmental organisations (OECD, United Nations, ISO[5], etc.). In September 2013, Thales signed the recommendations of the Chairmen and CEOs of member companies in the B20 "Transparency and Anti-corruption" *Task Force* intended for Heads of State of the G20, which calls on them to step up the fight against corruption by facilitating the emergence of new approaches (industry actions, public/private-sector dialogue, etc.). Thales was also chosen by the French Ministry of Foreign Affairs to present its anti-corruption policy at the Fifth Conference of the States Parties to the United Nations Convention against Corruption. This conference, which took place in November 2013 in Panama, was attended by 1,600 representatives from 132 countries, as well as all governmental or non-governmental organisations concerned by these issues; the choice of the French government illustrates the reputation of the Group for business ethics and corporate social responsibility.

(1) Advancing UK AeroSpace, Defence & Security Industries.
(2) AeroSpace and Defence Industries Association of Europe.
(3) International Chamber of Commerce.
(4) International Business Community, representing 22 employer organisations.
(5) International Organization for Standardization.

The Group actively participates in a variety of initiatives in the fight against corruption, both at European level (Business Ethics Committee of the ASD) and under the global sectoral initiative of the Aeronautics and Defence industries (IFBEC[1]) whose most recent world forum took place in Washington in September 2013.

Thales is also a stakeholder in international standardisation work carried out within the ISO on compliance and anti-corruption programmes.

At the same time, since 2012, Thales has been ranked by TI - an NGO working to combat corruption worldwide - as one of the top 10 companies of the Defence sector. The Transparency International[2] report published in October 2012 presents an analysis of the corruption prevention programmes of the world's 129 biggest defence sector companies. The companies are assessed in five areas (leadership, governance and organisation – risk assessment – company codes and policies - training – personnel and helplines) with regard to the ethics and anti-corruption systems they have put in place.

In addition, for the second consecutive year, Thales obtained the "Global Compact Advanced" level of the UN Global Compact, which, by respecting 21 specific criteria, is the highest level of reporting and performance in responsible development. Among the 8,000 companies that are members of the Global Compact, only 360 have so far obtained the Global Compact Advanced level – 26 of them are French and only one is in the aerospace & defence sector.

b) Export control

Exports account for a significant proportion of Thales' business. Many of the Group's products and systems are designed for military or dual-use applications. Consequently, the export of these products or systems to customers located outside Thales' domestic markets where they are manufactured, particularly in the defence sector, may be subject to limitations, export licences or specific export controls (imposed by the countries in which Thales operates, as well as by other countries where the suppliers of component products or technologies are based, most notably the United States).

There are no guarantees that (i) the export controls to which Thales is subject will not be tightened, (ii) new-generation products or systems developed by Thales will not be subject to similar or tighter controls and, (iii) geopolitical factors will not make it impossible for Thales or its suppliers to obtain export licences for certain customers or make it more difficult for Thales to execute previously signed contracts. Further limitations on access to military markets would thus have a negative impact on Thales' business, profitability and financial position.

Thales has put in place systems and formal procedures to ensure compliance with applicable regulations and controls, and reinforces these measures through awareness-raising programmes with dedicated e-learning modules. Operating units have access to a network of specialists within the Group, in charge of monitoring the application within operational units of compliance rules determined at Group level as well as monitoring the necessary authorisations and conformity of their implementation.

c) Competition

Thales' business activities are subject to a wide range of national and international regulations mainly aimed at combating anti-competitive practices.

Infringement of these rules could lead to severe sanctions, such as fines, payment of damages, and legal bans. They could also have a serious impact on the Group's reputation.

To avoid any such infringements, Thales has initiated an awareness-raising programme to these rules, in particular through the roll-out of a dedicated e-learning tool and training programmes.

d) Intellectual property

Thales is exposed to two main types of intellectual property risk: dependence on third-party technology and third-party actions against the Company for perceived infringement of their intellectual property rights.

To reduce the risk of reliance on critical third-party technology, Thales has implemented an identification process and management of each situation with a precise, strategic "Make/Team/Buy" (MTB) plan.

