IMPORTANT NOTICE
THIS OFFERING IS AVAILABLE ONLY TO INVESTORS WHO ARE EITHER (1) QIBs (AS DEFINED BELOW) OR (2) OUTSIDE THE UNITED STATES AND WHO ARE NON-U.S. PERSONS (AS DEFINED BELOW).

IMPORTANT: You must read the following before continuing. The following applies to the attached offering memorandum dated October 7, 2011, and you are therefore advised to read this carefully before reading, accessing or making any other use of the offering memorandum. In accessing the offering memorandum, you agree to be bound by the following terms and conditions, including any modifications to them, any time you receive any information from us as a result of such access. You acknowledge that this electronic transmission and the delivery of the attached offering memorandum is intended for you only and **you agree you will not forward this electronic transmission or the attached offering memorandum to any other person.**

The offering memorandum has been prepared in connection with the proposed offer and sale of the securities described therein. The offering memorandum and its contents are confidential and should not be distributed, published or reproduced (in whole or in part) or disclosed by the recipients to any other person.

NOTHING IN THIS ELECTRONIC TRANSMISSION CONSTITUTES AN OFFER OF SECURITIES FOR SALE IN ANY JURISDICTION WHERE IT IS UNLAWFUL TO DO SO. THE SECURITIES HAVE NOT BEEN, AND WILL NOT BE, REGISTERED UNDER THE UNITED STATES SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR ANY SECURITIES LAWS OF ANY STATE OF THE UNITED STATES OR OTHER JURISDICTION AND THE SECURITIES MAY NOT BE OFFERED OR SOLD WITHIN THE UNITED STATES OR TO, OR FOR THE ACCOUNT OR BENEFIT OF, ANY U.S. PERSONS (AS DEFINED IN REGULATION S UNDER THE SECURITIES ACT) EXCEPT PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND APPLICABLE STATE OR LOCAL SECURITIES LAWS.

THE ATTACHED OFFERING MEMORANDUM MAY NOT BE FORWARDED OR DISTRIBUTED TO ANY OTHER PERSON AND MAY NOT BE REPRODUCED IN ANY MANNER WHATSOEVER. ANY FORWARDING, DISTRIBUTION OR REPRODUCTION OF THIS DOCUMENT IN WHOLE OR IN PART IS UNAUTHORIZED. FAILURE TO COMPLY WITH THIS DIRECTIVE MAY RESULT IN A VIOLATION OF THE SECURITIES ACT OR THE APPLICABLE LAWS OF OTHER JURISDICTIONS. IF YOU HAVE GAINED ACCESS TO THIS TRANSMISSION CONTRARY TO ANY OF THE FOREGOING RESTRICTIONS, YOU ARE NOT AUTHORIZED AND WILL NOT BE ABLE TO PURCHASE ANY OF THE SECURITIES DESCRIBED IN THE OFFERING MEMORANDUM.

Confirmation of your Representation: In order to be eligible to view the offering memorandum or make an investment decision with respect to the securities, you must be either (1) a "qualified institutional buyer" ("QIB") (as defined in Rule 144A under the Securities Act) or (2) not a "U.S. person" (as defined in Regulation S under the Securities Act). By accepting the e-mail and accessing the offering memorandum, you shall be deemed to have represented to us that (1) you and any customers you represent are either (a) QIBs or (b) not U.S. persons and the electronic mail address that you gave us and to which this e-mail has been delivered is not located in the United States and (2) you consent to delivery of such offering memorandum by electronic transmission.

In addition, this electronic transmission and the attached offering memorandum is directed only at persons in member states of the European Economic Area (the "EEA") who are "qualified investors" within the meaning of Article 2(1)(e) of the Prospectus Directive (Directive 2003/71/EC) ("Qualified Investors"). Any person in the EEA who acquires the securities in any offer (an "EEA investor") or to whom any offer of the securities is made will be deemed to have represented and agreed that it is a Qualified Investor. Any EEA investor will also be deemed to have represented and agreed that any securities acquired by it in the offer have not been acquired on behalf of persons in the EEA other than Qualified Investors and that the securities have not been acquired with a view to their offer or resale in the EEA to persons where this would result in a requirement for publication by the issuer, Deutsche Bank Securities Inc., Goldman, Sachs & Co. or Morgan Stanley & Co. LLC, on behalf of themselves and the other initial purchasers (collectively, the "Initial Purchasers"), of a prospectus pursuant to Article 3 of the Prospectus Directive. The issuer, the Initial Purchasers and their respective affiliates will rely upon the truth and accuracy of the foregoing representations and agreements.

The offering memorandum may only be communicated or caused to be communicated to persons in the United Kingdom in circumstances in which section 21(1) of the Financial Services and Markets Act 2000 (the "FSMA") does not apply and may be distributed in the United Kingdom only to persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the FSMA) in connection with the issue or sale of any of the securities may lawfully be communicated or caused to be communicated (all such persons together being referred to as "Relevant Persons"). In the United Kingdom, the offering memorandum is directed only at Relevant Persons and must not be acted on or relied on by persons who are not Relevant Persons. Any investment or investment activity to which the offering memorandum relates is available only to Relevant Persons and will be engaged in only with Relevant Persons.

You are reminded that the offering memorandum has been delivered to you on the basis that you are a person into whose possession the offering memorandum may be lawfully delivered in accordance with the laws of the jurisdiction in which you are located and you may not, nor are you authorized to, deliver or disclose the contents of the offering memorandum to any other person.

The materials relating to the offering do not constitute, and may not be used in connection with, an offer or solicitation in any place where offers or solicitations are not permitted by law. If a jurisdiction requires that the offering be made by a licensed broker or dealer and the Initial Purchasers or any affiliate of the Initial Purchasers is a licensed broker or dealer in that jurisdiction, the offering shall be deemed to be made by the Initial Purchasers or such affiliate on behalf of the issuer in such jurisdiction.

The offering memorandum has been sent to you in an electronic form. You are reminded that documents transmitted via this medium may be altered or changed during the process of electronic transmission and consequently, none of the issuer, the Initial Purchasers nor any of their affiliates accepts any liability or responsibility whatsoever in respect of any difference between the offering memorandum distributed to you in electronic format and the hard copy version available to you on request.

You are responsible for protecting against viruses and other destructive items. Your use of this e-mail is at your own risk and it is your responsibility to take precautions to ensure that it is free from viruses and other items of a destructive nature.

OFFERING MEMORANDUM

NOT FOR GENERAL CIRCULATION IN THE UNITED STATES

BAE SYSTEMS

BAE Systems plc

(incorporated with limited liability in England and Wales under the Companies Acts 1948 to 1980 with registered number 1470151)

US$350,000,000 3.50% Notes due 2016

Issue price: 99.650%

US$500,000,000 4.75% Notes due 2021

Issue price: 99.898%

US$400,000,000 5.80% Notes due 2041

Issue price: 99.479%

BAE Systems plc, a public limited company registered in England and Wales (the "*Issuer*"), is offering \$350,000,000 aggregate principal amount of its 3.50% Notes due 2016 (the "*2016 Notes*"), \$500,000,000 aggregate principal amount of its 4.75% Notes due 2021 (the "*2021 Notes*") and \$400,000,000 aggregate principal amount of its 5.80% Notes due 2041 (the "*2041 Notes*"). The 2016 Notes, the 2021 Notes and the 2041 Notes are referred to collectively as the "*Securities*".

The 2016 Notes, the 2021 Notes and the 2041 Notes will mature on October 11, 2016, October 11, 2021 and October 11, 2041, respectively (in each case, a "*Stated Maturity Date*"), and upon surrender will be repaid in an amount equal to the principal amount thereof together with accrued and unpaid interest thereon. Interest on the Securities will be payable semi-annually in arrears on April 11 and October 11 of each year, commencing on April 11, 2012. The Securities will be redeemable at any time at the option of the Issuer at a redemption price calculated as set forth under "*Description of Securities — Optional Redemption.*"

The Securities will be direct, unsecured and unsubordinated obligations of the Issuer and will rank *pari passu* with all other direct, unsecured and unsubordinated obligations (except those obligations preferred by statute or operation of law) of the Issuer.

Application has been made to the Financial Services Authority in its capacity as competent authority under the Financial Services and Markets Act 2000 (the "*UK Listing Authority*") for the Securities to be admitted to the official list of the UK Listing Authority (the "*Official List*") and to the London Stock Exchange plc (the "*London Stock Exchange*") for the Securities to be admitted to trading on the London Stock Exchange's Regulated Market (the "*Market*"). References in this Offering Memorandum to the Securities being "listed" (and all related references) shall mean that the Securities have been admitted to the Official List and have been admitted to trading on the Market. The Market is a regulated market for the purposes of Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments.

This investment involves risk. See "Risk Factors" beginning on page 11.

The Securities have not been registered under the United States Securities Act of 1933, as amended (the "*Securities Act*"), or any state securities laws and are being offered and sold within the United States only to "qualified institutional buyers" ("*QIBs*") as defined in Rule 144A under the Securities Act and non-U.S. persons outside the United States in accordance with Regulation S under the Securities Act. For a description of certain restrictions on transfers of the Securities, see "*Plan of Distribution*" and "*Transfer Restrictions.*"

As of the date of this Offering Memorandum, the Issuer's long- term credit ratings are Baa2 ("Stable Outlook") (Moody's Investors Service, Inc. ("*Moody's*")), BBB+ ("Stable Outlook") (Standard & Poor's Credit Market Services Europe Limited ("*Standard & Poor's*")) and BBB+ ("Stable Outlook") (Fitch Ratings Ltd. ("*Fitch*")). A rating is not a recommendation to buy, sell or hold Securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating agency. Moody's is not established in the European Union and has not applied for registration under Regulation (EC) No. 1060/2009. Each of Standard & Poor's and Fitch is established in the European Union and has applied for registration under Regulation (EC) No. 1060/2009, although notification of the corresponding registration decision has not yet been provided by the relevant competent authority.