Given the nature of its activities and the specific features of its products, Thales conducts most of its research and development work in-house and controls the technology which is critical to the business. Thales is one of the largest filers of patents in France and was recognised in 2012 and 2013 by Thomson Reuters as one of the 100 most innovative companies in the world. Thales' extensive intellectual property portfolio (over 15,000 patents, as well as software and know-how) and its presence throughout the value chain (equipment, systems and systems of systems) reduce its reliance on third-party technology. As a result, Thales' dependence on such technology can be considered very low.

To reduce the risk of third-party actions for alleged infringement of their intellectual property rights by Thales entities, the Group identifies and analyses this risk in the context of its own patent filing procedures and/or when embarking on technical research or product development.

In the event of a third-party infringement claim against a Thales company, the legal and technical analysis of the allegedly infringing products and intellectual property rights are handled centrally by Thales experts, with the assistance of specialist external consultants where needed.

1.1.2.2.2 Litigation

Due to the nature of its business activities, Thales is exposed to the risk of technical and commercial litigation.

To prevent disputes or limit their impact, Thales policy is to systematically seek alternative methods of dispute resolution. This policy is reviewed on a regular basis to take into account changes in the Company's core areas of business and is backed by employee training programmes.

In addition, Thales implemented a procedure several years ago to centralise all civil and criminal litigation and claims. These are handled by the corporate legal affairs department, with the support of the Group companies concerned.

(1) International Forum on Business Ethical Conduct.
(2) Defence Companies Anti-corruption Index 2012 – Transparency International – http://companies.defenceindex.org/report.

At the end of 2002, a group of French manufacturers, including Thales and one of its subsidiaries, collectively received a request for arbitration relating to the execution of old contracts. In proportion to each industrial partner's involvement, Thales would have been liable for around 20% of the total claim of $260 million. Under an agreement signed in 2003, the client withdrew its request for arbitration.

In November 2012, the claimant filed a new request for arbitration for a revised amount of €226 million. Industrial partners are strongly challenging this claim and at this date it is not possible to evaluate any potential financial risk. Consequently, Thales has not recognised any provision.

This procedure is still in process.

The Company knows of no other governmental, legal or arbitration procedures, pending or threatened, that are likely to have or that have had a significant impact on the financial situation or profitability of the Company and/or Group over the last 12 months.

1.1.2.3 Risks related to Thales' businesses

1.1.2.3.1 Competitive environment

The markets in which Thales operates are highly competitive, both in terms of international groups, especially in a context of shrinking defence budgets in their home countries, and in terms of local or niche companies in certain market segments. This competitive pressure could negatively impact Thales' commercial position, sales and profits.

There is also no guarantee that competition will not intensify, particularly in an unfavourable environment, or that Thales will be able to successfully fight its current or future competitors.

In order to limit the impact of this risk, Thales continues its research and development efforts in order to provide competitive and differentiating elements to the Group's operating units and also works to upgrade its product offer in order to meet the needs of its customers, in both defence and civil markets.

1.1.2.3.2 Unfavourable trends in the civil aviation market

Demand for air travel appears closely linked to general economic trends, but is also affected by specific factors, such as the characteristics of aircraft fleets in service, regulatory changes (new environmental standards, deregulation, etc.) and the ability of airlines to access financing. In addition, the civil aviation market is also susceptible to the effects of intensification (real or perceived) of terrorist activity, as well as conflicts and epidemics or disasters, which can have an important, if temporary, impact on air traffic and thus affect the entire civil aviation market.

The economic environment is therefore likely to remain unsettled, especially in Europe. In order to remain profitable in a difficult market, airlines could cancel or postpone orders and aircraft manufacturers might have to reduce production rates. This environment could also lead the airlines to reduce or delay their maintenance expenditure or their investments in in-flight entertainment systems. Similarly, air navigation service providers could reduce or delay investments in air traffic control equipment and systems. Were they to materialise, these factors could have a negative impact on Thales' profitability and financial position.

To limit the impact of this risk, Thales is pursuing action on two fronts: (i) ongoing improvements to its competitive performance and industrial flexibility in order to better manage trading fluctuations during the cycle and (ii) a comprehensive strategy seeking a balance within the business portfolio (with exposure to the civil aviation market reduced to around 15% of Group sales).

1.1.2.3.3 Dependence on public procurement

Thales generates most of its business from governments, particularly in the defence markets in France and the UK, and, to a lesser extent, in the rest of Europe, North America and Australia. In these markets, public spending is dependent on political and economic factors and is therefore likely to fluctuate from one year to the next. A significant reduction in defence budgets, particularly in Europe as part of a more restrictive budget policy, could affect the Group's business and profitability. In effect, a reduction in the budget resources of government customers could generate delays in order booking, contract execution, payments or a decrease in funding for research and development programmes.

Thales has based its strategy on a balanced portfolio of defence operations (approximately 55% of sales) and civil operations (approximately 45% of sales). The overall solidity of the portfolio is underpinned by a diversified base of orders with a unit value of less than €100m. Finally, the broad geographic spread of Thales' business, particularly through its international operations, ensures further diversification of its customer base.

1.1.2.3.4 Control of projects and programmes

Many of Thales' products and systems are highly complex due to their advanced technology content, the rigorous operational constraints and harsh environments in which they operate (which require them to be extremely reliable) and the contractual arrangements surrounding their sale (comprehensive prime contractorships for large-scale systems, public-private partnerships or equivalent, local shares, compensation commitments etc.).

The actual cost of design, development and manufacture may therefore exceed initial cost estimates, which in turn may adversely impact Thales' results and financial position, especially considering that the associated contracts are generally based on a fixed, all-inclusive price. In addition, many contracts include stringent performance levels and/or tight delivery schedules for the products or systems sold, particularly given the increased competition. If Thales is unable to deliver these products or systems in line with the required level of performance and/or delivery schedule, customers may demand penalty payments or even decide to terminate the contract. The occurrence of such events could have a material impact on Thales' results and financial position.

Bid and project management is therefore subject to a detailed risk management and assessment process. Thales ranks the various levels of criticality. Critical bids and projects are specifically monitored at the management level of the operating entities (business lines, Global Business Units) and, as needed, by the Group's executive management.

Contractual risk assessment is an integral part of the tendering process. Depending on the complexity of the bid, this procedure involves a number of steps which progressively reveal the estimated level of profitability and the associated risks to be assessed. Particular attention is paid to long-term sales contracts that include fixed prices valid for the entire duration of the agreement.

For certain contracts that run for several years and involve products and services with a high degree of complexity, regular reviews are organised in order to monitor the technical and financial progress.

The Group continues to pay particular attention to analyses and action plans for the management efficiency of bids and projects by measuring and monitoring financial variance on the projects and the implementation of corrective actions.

The Group also continued action plans to improve the management of bids and projects, engineering and the supply chain. These actions aim in particular to:

- improve the management of commitments made, with widespread use of independent peer reviews, closer involvement of Purchasing, Production, Legal and Quality Control and the introduction of a "Project Design Authority" responsible for developing the technical project solution (during the bid or project execution phase);
- identify the centres of expertise (R&D, integration, production and services) within Thales in order to increase synergies and expertise and provide the best responses to the solution;
- improve the development of product lines in order to streamline new developments and thus reduce risks;
- introduce advanced training for project managers to obtain International Project Management Association (IPMA) certification. At the end of 2013, nearly 650 project managers within the Group have gained IPMA certification, with approximately 240 certified during the year.

1.1.2.3.5 Political risks

Thales generates a significant proportion of its sales in emerging markets and countries that can be, or could become, politically or economically unstable. These markets might therefore present risks with the potential to affect the Group's profitability and financial position.

In particular, a change in government, major political event, armed conflict, act of terrorism, sharp deterioration in the balance of payments, industrial action, strike or protest could lead to various types of risks. These include:

- more restrictive currency control, with limitations or exclusions on withdrawing currency from a client country, preventing it from honouring its financial commitments towards Thales;
- impairment of assets because of devaluations of the local currency or other measures taken by public authorities that significantly affect the value of operations;
- expropriation (by confiscation, nationalisation, requisition, etc.) or the forced sale of Thales' interest in a local company, or, more broadly, discriminatory measures that compromise Thales' operations in a country;
- a security situation entailing a risk of attack on the physical safety of its employees and/or its facilities, which strongly limit or prevent Thales from assuming its performance obligations under a contract, or reduce or prohibit the use of its local industrial assets;
- an unexpected breach of a contract or commitment;
- an unfair call of a bond or a guarantee;
- the non-certification of documents eligible for payment, or non-payment on the due dates stipulated in a contract, which prevent the anticipated progress of that contract.