It is expected that delivery of beneficial interests in the Securities will be made through the facilities of The Depository Trust Company ("*DTC*") and its participants, including Euroclear Bank, S.A./N.V. ("*Euroclear*"), and Clearstream Banking, *société anonyme* ("*Clearstream*"), on or about October 11, 2011, against payment therefor in immediately available funds.

Joint Bookrunners

Deutsche Bank Securities **Goldman, Sachs & Co.** **Morgan Stanley**

Credit Suisse **J.P. Morgan**

October 7, 2011

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IMPORTANT: You must read the following before continuing. The following applies to this Offering Memorandum. You are therefore advised to read this carefully before reading, accessing or making any other use of this Offering Memorandum. In accessing the Offering Memorandum, you agree to be bound by the following terms and conditions, including any modifications to them any time you receive any information.

This Offering Memorandum does not constitute an offer of any securities other than those to which it relates or an offer to sell, or solicitation of an offer to buy, to any person in any jurisdiction where such an offer or solicitation would be unlawful.

The Securities have not been registered with, or recommended or approved by, the U.S. Securities and Exchange Commission (the "SEC") or any other federal, state or foreign securities commission or regulatory authority, nor has the SEC or any such other commission or regulatory authority passed upon the accuracy or adequacy of this Offering Memorandum. Any representation to the contrary is a criminal offense.

This Offering Memorandum comprises a prospectus for the purposes of Directive 2003/71/EC (the "*Prospectus Directive*") and for the purpose of giving information with regard to BAE Systems (as defined herein) and the Securities which, according to the particular nature of BAE Systems and the Securities, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of BAE Systems. The Issuer accepts responsibility for the information contained in this Offering Memorandum. To the best of the knowledge and belief of the Issuer (which has taken all reasonable care to ensure that such is the case), the information contained in this Offering Memorandum is in accordance with the facts and does not omit anything likely to affect the import of such information.

This Offering Memorandum has been prepared on the basis that any offer of Securities in any Member State of the European Economic Area which has implemented the Prospectus Directive (each, a "*Relevant Member State*") will be made pursuant to an exemption under the Prospectus Directive from the requirement to publish a prospectus for offers of Securities. Accordingly, any person making or intending to make an offer in that Relevant Member State of Securities which are the subject of the offering contemplated in this Offering Memorandum may only do so in circumstances in which no obligation arises for the Issuer or any of initial purchasers named in "*Plan of Distribution*" (collectively, the "*Initial Purchasers*") to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive, in each case, in relation to such offer. Neither the Issuer nor the Initial Purchasers have authorized, nor do they authorize, the making of any offer of Securities in circumstances in which an obligation arises for the Issuer or the Initial Purchasers to publish or supplement a prospectus for such offer. The expression "Prospectus Directive" as used in this paragraph means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive, to the extent implemented in the Relevant Member State), and includes any relevant implementing measure in the Relevant Member State and the expression "2010 PD Amending Directive" means Directive 2010/73/EU.

NOTICE TO NEW HAMPSHIRE RESIDENTS

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER CHAPTER 421-B OF THE NEW HAMPSHIRE REVISED STATUTES WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE THAT ANY DOCUMENT FILED UNDER RSA 421-B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE SECRETARY OF STATE HAS PASSED IN

ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY, OR TRANSACTION. IT IS UNLAWFUL TO MAKE, OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER, OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

IMPORTANT NOTICE

THIS OFFERING IS AVAILABLE ONLY TO INVESTORS WHO ARE EITHER (1) QUALIFIED INSTITUTIONAL BUYERS ("*QIBs*") UNDER RULE 144A OR (2) NON-U.S. PERSONS OUTSIDE OF THE UNITED STATES IN ACCORDANCE WITH REGULATION S.

This Offering Memorandum is being provided to QIBs and to certain prospective investors outside of the United States for use solely in connection with the offering of the Securities. Its use for any other purpose is not authorized. This Offering Memorandum may not be copied or reproduced in whole or in part, nor may it be distributed or any of its contents be disclosed to any person other than the prospective investors to whom it is being provided.

Prospective investors should note that there are further restrictions on the offering and sale of the Securities and the distribution of this Offering Memorandum. See "*Plan of Distribution*" and "*Transfer Restrictions*".

No dealer, salesperson or other person has been authorized to give any information or to make any representation not contained in this Offering Memorandum and, if given or made, such information or representation must not be relied upon as having been authorized by the Issuer, any of its subsidiaries and equity accounted investments or the Initial Purchasers. Neither the delivery of this Offering Memorandum nor any sale made under it shall, under any circumstances, create any implication that there has been no change in the affairs of the Issuer since the date of this Offering Memorandum or that the information contained in this Offering Memorandum is correct as of any time subsequent to that date. In making an investment decision, investors must rely on their own examination of the Issuer and its subsidiaries and equity accounted investments, the terms of the offering of the Securities and the merits and risks involved. By receiving this Offering Memorandum, investors acknowledge that they have had an opportunity to request for review, and have received, all additional information they deem necessary to verify the accuracy and completeness of the information contained in this Offering Memorandum. Investors also acknowledge that they have not relied on the Initial Purchasers in connection with their investigation of the accuracy of this information or their decision on whether to invest in the Securities. The contents of this Offering Memorandum are not to be considered as legal, business or tax advice. Prospective investors should consult their own counsel, accountants and other advisors as to legal, tax, business, financial and related aspects of a purchase of the Securities.

This offering is being made in reliance upon exemptions from registration under the Securities Act for an offer and sale of securities that does not involve a public offering. The Securities may not be offered or sold within the United States or to, or for the account or benefit of, any U.S. persons (as defined in Regulation S) except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Accordingly, the Securities are being offered and sold only (i) to QIBs in reliance on the exemption from the registration requirements of the Securities Act provided by Rule 144A and (ii) in offers and sales that occur outside the United States to purchasers who are not U.S. persons (as defined in Regulation S) in offshore transactions in reliance on Regulation S under the Securities Act. By purchasing the Securities, investors are deemed to have made the acknowledgements, representations, warranties and agreements set forth under "*Transfer Restrictions.*"

The Initial Purchasers reserve the right to withdraw this offering of Securities at any time and to reject any commitment to subscribe for the Securities, in whole or in part. The Initial Purchasers also reserve the right to allot less than the full amount of Securities sought by investors. The Initial Purchasers and certain related entities may acquire a portion of the Securities for their own account.

No action has been taken by the Initial Purchasers, the Issuer or any other person that would permit an offering of the Securities or the circulation or distribution of this Offering Memorandum or any offering material in relation to the Issuer or its subsidiaries and equity accounted investments or the Securities in any country or jurisdiction where action for that purpose is required.

The laws of certain jurisdictions may restrict the distribution of this Offering Memorandum and the offer and sale of the Securities. Persons into whose possession this Offering Memorandum or any Securities may come must inform themselves about, and observe, any such restrictions on the distribution of this Offering Memorandum and the offering and sale of the Securities. In particular there are restrictions on the distribution of this Offering Memorandum and the offer or sale of the Securities in the United States and the European Economic Area (including the United Kingdom). For a further description of certain restrictions on the offering and sale of the Securities and the distribution of the Offering Memorandum, see "*Plan of Distribution*" and "*Transfer Restrictions.*" None of the Issuer, the Initial Purchasers or their respective representatives are making any representation to any offeree or any purchaser of the Securities regarding the legality of any investment in the Securities by such offeree or purchaser under applicable legal investment or similar laws or regulations. Accordingly, no Securities may be offered or sold, directly or indirectly, and neither this Offering Memorandum nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations.

The Securities will be issued in fully registered form and only in denominations of $2,000 and integral multiples of $1,000 in excess thereof. The Securities will be issued initially in fully registered form as beneficial interests in Global Securities (defined below). QIBs may elect to hold Global Securities (the "*Rule 144A Global Securities*") purchased by them through the facilities of The Depository Trust Company ("*DTC*"), which will act as depositary for the Securities. Holders of Securities sold in offshore transactions in reliance on Regulation S under the Securities Act may elect to hold Global Securities (the "*Regulation S Global Securities*" and, together with the Rule 144A Global Securities, the "*Global Securities*") through the facilities of Euroclear and Clearstream as participants in DTC. Prior to the date that is 40 days after the later of the commencement of the offering or the closing date, beneficial interests in such Regulation S Global Securities may be held only through Euroclear and Clearstream. See "*Description of Securities — Book-Entry, Delivery and Form.*"

To purchase the Securities, investors must comply with all applicable laws and regulations in force in any jurisdiction in which investors purchase, offer or sell the Securities or possess or distribute this Offering Memorandum. Investors must also obtain any consent, approval or permission required by such jurisdiction for investors to purchase, offer or sell any of the Securities under the laws and regulations in force in any jurisdiction in which investors are subject or in which investors make such purchase, offer or sale. None of the Issuer, its subsidiaries and equity accounted investments or the Initial Purchasers will have responsibility therefor.