To limit the financial impact of these risks, Thales uses government and/or private-sector insurers when necessary to provide appropriate cover. It may also transfer receivables without recourse to financial institutions.

In addition, the Group has deployed a global procedure for employee security, protection and monitoring to ensure they have an appropriate level of security in the countries in which they perform their work.

1.1.2.3.6 Violations of data confidentiality

Thales is exposed to the risk of attacks on the security of its industrial infrastructures or its information technology systems (hacking attempts to access confidential information, threats to the physical security of facilities, etc.). The occurrence of such events could affect the rollout of the Group's activities and its reputation and, consequently, its results and financial situation.

In its defence businesses, the Group is subject to different national regulations requiring it to implement measures to protect its employees and industrial assets.

The Group is therefore subject to a large number of audits and inspections by the national supervisory authorities.

The Group has also established internal policies to protect its sites and sensitive information systems and increase employee awareness. These policies, which are replicated in all the subsidiaries, are relayed by the network of information system safety and security officers in the countries and the Global Business Units. For example, the application of Thales' "Information System Security" policy, based on ISO 27000, relies on the secure architecture of its information system, the critical awareness of users and IT personnel and appropriate means of monitoring and surveillance; it is regularly assessed through audits, vulnerability tests and surveys.

1.1.2.3.7 Management of supplier risk

Purchases constitute a very significant proportion of Thales' business, representing nearly half its sales in manufacturing, services, equipment and sub-systems. Thales is thus exposed to the risk of industrial, technical or financial failure of any of its suppliers, which in turn could affect the Company's profitability and performance.

There are two major types of supplier risk:

- legal or regulatory non-compliance (ethics, export control, intellectual property, etc.); these risks are handled by the departments concerned using the Group Risk Management system, with the support of the Purchasing Department;
- structural and operational risks that could disrupt supply are dealt with by the Purchasing Department using the Group Risk Management system. The Purchasing Department has identified two key triggers: supplier default and economic dependence. Although individual events might be considered to have a minor financial impact, they could potentially occur several times a year. The financial impact could become significant if several events are considered together, due to the domino effect and the large number of suppliers in Thales' supplier panel.

a) Management of the risks of supplier default

Supplier default could be caused by a major incident at one of its sites, by its external environment (shortage of raw materials - particularly critical materials - or components, major political instability, natural disaster, etc.) or through mismanagement. The supplier's management performance is monitored both in operating terms (lack of procurement planning, failure to manage tier 2 suppliers, loss of control over industrial processes, plant obsolescence, etc.) and in cross-disciplinary and financial terms (poor skills management, loss of know-how, fall in sales, mismanagement of working capital requirement, cash flow problems, administration or bankruptcy protection, etc.). A combination of problems could lead to the disappearance of a company or its takeover by investors with different interests from those of Thales.

Faced with this risk of a supply shortage, Thales seeks to implement a dual sourcing (or alternative-source) policy for each technology family, regularly updated and accompanied by buffer stocks that cover its requirements until customer contracts have been fulfilled.

In addition, taking into account the increased risk of fragility of certain suppliers in the current economic climate, Thales has introduced a special measure aimed at identifying, from among its critical suppliers, those that would be particularly exposed financially and implementing an appropriate action plan to ensure continuity of supply. Apart from individual monitoring, analysis is carried out by technology field in conjunction with the professional bodies concerned to identify appropriate solutions.

Alongside these financial supervision measures, Purchasing and Quality Control have stepped up their appraisal, accreditation and management of supplier performance to better identify structural risks. Supplier performance audits are broad-based (quality control, industrial maturity, flow optimisation, compliance with environmental regulations, expertise in technical and technological processes, financial solidity, etc.) and therefore allow a complete risk analysis to be carried out. When executing a purchasing contract, Thales closely monitors the implementation by the supplier of measures aimed at tackling the risks identified during the selection process.

b) Management of the risks of economic dependence

The economic dependence of small and medium-sized enterprises (SMEs) on Thales is considered a separate risk in its own right. It is particularly significant now that the economic crisis has disrupted the sales portfolios of a number of them, jeopardising the operating cycle with Thales and potentially leading to a supply shortage.

In order to mitigate this risk, the commitment rate (orders placed by Thales as a percentage of the supplier's total annual sales) is monitored for each panel of suppliers by market segment and for the main countries where the Group is implanted (France, the UK, the Netherlands, etc.). If the commitment rate exceeds 50% for more than two consecutive years, an action plan coordinated with internal prescriptors and internal users is drawn up and implemented in order to return to a reduced commitment rate.

The procurement policy, supplier selection and performance monitoring processes and supervisory and risk mitigation measures are all designed to reduce these risks, both during the bidding phase and during the preliminary project phase.

1.1.2.3.8 Raw materials risk

Given the nature of its business, Thales uses few raw materials. The Group's exposure to raw materials risk is therefore negligible.

1.1.2.3.9 Risk related to failure of equipment or technology

Thales systems and equipment are highly complex and technical and are likely to be integrated within high-value civil or military platforms. A malfunction of any such systems, equipment or technologies could result in client claims or third-party litigation. Thales could thus be held liable in the event of damage to property or personal injury. Were they to occur, such events would be liable to impact Thales' results and financial position, as well as its reputation.

In order to limit the impact, Thales has put Group-wide procedures in place (risk management, Design Authority, quality, documentation and contractualisation). In addition, Thales conducts a policy to maintain appropriate insurance coverage (see section 1.1.2.7 below).

1.1.2.3.10 Risk of lower impact of performance improvement measures

Thales initiated a plan to improve the Group's overall performance. This performance plan provides a common framework within which the units can implement plans and measurements adapted to their own issues in terms of performance improvements. The programme, whose objectives are validated during the multi-year budget preparations, covers all Group issues in terms of growth, competitivity and talent development.

The actual results may differ significantly from the objectives. Performance initiatives are based on economic and commercial assumptions defined during the preparation of the Group's multi-year budget and do not take into consideration any potential changes that could affect Thales' operations or its markets, such as the development of new activities, increased competition in its domestic or export markets or unfavourable regulatory or legislative changes.

Furthermore, the future earnings and financial position of Thales could be negatively impacted if the proposed initiatives could not be fully implemented or if they failed to generate the expected results according to the original timetable. The cost of implementing these initiatives could also be higher than forecast.

Thales pays particular attention to the management and monitoring of performance improvement initiatives. The Group's corporate management regularly reviews the progress of the main initiatives. Expected impacts for all initiatives for the year are regularly updated as part of the Group's steering process.

1.1.2.3.11 Human resources risk

a) Health and safety at work

Ensuring a healthy and safe working environment for its employees pursuant to the laws in force, monitoring procedures, preventing health and professional risks and employee training are key priorities for Thales.

These principles are reflected in a structure designed to prevent risks related to health and safety in the workplace. Concrete measures are implemented to anticipate and manage health risks that might occur at the international level. The creation of a permanent Health Supervision Unit, a Crisis Unit in the event of a major international health risk and the implementation of a specific procedure for missions in countries posing a major health risk all contribute to better management of the risks in this area. Finally, regular and specific monitoring of risks (discriminatory practices, moral and sexual harassment, injuries to health such as professional and psycho-social risks, etc.) that could affect the Group's employees is conducted every year on the basis of specialised indicators. Undertakings made by the Group HR Department on employees' occupational health and safety worldwide are on-going. Thus, new employees, whatever their country, can have a medical in the year of recruitment with Thales.

Thales is also committed to increasing the quality of life in the workplace. In France, negotiations have been conducted with trade union organisations at Group level with the aim of reaching a new agreement on "Quality of Life at Work", following on from an agreement signed in 2009, which defined a general framework for prevention, with a particular focus on the detection and prevention of psycho-social risks by implementing preventive actions at employee level and by collective preventive actions.

Proof of the Group's continuing commitment to certification, 95 Thales entities (representing 65% of the workforce) had obtained OHSAS 18001 certification by the end of 2013.

b) Talent development

If Thales is not attractive enough to recruit the qualified staff it needs in a timely manner and retain and motivate its employees to develop and conduct its business, sales and operating profitability could be negatively affected. Thales' success and performance effectively depend on its capacity to recruit employees in the different employment markets, in France and abroad, the quality of the key skills and the commitment of its employees, and its capacity to globally manage the talents required for the development of its activity worldwide.