Any prospective investor subject to the United States Employee Retirement Income Security Act of 1974, as amended ("*ERISA*") and/or Section 4975 of the United States Internal Revenue Code of 1986, as amended (the "*Code*") should consult with its own counsel and other advisors regarding the consequences under ERISA and/or the Code of an investment in the Securities. See "*Certain ERISA Considerations*" and "*Transfer Restrictions.*"

In connection with the offering, Deutsche Bank Securities Inc., Goldman, Sachs & Co. and Morgan Stanley & Co. LLC (together, the "*Representatives*") may purchase and sell the Securities in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the Representatives of a greater number of Securities than they are required to purchase in the offering. Stabilizing transactions consist of certain bids or purchases made for the purpose of preventing or retarding a decline in the market price of the Securities while the offering is in progress.

The Representatives also may impose a penalty bid. This occurs when a particular Representative repays to the other Representatives a portion of the underwriting discount received by it because the other Representatives or their affiliates have repurchased Securities sold by or for the account of such Representative in stabilizing or short covering transactions.

These activities by the Representatives, as well as other purchases by the Representatives for their own accounts, may stabilize, maintain or otherwise affect the market price of the Securities. As a result, the price of the Securities may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued by the Representatives at any time. These transactions may be effected in the over-the-counter market or otherwise.

INTERNAL REVENUE SERVICE CIRCULAR 230 DISCLOSURE

To ensure compliance with requirements imposed by the Internal Revenue Service Circular 230, we inform you that: (i) any U.S. federal tax advice contained in this Offering Memorandum is not intended or written by us to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties under the Internal Revenue Code; (ii) such advice was written in connection with the promotion or marketing of the Securities; and (iii) taxpayers should seek advice based on their particular circumstances from an independent tax advisor.

AVAILABLE INFORMATION AND REPORTS TO SECURITYHOLDERS

The Issuer is not subject to reporting requirements under the U.S. Securities Exchange Act of 1934, as amended (the "*Exchange Act*"). The Issuer, however, makes available information under Rule 12g3-2(b) under the Exchange Act. In addition, the Issuer files information, including annual reports, with the Financial Services Authority. Copies of the Issuer's annual reports, the contents of which are not part of this Offering Memorandum, may be obtained through the website maintained by BAE Systems plc at http://www.baesystems.com. Information on BAE Systems' website is not incorporated by reference into this Offering Memorandum.

The Issuer has agreed that it will make available, upon request, to any holder or prospective purchaser of the Securities the information required pursuant to Rule 144A(d)(4) under the Securities Act with respect to itself, during any period in which the Issuer is not subject to Section 13 or 15(d) of the Exchange Act or not exempt by virtue of Rule 12g3-2(b) thereunder. Any such requests to the Issuer should be directed to the Issuer care of the Company Secretary at BAE Systems plc, 6 Carlton Gardens, London, SW1Y 5AD, United Kingdom.

BAE Systems plc publishes the following information regarding its financial accounts:

Annual Report. The full, consolidated, annual, audited accounts for BAE Systems plc, with some information on BAE Systems plc, which is published annually in March/April.

Half-Yearly Report. The extracted, consolidated, unaudited accounts for the first six months of the financial year for BAE Systems plc, which is published annually in July/August.

Preliminary Announcement. The extracted, consolidated accounts for BAE Systems plc, which is published annually in February.

PRESENTATION OF CURRENCY AND FINANCIAL INFORMATION

Unless otherwise specified or the context otherwise requires, references to "$", "US$", "Dollars" and "U.S. Dollars" are to the lawful currency of the United States of America, references to "pounds", "pounds Sterling" or "£" are to the lawful currency of the United Kingdom of Great Britain and Northern Ireland, references to "A$" are to the lawful currency of the Commonwealth of Australia, references to "SEK" are to the lawful currency of the Kingdom of Sweden and references to "Euro," or "€" are to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty establishing the European Community, as amended. Unless otherwise stated, all monetary amounts with respect to the financial information of BAE Systems plc in this Offering Memorandum are expressed in pounds Sterling.

The consolidated annual financial statements of BAE Systems plc for the year ended December 31, 2010 included in this Offering Memorandum are referred to herein as the "*BAE Systems 2010 Annual Financial Statements*". The consolidated annual financial statements of BAE Systems plc for the year ended December 31, 2009 included in this Offering Memorandum are referred to herein as the "*BAE Systems 2009 Annual Financial Statements*". The consolidated interim financial statements of BAE Systems plc for the six months ended June 30, 2011 included in this Offering Memorandum are referred to herein as the "*BAE Systems Interim Financial Statements*". The BAE Systems 2010 Annual Financial Statements and the BAE Systems 2009 Annual Financial Statements are referred to herein collectively as the "*BAE Systems Annual Financial Statements*". The BAE Systems Annual Financial Statements and the BAE Systems Interim Financial Statements are referred to herein collectively as the "*BAE Systems Financial Statements*". The BAE Systems Annual Financial Statements are prepared in accordance with applicable law and EU-endorsed International Financial Reporting Standards ("*IFRS*") and International Financial Reporting Interpretations Committee interpretations ("*IFRICs*"). The BAE Systems Interim Financial Statements are prepared in accordance with International Accounting Standard ("*IAS*") 34, *Interim Financial Reporting*.

Various numbers and percentages set out in this Offering Memorandum have been subject to rounding adjustments. Accordingly, figures shown for the same category presented in different tables may vary slightly and figures shown as totals in certain tables may not be the sum of the figures that precede them.

See "*Independent Accountants*" for a description of the independent auditor's reports to the members of BAE Systems plc dated February 16, 2011 and February 17, 2010 on the BAE Systems 2010 Annual Financial Statements and BAE Systems 2009 Annual Financial Statements, respectively. In accordance with guidance issued by The Institute of Chartered Accountants in England and Wales, each of the independent auditor's reports states that: "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." The independent auditor's reports are included on pages F-3 and F-62 of this Offering Memorandum. The SEC would not permit such limiting language to be included in a registration statement or a prospectus used in connection with an offering of securities registered under the Securities Act, or in a report filed under the Exchange Act. If a U.S. court (or any other court) were to give effect to such limiting language, the recourse that investors in the Securities may have against the independent auditor based on its report or the consolidated financial statements to which it relates could be limited.

The financial statements and other information contained in this Offering Memorandum as of and for the six-month period ended June 30, 2010 have been restated to give effect to the classification of the Regional Aircraft line of business as a discontinued operation. Certain financial statements and other financial information contained in this Offering Memorandum as of and for the years ended December 31, 2009, 2008, 2007 and 2006 have been restated to give effect to the sale in June 2010 of half of BAE Systems' 20.5% shareholding in Saab AB and subsequent reclassification as a discontinued operation and following finalization of the fair values recognized on acquisition of the 45% shareholding in BVT Surface Fleet Limited.

The financial information for the year ended December 31, 2009 found in the BAE Systems 2010 Annual Financial Statements has been restated as described above. As a result, financial data in the BAE Systems 2009 Annual Financial Statements are not directly comparable to financial data found in the BAE Systems 2010 Annual Financial Statements.

Unless otherwise specified or the context otherwise requires, as used or presented in this Offering Memorandum:

- "*Sales*" refers to the amounts derived by BAE Systems from the provision of goods and services, and includes BAE Systems' share of equity accounted investments. Unless in respect of operating groups or as otherwise indicated, "sales" refers to any such amounts after elimination of intra-group sales.

- "*Revenue*" represents sales made by BAE Systems plc and its subsidiary undertakings, excluding BAE Systems' share of sales of equity accounted investments.
- "*Finance Costs*" and "*Taxation Expense*" include BAE Systems' share of equity accounted investments.
- "*EBITA*" refers to earnings before amortization and impairment of intangible assets, finance costs and taxation expense.
- "*Underlying EBITA*" refers to earnings before amortization and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. Management uses Underlying EBITA as an underlying profit measure to monitor the year-on-year profitability of BAE Systems and to evaluate the segment performance of the operating groups. The definition of Underlying EBITA was amended in 2008 to exclude profit/(loss) on disposal of businesses. For the six months ended 2011 and 2010, non-recurring items included loss from disposal of businesses and regulatory penalties. In 2010 and 2009, non-recurring items included profit from disposal of businesses, pension accounting gain and regulatory penalties.
- The presentation of Sales or Underlying EBITA by operating group as a percentage of BAE Systems' total sales or Underlying EBITA, as the case may be, excludes sales or Underlying EBITA attributable to the HQ & Other Businesses operating group and the elimination of intra-group sales.
- "*Return on sales*" refers to Underlying EBITA expressed as a percentage of sales.
- "*Underlying earnings*" refers to earnings excluding amortization and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives and non-recurring items.
- "*Cash Inflow*" refers to net cash inflow/(outflow) from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust.
- References to the number of employees of BAE Systems or of an operating group include share of equity accounted investments.
- "*Closing Order Book*" refers to the estimated remaining sales value of work BAE Systems is to perform or equipment it is to deliver. BAE Systems includes an order in its order book when a firm funded contract exists with the customer. For contracts where the pricing is not fixed but subject to a limit of liability, the value of the order included in the order book is not greater than the limit of liability. In other cases, BAE Systems includes a provisional price or, if unavailable, an estimated price, which is later updated when pricing details become provisional or fixed. Unless otherwise indicated, "Closing Order Book" includes BAE Systems' share of equity accounted investments' order books and is after the elimination of intra-group orders.