Thales therefore attaches great importance to its attractiveness and positioning as a top employer, ensuring a good external image which will boost recruitment and an internal situation that will contribute to retaining employees.

As an attractive and recognised employer in France, Thales also intends to build its image in all the countries where the Group is already present or is intending to develop.

Thus, particular attention is paid to the systematic deployment of recruitment tools and organisations in emerging markets. In addition, a global recruitment function, attached to the HR general management has been created to help the Group develop in these geographical zones. The global process of identification and management of the Group's talents has also been reinforced, by encouraging exchanges between management teams in different parts of the organisation.

Thales is also continuing its dynamic skills management policy for the Group's main professional families. A steering committee per family, composed of operational and HR managers, annually analyses developments in the jobs, expertise, and the needs of the Company, and establishes action plans (training, anticipated management of internal mobility, external recruitment etc.). To complement this tool, each year the Group's internal University updates the key programmes in response to changing needs.

Finally, in 2013, the Group signed, with all the representative trade unions in France, agreements to welcome young people in work-study programmes or those already graduated through the transfer of knowledge (so-called "Generation contracts"), the development of mixity in the organisation (Gender Equality Agreement), and anticipated management of jobs and skills.

These agreements will enable the Group, in the coming months and years in France, to better manage the integration of young graduates, improve the development of critical skills, favour diversity and better anticipate change in the Group.

1.1.2.4 Environmental risks

For many years, Thales has conducted regular analysis and update of environmental risks in accordance with its business activities, scientific and technical developments and the emerging environmental challenges.

This analysis aims at:

- ensuring that employees and surrounding residents are not exposed to health and environmental risks (pollution, asbestos, etc); through their activities or work environment, including outside of Thales sites and in production units;
- ensuring the compliance of activities and products (substances, waste, etc);
- analysing the impact of new regulations, including on product design;
- analysing the impact of the environment on activities (water stress, climatic events, etc.);
- specifying an appropriate organisation and associated action plans, either at Group level or locally, according to the results of this analysis.

In support of this analysis, an Environmental Management System has been deployed at all sites in order to ensure the control and limitation of the products' and activities' environment impacts. Integrated into the Group commitments, this management system is applied to the different functions. As such, environmental competences have been widened to include engineering, research, procurement and contracts.

At the end of 2013, 125 entities had been certified ISO 14001, representing 82% of the Group's workforce.

At 31 December 2013, the amount of reserves for environmental contingencies amounted to €7.8m.

1.1.2.5 Risks relating to strategic acquisitions and investments

Thales regularly looks to acquire new companies (as well as making strategic investments and combining business activities through joint ventures, etc.) in order to round out its technological portfolio and strengthen its presence in certain markets. Integrating these businesses within Thales could prove more difficult and take longer than envisaged, requiring a more significant involvement by senior managers and the teams concerned and, in turn, negatively impacting the Company's results and financial position.

In addition, there are no guarantees that the newly acquired companies will perform as well as expected in accordance with the initial business plans, which form the basis of the investment decision. This type of variance could lead to the recognition of impairment losses on goodwill and other intangible assets, thereby negatively impacting Thales' results and financial position.

Before any planned acquisitions, Thales conducts audits and due diligence with the assistance of external consultants where necessary, in order to analyse the fundamentals of the target company. A review is also conducted at each key stage in the acquisition process to confirm Thales' interest and specify the necessary conditions and parameters to ensure a successful outcome. The newly acquired company is then integrated into Thales' financial reporting system so that its performance can be monitored.

1.1.2.6 Risks linked to joint ventures, consortiums and minority investments

Thales generates an important part of its sales within the framework of various consortiums, joint ventures and investments, where control is shared with other partners.

The signing of partnerships and alliances with other market players is an integral part of Thales' strategy, particularly as part of its international development, and the share of sales generated by consortiums, common companies and investments is likely to increase.

However, Thales exercises a variable degree of control over these consortiums, common companies and investments. The risk of disagreement or blockage, inherent in any jointly-controlled entity, exists, particularly in those where important decisions require the unanimity of members or where there are limited exit rights.

Consequently, the Group ensures that appropriate governance modes are defined, in order to best protect its interests. In addition, activities managed by consortiums, common companies and investments are integrated into the Group's financial reporting system in order to monitor their performance and all the Group's procedures and directives apply to joint ventures where Thales has exclusive control.

1.1.2.7 Insurance

Thales' Insurance and Risk Management Department, based at head office and reporting to the SEVP Finance & Information Systems, is responsible for the Group's insurance activities and insurable risk management. It is in charge of Group operations and oversees policy implementation by Group companies.

The Group covers the financial consequences of the risk of accidental damage suffered or caused by property or people using appropriate insurance policies with leading international insurance and reinsurance companies.

The insurance policies arranged by the Group to cover these major risks relate to areas such as:

- damage to property and consequent operating losses;
- transport;
- testing and development;
- aviation liability, including liability for aeronautical products and hull/test flight insurance;
- civil liability for space products;
- risks of damage to or by naval vessels by subsidiaries, as naval equipment suppliers;
- general third-party liability;
- environmental liability;
- liability of executive officers and directors.

Whilst certain damageable events were notified to insurers, the Group had no major loss in 2013.

Thales' policy is to arrange cover on the insurance market based on the rates and limits that it considers reasonable, in view of the conditions offered by the market. Limits are applicable to insurance for major risks, while general exclusions for the entire market (e.g. asbestos) also apply to Thales.

The maximum coverage limit of €1.3bn in 2013 for damage to property and consequent business interruptions takes into account an estimate of the maximum loss caused to an industrial site which the Group could incur for direct damages and business interruptions.

Levels of liability cover depend on the quantification of a reasonable claim expectancy for Thales, as identified by the risk map of the main business activities and at Group level, and on cover capacity available on the insurance market. The insurance coverage for aviation liability commitments, which is covered by a specific programme, amounts to USD 2bn.

The insurance industry, which was affected by the recent financial crisis, is still trying to reduce its overall risk exposure. We are witnessing an increase in insurance premiums, a rise in deductibles and additional limits on the scope of cover. In addition, there are fewer insurers with the necessary resources and financial capacity to insure major industrial risks. There are no guarantees that Thales will be able in the future to maintain current levels of insurance under similar financial conditions.

In order to reduce its exposure to insurance market volatility, Thales insures major risks on a two-tier basis:

- the Group's contribution, through captive insurance and reinsurance companies, towards the settlement of claims, to a maximum net retention of €13.5m per year, for damage to property and consequent business interruptions, transport, general third-party liability, testing and development and space risks;
- transfer to insurers of payment for catastrophic losses.

An active Prevention and Protection policy for industrial sites is designed to reduce the magnitude and frequency of the accidental risks of fire or explosion and to detect other exposures, such as environmental or natural disasters and the vulnerability of critical industrial facilities. In 2013, more than 80% of the assets insured were the subject of a "multi-peril" audit by the insurers during their visits to the principal operating sites and infrared thermography inspections by an outside organisation specialised in the prevention of electrical damage.

In accordance with Group processes, measures were taken to minimise business interruption and the consequences of any unforeseen events. An organisational structure and crisis management tools are in place to deal as efficiently as possible with the immediate consequences of a catastrophic event and to take the necessary emergency measures.

Thales continues to roll out professional indemnity cover for its staff. In addition, specific and/or local cover has been arranged to comply with the regulations in force and to satisfy the specific requirements of certain activities or projects, particularly public-private partnerships.

1.1.3 Social, environmental and societal information

Table of reconciliation decree no. 2012-557 of 24 April 2012

In accordance with decree no. 2012-557 of 24 April 2012 and with Article R. 225-105-1 of the French Commercial Code on transparency obligations for companies on social and environmental matters, in its management report, Thales provides information on the Group's social, environmental and societal issues. This information, which has been verified by a declaration of inclusion and an assurance report moderated by independent verifiers, presented on pages 221 and 222 for the social data, on pages 237 and 238 for the environmental data and on pages 246 and 247 for the societal data, is presented in full in chapter 4 on "Corporate Responsibility" in this registration document.

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1.1.4 Events since year-end

No significant events after reporting period.