EXCHANGE RATES

The following table sets forth, for each of the periods indicated, certain information concerning the closing exchange rates between pounds Sterling and U.S. Dollars as published by Bloomberg, expressed in U.S. Dollars per £1.00.

Year Ended December 31,	**Period End**	**Average[(1)]**	**High**	**Low**
	(Bloomberg Generic Rate (BGR), $ per £1.00)			
2006	1.96	1.86	1.98	1.72
2007	1.99	2.01	2.11	1.92
2008	1.46	1.84	2.03	1.44
2009	1.62	1.57	1.70	1.38
2010	1.56	1.54	1.64	1.43
2011 through October 4, 2011	1.55	1.62	1.67	1.53

(1) The average of the Bloomberg Generic Rates (BGR) in effect on the last business day of each month during the relevant period. The BGR on October 4, 2011 was $1.55 per £1.00.

The above rates may differ from the actual rates used in the preparation of the financial statements and other financial information appearing in this Offering Memorandum. The Issuer's inclusion of these exchange rates and other exchange rates specified elsewhere in this Offering Memorandum is not meant to suggest that the pounds Sterling amounts actually represent such U.S. Dollar amounts or that such amounts could have been converted into U.S. Dollars at any particular rate, if at all.

Unless otherwise indicated in this Offering Memorandum, the exchange rates used to translate amounts shown in U.S. Dollars represent, as applicable, the average exchange rate for the relevant period or the exchange rate at period end. The exchange rates used to translate amounts for individual transactions, including business acquisitions and disposals, debt redemption and a regulatory penalty, represent either (i) the spot rate on the day of the transaction, (ii) the weighted average of the relevant foreign exchange contract rates, or (iii) a blended rate based on a combination of (i) and (ii).

INDUSTRY AND MARKET DATA

The global and national defense market and competitive position data in this Offering Memorandum generally has been obtained from industry publications and from surveys or studies conducted by third-party sources. There are a variety of limitations with respect to the availability, accuracy, completeness and comparability of such data. The Issuer and the Initial Purchasers cannot assure prospective investors of the accuracy and completeness of such information and the Issuer and the Initial Purchasers have not independently verified such defense market and competitive position data.

In addition, in many cases, statements made in this Offering Memorandum regarding the defense market and the position in the market of BAE Systems and its competitors is based on the internal analyses of the Issuer of market conditions, which analyses contain certain assumptions and estimates. There can be no assurance that any of these assumptions or estimates are accurate or correctly reflect the position of BAE Systems or its competitors in the defense market, and none of the internal analyses have been verified by any independent sources.

FORWARD-LOOKING STATEMENTS

This Offering Memorandum contains and refers to certain forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act with respect to the financial condition, results of operations and business of the Issuer and its subsidiaries and equity accounted investments. These forward-looking statements include, but are not limited to, statements about BAE Systems' plans, objectives, expectations and intentions and other statements contained in this Offering Memorandum that are not historical facts. Forward-looking statements are typically identified by the words "may," "will," "believe," "anticipate," "intend," "estimate" and similar expressions. All of these forward-looking statements are based on estimates and assumptions made by BAE Systems that, although believed to be reasonable, are inherently uncertain. Therefore, you should not place undue reliance on forward-looking statements, which are based on the information currently available to BAE Systems and speak only as of the date of this Offering Memorandum. Because these forward-looking statements involve known and unknown risks and uncertainties, there are important factors that could cause actual results to differ materially from those contemplated by such forward-looking statements. These factors include, among other things:

- the direct effect of budget constraints on defense spending;
- the dependence of certain parts of the business on a small number of large contracts;
- the performance of government contracts;
- the effect of the timing or award of, and payment under, defense contracts;
- the performance of fixed-price contracts;

- the difficulties associated with operating in a global market;
- the level of export controls on defense-related products and systems;
- the varying degrees of control in consortia, joint venture and non-controlling equity holdings;
- the competition with large national and multi-national defense firms and the affect of the home-country defense contract preference;
- the exposure to funding risks under pension schemes;
- the ability to integrate acquired businesses successfully;
- the failure to comply with numerous laws, regulations and restrictions;
- the exposure to volatility in currency exchange rates; and
- the exposure to suppliers and subcontractors.

For further information regarding factors that could affect the business and financial results of the Issuer or its subsidiaries and equity accounted investments and such forward-looking statements, see "*Risk Factors.*"

The forward-looking statements speak only as of the date of this Offering Memorandum. The Issuer expressly disclaims any obligation or undertaking, and does not intend, to release publicly any updates or revisions to any forward-looking statements contained in this Offering Memorandum, to reflect any change in its expectations or any change in events, conditions or circumstances, on which any forward-looking statement contained in this Offering Memorandum is based.

SUMMARY

The following summary must be read as an introduction to this Offering Memorandum and any decision to invest in the Securities should be based on a consideration of this Offering Memorandum as a whole. Capitalized terms used but not defined in this summary are defined in the text of this Offering Memorandum. Investors should thoroughly consider this Offering Memorandum in its entirety, including the information set forth under "Available Information and Reports to Securityholders" and "Risk Factors," prior to an investment in the Securities. For information regarding the use of certain financial terms used in this Offering Memorandum, including sales, EBITA and Underlying EBITA, investors should refer to the information set forth under "Presentation of Currency and Financial Information".

No civil liability will attach to the Issuer in any relevant Member State of the European Economic Area (each an "EEA State") in respect of the following summary, including any translation hereof, unless it is misleading, inaccurate or inconsistent when read together with the other parts of this Offering Memorandum. Where a claim relating to information contained in this Offering Memorandum is brought before a court in an EEA State, the plaintiff may, under the national legislation of the Member State where the claim is brought, be required to bear the costs of translating this Offering Memorandum before the legal proceedings are initiated.

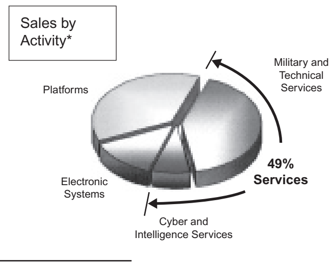
BAE Systems plc (the "Issuer") is a public limited company registered in England and Wales. The Issuer is the parent holding company of the BAE Systems group of companies (which, together with Issuer, are referred to herein as "BAE Systems").

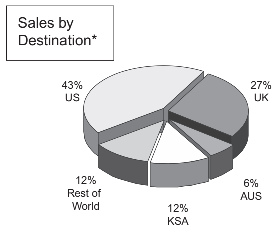
BAE Systems

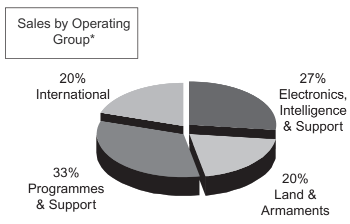
Business of BAE Systems

BAE Systems is a global defense and security company. BAE Systems delivers a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services. As of June 30, 2011, BAE Systems employed 95,600 employees and in 2010 generated sales of £22,392 million and Underlying EBITA of £2,214 million through its wholly-owned operations and equity accounted investments. On a restated basis, after giving effect to the classification of the Regional Aircraft line of business as a discontinued operation, BAE Systems had sales of £22,275 million and Underlying EBITA of £2,179 million in 2010. The issued ordinary shares of the Issuer are traded on the London Stock Exchange and the Issuer is a member of the FTSE 100 with a market capitalization of £8.4 billion as of October 4, 2011.

The following charts set forth BAE Systems' sales by operating activity, sales by destination and sales by operating group as of June 30, 2011.







* Sales excluding the HQ & Other Businesses operating group, before the elimination of intra-group sales.

BAE Systems is a major supplier to the United States Department of Defense. BAE Systems' two U.S.-managed operating groups, Electronics, Intelligence & Support and Land & Armaments, represented approximately 51% of total sales and approximately 56% of Underlying EBITA for 2010. The U.S. Department of Defense is BAE Systems' largest customer, with revenue in 2010 of £7,696 million, representing approximately 36% of total revenue in 2010.

BAE Systems reports based on the following principal operating groups:

Electronics, Intelligence & Support. The Electronics, Intelligence & Support (EI&S) operating group provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for U.S. national security and federal markets and ship repair and modernization services. The operating group is managed out of the United States and had 31,700 employees as of June 30, 2011. The operating group comprises three lines of businesses: Electronic Systems, Intelligence & Security and Support Solutions. Sales and Underlying EBITA of the Electronics, Intelligence & Support operating group (£5,653 million and £668 million, respectively) represented approximately 25% and 29%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

Land & Armaments. The Land & Armaments operating group designs, develops, produces, supports and upgrades armored combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products. The operating group is headquartered in the United States and had 14,200 employees as of June 30, 2011. Sales and Underlying EBITA of the Land & Armaments operating group (£5,930 million and £604 million, respectively) represented approximately 26% and 27%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

Programmes & Support. The Programmes & Support operating group primarily comprises BAE Systems' U.K.-based air, maritime and Cyber & Intelligence activities. The operating group is headquartered in the United Kingdom and had 30,300 employees as of June 30, 2011. Sales and Underlying EBITA of the Programmes & Support operating group (£6,680 million and £529 million, respectively) represented approximately 29% and 23%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

International. The International operating group comprises BAE Systems' businesses in Australia, India and Saudi Arabia, together with interests in the pan-European MBDA joint venture and Air Astana. The operating group had 17,500 employees as of June 30, 2011. Sales and Underlying EBITA of the International operating group (£4,534 million and £478 million, respectively) represented approximately 20% and 21%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

In addition, the HQ & Other Businesses operating group comprises the head office and United Kingdom shared services activity, including research centers and property management.

Changes to BAE Systems' external reporting segments are planned to improve the alignment of reporting with both markets served and management of operations.

BAE Systems' Strategy

At the core of BAE Systems' strategy is the creation of long-term, sustainable value for its shareholders, and leadership in three market segments — Services, Electronic Systems and Platforms. BAE Systems delivers its strategy through its strategic objectives, strategic actions and integrated business plans.

BAE Systems' strategic objectives are to:

- Operate and grow in the defense and security markets in the segments of Services, Electronic Systems and Platforms;
- Grow in existing home markets and develop new home markets; and
- Grow its export business.

BAE Systems' strategic objectives are enabled through the following strategic actions:

- Invest and grow in Services, including Military & Technical Services and Cyber & Intelligence;

- Invest and grow in Electronic Systems;
- Sustain its Platform positions;
- Implement the home market strategy to grow its business;
- Develop new home markets and grow its export business; and
- Implement rationalization and efficiency programs.

Financial Results

For the six months ended June 30, 2011, BAE Systems had sales of £9,229 million, compared with sales during the six months ended June 30, 2010 of £10,582 million. Underlying EBITA for the six months ended June 30, 2011 was £968 million compared with £1,097 million for the six months ended June 30, 2010. For the six months ended June 30, 2011, BAE Systems had operating profit of £757 million, compared with operating profit of £849 million in the six months ended June 30, 2010.

For the year ended December 31, 2010, BAE Systems had sales of £22,392 million, compared with 2009 sales of £21,990 million. Underlying EBITA for 2010 was £2,214 million compared with £2,197 million in 2009. For 2010, BAE Systems had operating profit for the year of £1,636 million, compared with operating profit of £966 million in 2009. On a restated basis, after giving effect to the classification of the Regional Aircraft line of business as a discontinued operation, BAE Systems had sales of £22,275 million, Underlying EBITA of £2,179 million and operating profit of £1,601 million in 2010.

Recent Developments

On July 28, 2011, BAE Systems announced that it commenced a share repurchase program of up to £500 million.

In September 2011, BAE Systems announced the sale of its Advanced Ceramics business in the United States for cash consideration of approximately $7 million. On July 15, 2011, the sale of BAE Systems' Regional Aircraft Asset Management business was completed for cash consideration of approximately $190 million. Also in July 2011, the sale of BAE Systems' U.S. Composite Structures business was completed for cash consideration of approximately $33 million.

Following recent severe weather along the east coast of the United States, BAE Systems is assessing the implications of serious flood damage at its Johnson City, New York electronics facility, forming part of BAE Systems' Electronic Systems business.

Principal Business Office

The Issuer's principal business office is located at 6 Carlton Gardens, London, SW1Y 5AD, United Kingdom, telephone number +44 (0)1252 373232.

Overview of Risk Factors

There are certain factors that may affect the Issuer's ability to fulfill its obligations under the Securities. In addition, there are certain factors which are material for the purpose of assessing the market risks associated with the Securities. These include the following:

- BAE Systems is dependent on defense spending and reductions in such spending could adversely affect BAE Systems;

- Certain parts of BAE Systems' business are dependent on a small number of large contracts;
- BAE Systems' largest customer contracts are government contracts;
- The timing of contract awards could materially affect BAE Systems' future results of operations and financial condition;
- BAE Systems has fixed-price contracts;
- BAE Systems is exposed to risks inherent in operating in a global market;
- BAE Systems is subject to export controls and other restrictions;
- BAE Systems is involved in consortia, joint ventures and equity holdings where it does not have control;
- BAE Systems' business is subject to significant competition;
- BAE Systems is exposed to funding risks in relation to the defined benefits under its pension schemes;
- BAE Systems has experienced growth through acquisitions. Anticipated benefits of acquisitions may not be realized;
- BAE Systems is subject to risk from a failure to comply with laws and regulations;
- BAE Systems is exposed to volatility in currency exchange rates;
- BAE Systems is dependent upon component availability, subcontractor performance and key suppliers;
- The Issuer is a holding company with no revenue-generating operations of its own;
- Investors in the Securities may have limited recourse against the independent auditor;
- There is no prior market for the Securities; and
- The Issuer does not intend to register the Securities for resale or to exchange a new series of registered securities for the Securities offered pursuant to this Offering Memorandum.

The Offering

Issuer	BAE Systems plc.
The Offering	3.50% Notes due 2016 (the "*2016 Notes*"), 4.75% Notes due 2021 (the "*2021 Notes*") and 5.80% Notes due 2041 (the "*2041 Notes*"). The 2016 Notes, the 2021 Notes and the 2041 Notes are referred to collectively as the "*Securities*", and are being offered in the United States to qualified institutional buyers ("*QIBs*") in reliance on Rule 144A under the Securities Act and outside the United States to non-U.S. persons in reliance upon Regulation S.
Principal Amount	2016 Notes: $350,000,000 aggregate principal amount. 2021 Notes: $500,000,000 aggregate principal amount. 2041 Notes: $400,000,000 aggregate principal amount.
Issue Price	2016 Notes: 99.650% of the principal amount, plus accrued interest from the issue date, if any. 2021 Notes: 99.898% of the principal amount, plus accrued interest from the issue date, if any. 2041 Notes: 99.479% of the principal amount, plus accrued interest from the issue date, if any.
Stated Maturity Date	2016 Notes: October 11, 2016. 2021 Notes: October 11, 2021. 2041 Notes: October 11, 2041.
Interest	The 2016 Notes will bear interest at the rate of 3.50% per year from October 11, 2011, based upon a 360-day year consisting of twelve 30-day months. The 2021 Notes will bear interest at the rate of 4.75% per year from October 11, 2011, based upon a 360-day year consisting of twelve 30-day months. The 2041 Notes will bear interest at the rate of 5.80% per year from October 11, 2011, based upon a 360-day year consisting of twelve 30-day months.
Interest Payment Dates	Interest on the Securities will be payable semi-annually in arrears on April 11 and October 11 of each year, commencing April 11, 2012.
Status of Securities	The Securities will be direct, unsecured and unsubordinated obligations of the Issuer, ranking *pari passu* among themselves and with all other direct, unsecured and unsubordinated obligations (except those obligations preferred by statute or operation of law) of the Issuer.
Restrictive Covenants	The Issuer has agreed to observe certain covenants with respect to the Securities including, among other things, limitations on liens and conditions relating to consolidation, merger and conveyance transactions. See "*Description of Securities — Certain Covenants.*"

Events of Default	For a discussion of certain events that will permit acceleration of the Securities, including acceleration of certain other indebtedness of the Issuer, see "*Description of Securities — Events of Default.*"
Optional Redemption	The Securities will be redeemable at the option of the Issuer at any time, in whole or in part, at a redemption price equal to the greater of (i) 100% of the outstanding principal amount of the Securities to be redeemed plus accrued but unpaid interest, if any, to the date of redemption and all Additional Amounts (as defined herein), if any, then due and (ii) the sum of the present values of the Remaining Scheduled Payments (as defined herein) thereon discounted to the redemption date on a semi-annual basis (assuming a 360-day year consisting of twelve 30-day months) at the Treasury Rate (as defined herein) plus 40 basis points (in the case of the 2016 Notes), the Treasury Rate plus 45 basis points (in the case of the 2021 Notes) or the Treasury Rate plus 45 basis points (in the case of the 2041 Notes). See "*Description of Securities — Optional Redemption.*"
Tax Redemption	The Securities may be redeemed in whole but not in part, at the option of the Issuer, at a redemption price equal to 100% of the principal amount (and premium, if any) thereof, plus accrued and unpaid interest to the date of redemption, if the Issuer has been or would be required to pay Additional Amounts under the Fiscal and Paying Agency Agreement with respect to the Securities. See "*Description of Securities — Redemption for Taxation Reasons.*"
Additional Amounts	Subject to certain exceptions and limitations, the Issuer will pay such Additional Amounts on the Securities as may be necessary to ensure that the net amounts received by each holder of a Security after all withholding or deductions, if any, shall equal the amount of principal (and premium, if any) and interest which such holder would have received in respect of such Security in the absence of such withholding or deduction. See "*Description of Securities — Additional Amounts.*"
Use of Proceeds	The proceeds to the Issuer from the offering are estimated to be approximately $1.24 billion, after deducting discounts and commissions but before deducting any expenses associated with the offering. The net proceeds of the offering will be used for general corporate purposes, including the repayment of indebtedness. See "*Use of Proceeds.*"
Denomination, Form and Registration of Securities	The Securities will be issued in fully registered form and only in denominations of $2,000 and integral multiples of $1,000 in excess thereof. The Securities will be issued initially as Global Securities. QIBs may elect to hold Securities purchased by them through the facilities of DTC, which will act as depositary for the Securities. Holders of Securities sold in offshore transactions in reliance on Regulation S under the Securities Act may elect to hold Global Securities through Euroclear and Clearstream. Prior to the date that is

	40 days after the later of the commencement of the offering or the closing date, beneficial interests in a Regulation S Global Security may be held only through Euroclear and Clearstream. See "*Description of Securities — Book-Entry; Delivery and Form.*"
Further Issues	The Issuer may from time to time without the consent of the holders of the Securities issue additional debt securities having the same terms and conditions as the Securities so that the further issue is consolidated and forms a single series of notes with the 2016 Notes, the 2021 Notes or the 2041 Notes, as applicable; *provided* that, unless issued under a separate CUSIP number, such additional debt securities will be fungible with the applicable outstanding Securities for U.S. federal income tax purposes. The period of the resale restrictions applicable to any Securities previously offered and sold in reliance on Rule 144A under the Securities Act shall automatically be extended to the last day of the period of any resale restrictions imposed on any such additional Securities.
Fiscal and Paying Agent	Citibank, N.A., London Branch.
Transfer Restrictions	The Securities have not been and will not be registered under the Securities Act and may be offered or sold only (1) in the United States to QIBs in reliance upon the exemption from the registration requirement of the Securities Act provided by Rule 144A and (2) outside the United States to non-U.S. persons in reliance upon Regulation S. See "*Transfer Restrictions.*"
Governing Law	The Fiscal and Paying Agency Agreement and the Securities will be governed by, and construed in accordance with, the laws of the State of New York.
Ratings	As of the date of this Offering Memorandum, the Issuer's long-term credit ratings are Baa2 ("Stable Outlook") (Moody's), BBB+ ("Stable Outlook") (Standard & Poor's) and BBB+ ("Stable Outlook") (Fitch). A rating is not a recommendation to buy, sell or hold Securities and may be subject to revision, suspension or withdrawal at any time by the assigning rating agency. Moody's is not established in the European Union and has not applied for registration under Regulation (EC) No. 1060/2009. Each of Standard & Poor's and Fitch is established in the European Union and has applied for registration under Regulation (EC) No. 1060/2009, although notification of the corresponding registration decision has not yet been provided by the relevant competent authority.
Listing	Application has been made to the Financial Services Authority in its capacity as competent authority under the Financial Services and Markets Act 2000 (the "*UK Listing Authority*") for the Securities to be admitted to the official list of the UK Listing Authority (the "*Official List*") and to the London Stock Exchange plc (the "*London Stock Exchange*") for the Securities to be admitted to trading on the London Stock Exchange's Regulated Market (the "*Market*").

SELECTED FINANCIAL AND OTHER DATA

The following tables present summary consolidated financial and certain other operating data for BAE Systems. Other than as described in footnotes 6 to 22 to these tables, the data presented in these tables as of and for the six months ended June 30, 2011 and 2010 are extracted from the BAE Systems Interim Financial Statements and related notes which are included elsewhere in this Offering Memorandum. The BAE Systems Interim Financial Statements and related notes have not been audited. The data as of and for the years ended December 31, 2010, 2009, 2008, 2007 and 2006 are extracted from the five-year summary included on pages F-59 and F-60 of this Offering Memorandum. The BAE Systems Annual Financial Statements and related notes as of and for the years ended December 31, 2010, 2009, 2008, 2007 and 2006 were audited by KPMG Audit Plc, independent accountants. Certain financial data for past periods has been restated to give effect to the classification of certain lines of business as discontinued operations. These tables should be read in conjunction with "*Management's Discussion and Analysis of Financial Condition and Results of Operations,*" "*Business*" and the BAE Systems Financial Statements and related notes.

The BAE Systems Annual Financial Statements are prepared in accordance with EU-endorsed IFRS and IFRICs. The BAE Systems Interim Financial Statements are prepared in accordance with IAS 34, *Interim Financial Reporting*.

	Six Months Ended June 30,		Year Ended December 31,				
	2011 (unaudited)	2010[1] (unaudited)	2010 (audited)	2009[2] (audited)	2008[2] (audited)	2007[2] (audited)	2006[2] (audited)
	(In £ millions, except order book, which is in £ billions, and personnel numbers)						
Profit and Loss Account Data:							
Sales[3]	9,229	10,582	22,392	21,990	18,136	15,360	13,439
Underlying EBITA[4]	968	1,097	2,214	2,197	1,879	1,417	1,169
Profit/(loss) on disposal of businesses	(6)	—	1	68	238	40	13
Pension curtailment gains	—	—	2	261	—	—	—
Uplift on acquired inventories	—	—	—	—	—	(12)	—
Regulatory Penalties	(49)	(18)	(18)	(278)	—	—	—
EBITA[5]	913	1,079	2,199	2,248	2,117	1,445	1,182
Amortization and impairment of intangible assets	(148)	(219)	(517)	(1,259)	(303)	(297)	(139)
Finance costs[3]	(62)	(66)	(194)	(698)	701	93	(174)
Profit before taxation	703	794	1,488	291	2,515	1,241	869
Taxation expense[3][6]	(203)	(242)	(461)	(352)	(636)	(366)	(243)
Profit/(loss) for the year from continuing operations	500	552	1,027	(61)	1,879	875	626
Profit/(loss) for the year from discontinued operations	(16)	73	54	16	(111)	47	1,013
Profit/(loss) for the period	484	625	1,081	(45)	1,768	922	1,639
Balance Sheet Data:							
Intangible assets	11,514		11,216	11,306	12,306	9,559	7,595
Property, plant and equipment, and investment property	2,646		2,848	2,663	2,558	1,887	1,869
Non-current investments[7]	844		798	852	1,040	787	678
Inventories	697		644	887	926	701	395
Assets held in Trust[8]	287		261	227	—	—	—
Payables (excluding cash on customers' account) less receivables[9]	(5,646)		(6,159)	(6,918)	(5,866)	(5,373)	(4,298)
Other financial assets and liabilities[10]	(59)		(10)	(45)	240	52	6
Retirement benefit obligations	(3,557)		(3,456)	(4,679)	(3,365)	(1,629)	(2,499)
Provisions	(900)		(1,077)	(929)	(845)	(809)	(695)
Net tax[11]	483		580	896	256	63	648
Net cash/(debt) as defined by BAE Systems[12]	(1,122)		(242)	403	39	700	435
Disposal groups held for sale[13]	104		—	—	—	64	—
Non-controlling interests	(57)		(71)	(72)	(55)	(36)	(17)
Total equity attributable to equity holders of the parent	5,234		5,332	4,591	7,234	5,966	4,117
Summarized Cash Flow Data:							
Cash flow from operating activities	176	(185)	1,535	2,232	2,009	2,162	778
Net capital expenditure and financial investment[14][15]	(146)	(143)	(364)	(489)	(503)	(262)	(141)
Dividends from equity accounted investments	6	24	71	77	89	78	145
Assets contributed to Trust[16]	(25)	(25)	(25)	(225)	—	—	—
Cash held for charitable contribution to Tanzania	—	—	(30)	—	—	—	—
Operating business cash flow	11	(329)	1,187	1,595	1,595	1,978	782
Acquisitions and disposals[17]	(382)	90	(88)	(254)	(1,038)	(2,112)	1,330
Net interest[18]	(96)	(83)	(173)	(186)	(98)	(65)	(207)
Income from financial assets at fair value through profit or loss	4	—	—	—	—	—	—
Tax and dividends[19]	(494)	(617)	(958)	(889)	(750)	(509)	(431)
Cash classified as held for sale	(15)	—	—	—	—	—	—
(Purchase)/issue of equity shares	(11)	(466)	(520)	(20)	(27)	603	(71)
Preference share conversion	—	—	—	—	—	245	6
Exchange movements[20]	53	(227)	(20)	262	(374)	36	323
Other movements[21]	44	16	(80)	(132)	5	57	(11)
Movement in cash received on customers' account[22]	6	11	—	—	—	—	—
Net (decrease)/increase in net funds	(880)	(1,605)	(652)	376	(687)	233	1,721
Other Data:							
Number of employees, excluding share of employees of equity accounted investments, at year end	89,000	95,000	92,000	98,000	94,000	88,000	79,000
Capital expenditures including leased assets	162	174	437	522	552	341	538
Order book including BAE Systems' share of equity accounted investments	36.9	43.4	39.7	46.3	45.7	37.9	30.9

(1) Restated following the classification of the Regional Aircraft line of business as a discontinued operation. See note 4 to the BAE Systems Interim Financial Statements.

(2) Restated following the sale of half of BAE Systems' 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation and following finalization of the fair values recognized on acquisition of the 45% shareholding in BVT Surface Fleet Limited. See notes 9 and 29 to the BAE Systems 2010 Annual Financial Statements.

(3) Includes share of equity accounted investments.

(4) Earnings before amortization and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

(5) Earnings before amortization and impairment of intangible assets, finance costs and taxation expense.

(6) Taxation expense for the six months ended June 30, 2011 and 2010 is derived from the line items UK taxation *plus* Overseas taxation *plus* Taxation expense of equity accounted investments in the BAE Systems Interim Financial Statements.

(7) Non-current investments as of June 30, 2011 is derived from the line items Equity accounted investments *plus* Other investments in the BAE Systems Interim Financial Statements.

(8) Assets held in Trust as of June 30, 2011 represents cumulative contributions of £275 million *plus* fair value gains of £12 million. See note 6 to the BAE Systems Interim Financial Statements.

(9) Payables (excluding cash on customers' account) less receivables as of June 30, 2011 is derived from the line items non-current Other receivables *plus* current Trade and other receivables including amounts due from customers for contract work *less* Trade and other payables in the BAE Systems Interim Financial Statements, excluding cash on customers' account of £10 million and a charitable contribution to Tanzania of £30 million.

(10) Other financial assets and liabilities as of June 30, 2011 is derived from the line items Other financial assets *less* Other financial liabilities in the BAE Systems Interim Financial Statements, excluding debt-related derivative financial assets of £37 million.

(11) Net tax as of June 30, 2011 is derived from the line items Deferred tax assets *plus* Current tax assets *less* Deferred tax liabilities *less* Current tax liabilities in the BAE Systems Interim Financial Statements.

(12) See "*Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources*".

(13) Disposal groups held for sale as of June 30, 2011 is derived from the line items Assets of disposal group held for sale *less* Liabilities of disposal group held for sale in the BAE Systems Interim Financial Statements.

(14) Includes net expenditure on property, plant and equipment, investment property, intangible assets and other investments and equity accounted investment funding.

(15) Net capital expenditure and financial investment for the six months ended June 30, 2011 and 2010 is derived from the line items Proceeds from sale of property, plant and equipment *plus* Proceeds from sale of investment property *less* Purchase of property, plant and equipment *less* Purchase of investment property *less* Purchase of intangible assets in the BAE Systems Interim Financial Statements.

(16) See note 6 to the BAE Systems Interim Financial Statements.

(17) Acquisitions and disposals for the six months ended June 30, 2011 and 2010 is derived from the line items Cash and cash equivalents acquired with subsidiary undertakings *plus* Proceeds from sale of subsidiary undertakings *plus* Proceeds from sale of equity accounted investments *plus* Proceeds from sale of financial assets at fair value through profit or loss *less* Purchase of subsidiary undertakings *less* Purchase of equity accounted investments *less* Cash and cash equivalents disposed of with subsidiary undertakings in the BAE Systems Interim Financial Statements.

(18) Net interest for the six months ended June 30, 2011 and 2010 is derived from the line items Interest received *less* Interest element of finance lease rental payments *less* Interest paid in the BAE Systems Interim Financial Statements.

(19) Tax and dividends for the six months ended June 30, 2011 and 2010 is derived from the line items Taxation paid *plus* Equity dividends paid *plus* Dividends paid to non-controlling interests in the BAE Systems Interim Financial Statements.

(20) Exchange movements for the six months ended June 30, 2011 and 2010 is derived from BAE Systems' accounting records.

(21) Other movements include cash flows from matured derivative financial instruments, cash flows from movement in cash collateral and other non-cash movements.

(22) Cash received on customers' account is included within Trade and other payables in BAE Systems' balance sheet. Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to BAE Systems' performance.

RISK FACTORS

The Issuer believes that the following factors may affect its ability to fulfil its obligations under the Securities. All of these factors are contingencies which may or may not occur, and the Issuer is not in a position to express a view on the likelihood of any such contingency occurring. Factors which the Issuer believes may be material for the purpose of assessing the market risks associated with the Securities are also described below.

The Issuer believes that the factors described below represent the principal risks inherent in investing in the Securities, but the Issuer may be unable to pay interest, principal or other amounts on or in connection with the Securities for other reasons, and the Issuer does not represent that the statements below regarding the risks of holding the Securities are exhaustive. Prospective investors should also read the detailed information set out elsewhere in this Offering Memorandum and reach their own views prior to making any investment decision.

Risks relating to the Industry and Business

BAE Systems is dependent on defense spending and reductions in such spending could adversely affect BAE Systems.

BAE Systems' core businesses are primarily defense- and security-related, selling products and services directly and indirectly primarily to the United States, United Kingdom, Saudi Arabian and other national governments. Defense spending depends on a complex mix of political considerations, budgetary constraints and the ability of the armed forces to meet specific threats and perform certain missions. Because of these factors, defense spending may be subject to significant fluctuations from year to year.

A decrease in defense purchases by BAE Systems' major customers could have a material adverse effect on BAE Systems' future results of operations and financial condition.

Certain parts of BAE Systems' business are dependent on a small number of large contracts.

A significant proportion of BAE Systems' revenue comes from a small number of large contracts. Each of these contracts, which are primarily in the Programmes & Support and International operating groups, is typically worth or potentially worth over £1 billion. The loss, expiration, suspension, cancellation or termination of any one of these contracts, for any reason, could have a material adverse effect on BAE Systems' future results of operations and financial condition.

BAE Systems' largest customer contracts are government contracts.

The governments of the United States, United Kingdom and Kingdom of Saudi Arabia are BAE Systems' three largest end customers. Any significant disruption or deterioration in the relationship with these governments and a corresponding reduction in government contracts would significantly reduce BAE Systems' revenues.

Companies engaged in the supply of defense- and security-related equipment and services to government agencies are subject to certain business risks particular to the defense and security industries. These governments could modify contracts or terminate them at short notice and at their convenience. For example, long-term United States government contracts are normally funded annually and are subject to cancellation or delay if funding appropriations for subsequent performance periods are not made. Terms and risk sharing agreements can also be amended. In addition, BAE Systems, as a government contractor, is subject to financial audits and other reviews by some of its governmental customers with respect to the performance of, and the accounting and general practices relating to, government contracts. As a result of these audits and reviews, costs and prices under these contracts may be subject to adjustment.

The termination of one or more of the contracts for BAE Systems' programs by governments, or the failure of the relevant agencies to obtain expected funding appropriations for BAE Systems' programs, could have a material adverse effect on BAE Systems' future results of operations and financial condition.

The timing of contract awards could materially affect BAE Systems' future results of operations and financial condition.

BAE Systems' operating performance and cash flows are dependent, to a significant extent, on the award of defense contracts. Because the amounts payable under these contracts can be substantial, the timing of award or failure to receive anticipated orders could materially affect BAE Systems' operating results and cash flow for the periods affected.

BAE Systems has fixed-price contracts.

A significant portion of BAE Systems' revenue is derived from fixed-price contracts. An inherent risk in these fixed-price contracts is that actual performance costs may exceed the projected costs on which the fixed prices for such contracts are agreed. These contracts can extend over many years and it can be difficult to predict the ultimate outturn costs associated with the terms on which they are based. BAE Systems' failure to anticipate technical problems, estimate costs accurately or control costs during performance of a fixed-price contract may reduce the profitability of such a contract or result in a loss.

BAE Systems is exposed to risks inherent in operating in a global market.

BAE Systems is a global company which conducts business in a number of regions, including the Middle East, and, as a result, assumes certain risks associated with businesses with a broad geographical reach. In some countries, these risks include, and are not limited to, the following:

- government regulations and administrative policies could change quickly and restraints on the movement of capital could be imposed;
- governments could expropriate BAE Systems' assets;
- burdensome taxes or tariffs could be introduced;
- political changes could lead to changes in the business environment in which BAE Systems operates; and
- economic downturns, political instability and civil disturbances could disrupt BAE Systems' business activities.

The occurrence of any such events could have a material adverse effect on BAE Systems' future operational performance and financial condition.

BAE Systems is subject to export controls and other restrictions.

A portion of BAE Systems' sales is derived from the export of its products. The export of defense and security products outside the jurisdictions in which they are produced is subject to licensing and export controls and other restrictions. No assurance can be given that the export controls to which BAE Systems is subject will not become more restrictive, that new generations of BAE Systems' products will not also be subject to similar or more stringent controls or that political factors or changing international circumstances will not result in BAE Systems being unable to obtain necessary export licenses. Reduced access to export markets could have a material adverse effect on BAE Systems' future results of operations and financial condition. Failure to comply with export controls and wider regulations could expose BAE Systems to fines, penalties, suspension or debarment, which could have a material adverse effect on BAE Systems.

BAE Systems is involved in consortia, joint ventures and equity holdings where it does not have control.

BAE Systems participates in various consortia, joint ventures and equity holdings, exercising varying and evolving degrees of control. While BAE Systems seeks to participate only in ventures in which its interests are aligned with those of its partners, the risk of disagreement is inherent in any jointly controlled entity, and particularly in those entities that require the unanimous consent of all members with regard to major decisions and that specify restricted rights. In the event of disagreement within a consortium, joint venture or equity holding and the business arrangement failing to meet its strategic objectives or expected benefits, BAE Systems' business and results of operations may be adversely affected.

BAE Systems' business is subject to significant competition.

Most of BAE Systems' businesses are focused on the defense and security sectors, and subject to competition from national and multi-national firms with substantial resources and capital, and many contracts are obtained through a competitive bidding process. BAE Systems' ability to compete for contracts depends to a large extent on the strength of its intellectual property rights and technical know-how, together with the effectiveness and innovation of its research and development programs, its ability to offer better program performance than its competitors at a lower cost to its customers, and the readiness of its facilities, equipment and personnel to undertake the programs for which it competes.

In some instances, governments direct to a single supplier all work for a particular program, commonly known as a sole-source program. Although governments have historically awarded certain programs to BAE Systems on a sole-source basis, they may in the future determine to open such programs to a competitive bidding process. In addition, government contracts for defense-related products can, in certain countries, be awarded on the basis of home country preference.

In the event that BAE Systems is unable adequately to compete in the markets in which it operates, BAE Systems' business and results of operations may be adversely affected.

BAE Systems is exposed to funding risks in relation to the defined benefits under its pension schemes.

BAE Systems operates certain defined benefit pension schemes. At present, in aggregate, there is an actuarial deficit between the value of the projected liabilities of these schemes and the value of the assets they hold. BAE Systems continues to implement the deficit recovery plans agreed with the respective scheme trustees based on actuarial advice and funding valuation results. The amount of the deficits may be adversely affected by changes in a number of factors, including investment returns, long-term interest rate and price inflation expectations and anticipated members' longevity. Further increases in pension scheme deficits may require BAE Systems to increase the amount of cash contributions payable to these schemes, thereby reducing cash available to meet BAE Systems' other operating, investing and financing requirements.

BAE Systems has experienced growth through acquisitions. Anticipated benefits of acquisitions may not be realized.

BAE Systems has experienced growth through acquisitions and continues to pursue acquisitions in order to meet its strategic objectives. Whether BAE Systems realizes the anticipated benefits from these transactions depends upon the integration of the acquired businesses and their performance relative to BAE Systems' acquisition expectations. The diversion of management attention to integration efforts, difficulties in combining operations and the performance of the acquired businesses below expectations could adversely affect BAE Systems' business, and create the risk of impairments arising on goodwill and other intangible assets.

BAE Systems is subject to risk from a failure to comply with laws and regulations.

BAE Systems has contracts and operations in many parts of the world, operates in a highly regulated environment and is subject to applicable laws and regulations of many jurisdictions. These include, without limitation, regulations relating to import-export controls, money-laundering, false accounting, anti-bribery and anti-boycott provisions. Non-compliance could expose BAE Systems to fines, penalties, suspension or debarment, which could have a material adverse effect on BAE Systems. From time to time, BAE Systems is subject to government investigations relating to its operations. Failure by BAE Systems or its sales representatives, marketing advisers or others acting on its behalf to comply with these laws and regulations could result in administrative, civil or criminal liabilities resulting in significant fines and penalties and/or result in the suspension or debarment of BAE Systems from government contracts for some period of time or suspension of BAE Systems' export privileges.

BAE Systems is exposed to volatility in currency exchange rates.

The global nature of BAE Systems' business means it is exposed to volatility in currency exchange rates in respect of foreign currency-denominated transactions, and the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. BAE Systems is exposed to a number of foreign currencies, the most significant being the U.S. dollar. Significant fluctuations in exchange rates to which BAE Systems is exposed could have a material adverse effect on BAE Systems' future results of operations and financial condition.

BAE Systems is dependent upon component availability, subcontractor performance and key suppliers.

BAE Systems is dependent upon the delivery of materials by suppliers and the assembly of components and subsystems by subcontractors used in its products in a timely and satisfactory manner, and in full compliance with applicable terms and conditions. Some of BAE Systems' suppliers or subcontractors may be impacted by the economic environment and constraints on available financing, which could impair their ability to meet their obligations to BAE Systems. In addition, some products require relatively scarce raw materials. BAE Systems is generally subject to specific procurement requirements which may, in effect, limit the suppliers and subcontractors BAE Systems may utilize. In some instances, BAE Systems is dependent on one or a limited number of suppliers. If any of these suppliers or subcontractors fails to meet BAE Systems' needs, BAE Systems may not, in the short term, have readily available alternatives or alternatives that are able to supply quantities BAE Systems requires, thereby impacting its ability to complete its customer obligations satisfactorily and in a timely manner. BAE Systems could incur additional costs in addressing any such problem. Any of these events could have a negative impact on BAE Systems' future results of operations and financial condition.

Risks Related to the Offering and the Securities

The Issuer is a holding company with no revenue-generating operations of its own.

The Issuer is a holding company and does not directly conduct any business operations. The business of BAE Systems is carried out through several operating subsidiaries and joint ventures. Therefore, securityholders will not have any direct claim on any of the income generated from BAE Systems' business operations.

Because the Issuer does not have significant business operations of its own, the Issuer will depend upon operating subsidiaries to provide the funds necessary to pay the principal of, and interest on, the Securities. These operating subsidiaries have not guaranteed the Securities, and have no obligation, contingent or otherwise, to pay amounts due under the Securities or to make funds available for these payments, whether in the form of loans, dividends or otherwise. Payments from the operating subsidiaries to the Issuer might not be able to be made in some circumstances, due to corporate law or contractual or other legal restrictions.

Securityholders will have a direct claim based on the Securities against the Issuer, but will not have a direct claim based on the Securities against any operating subsidiaries. The right of securityholders to receive payments under the Securities will be structurally subordinated to all liabilities of the operating subsidiaries. In the event of a bankruptcy, liquidation, reorganization or similar proceeding relating to a subsidiary, the right of securityholders to participate in a distribution of the assets of such subsidiary will rank behind such subsidiary's creditors (including trade creditors) and preferred stockholders (if any), except to the extent that the Issuer has direct claims against such subsidiary.

Investors in the Securities may have limited recourse against the independent auditor.

See "*Independent Accountants*" for a description of the independent auditor's reports to the members of BAE Systems plc dated February 16, 2011 and February 17, 2010 on the BAE Systems 2010 Annual Financial Statements and BAE Systems 2009 Annual Financial Statements, respectively. In accordance with guidance issued by The Institute of Chartered Accountants in England and Wales, each of the independent auditor's reports included in this Offering Memorandum states that: "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." The independent auditor's reports are included on pages F-3 and F-62 of this Offering Memorandum. The SEC would not permit such limiting language to be included in a registration statement or a prospectus used in connection with an offering of securities registered under the Securities Act or in a report filed under the Exchange Act. If a U.S. court (or any other court) were to give effect to such limiting language, the recourse that investors in the Securities may have against the independent auditor based on its report or the consolidated financial statements to which it relates could be limited.

There is no prior market for the Securities.

The Securities are new securities with no established trading market and the Issuer cannot assure you that any market will develop, or, if it does develop, that it will continue to exist. Although application has been made for the Securities to be admitted to the Official List and to trading on the Market, there can be no assurance that the Securities will be approved for listing or that such listing will be maintained. If a market for the Securities were to develop, prevailing interest rates and general market conditions could affect the price of the Securities. This could cause the Securities to trade at prices that may be lower than their principal amount or their initial offering price. As a result, the Issuer cannot assure you as to the liquidity of any trading market for the Securities.

The Issuer does not intend to register the Securities for resale or to exchange a new series of registered securities for the Securities offered pursuant to this Offering Memorandum.

The Securities have not been registered under the Securities Act, and the Issuer has no obligation or intention subsequently to register or exchange registered securities for the Securities. Accordingly, the Securities can only be offered or sold pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Therefore, a securityholder may be required to bear the risk of its investment for an indefinite period. For a discussion of certain restrictions on resale and transfer, see "*Transfer Restrictions.*"

CAPITALIZATION

The following table sets out the share capital and reserves and indebtedness of BAE Systems as at June 30, 2011. This table does not give effect to this offering and the use of proceeds from this offering. See "*Use of Proceeds*" and "*Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources*".

	As at June 30, 2011
	(In £ millions)
Share Capital and Reserves:	
Issued share capital — equity(1)	90
Issued share capital — non-equity(1)	—
Share premium	1,249
Other reserves(2)	5,445
Accumulated losses	(1,550)
Total equity attributable to equity holders of parent	5,234
Non-controlling interests	57
Total equity	5,291
Indebtedness and Other Borrowing:(3)(4)(5)(6)	
Long term loans	1,822
Short term loans(7)	1,011
Total indebtedness	2,833
Total capitalization(8)	8,124

(1) The following table sets out the share capital of BAE Systems at June 30, 2011.

	Authorized		Issued	
	Number	Value	Number	Value
		(In £)		(In £)
Equity: Ordinary shares of £0.025 each	4,800 million	90 million	3,588 million	90 million
Non-Equity: Special share of £1.00	1	1	1	1

(2) Other Reserves:

	(In £ millions)
Statutory reserve	202
Hedging reserve	47
Translation reserve	597
Revaluation reserve	10
Merger reserve	4,589
	5,445

Under Section 4 of the British Aerospace Act of 1980, the statutory reserve may only be applied in paying up unissued shares of BAE Systems to be allotted to members of BAE Systems as fully paid bonus shares.

(3) Except as set out in the table and excluding intercompany arrangements, BAE Systems did not have outstanding at June 30, 2011 any loan capital (either issued or created but unissued), term loans or other borrowings or indebtedness in the nature of borrowings, including bank overdrafts and liabilities under acceptances (other than normal trade bills) or acceptance credits, mortgages, charges or hire purchase commitments. BAE Systems' commitments under operating leases at December 31, 2010 are referred to in footnote 4 below.

(4) Under IFRS, operating lease commitments are not reported as indebtedness. See note 23 to the BAE Systems 2010 Annual Financial Statements.

(5) All debt is unsecured and not guaranteed by any third party.

(6) The carrying amount of loans and overdrafts at June 30, 2011 excludes debt-related derivative financial assets of £37 million presented as other financial assets on BAE Systems' balance sheet.

(7) Includes overdrafts.

(8) Total equity plus total indebtedness.

USE OF PROCEEDS

The proceeds to the Issuer from the offering are estimated to be approximately $1.24 billion, after deducting discounts and commissions but before deducting any expenses associated with the offering. The expenses associated with the offering are estimated to be approximately $1,140,000 (consisting of estimates of approximately $765,000 of legal, auditor and Fiscal and Paying Agent expenses, $55,000 of printing expenses, $20,000 of listing fees and $300,000 of expenses associated with obtaining a credit rating for the Securities). Actual amounts of expenses associated with the offering may vary from estimated amounts. The net proceeds from the offering will be used for general corporate purposes, including the repayment of indebtedness.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of the financial condition and results of operations of BAE Systems should be read in conjunction with the BAE Systems Financial Statements and related notes, and the other financial information included elsewhere in this Offering Memorandum. For information regarding the use of certain financial terms used in the following discussion and analysis, including sales, EBITA and Underlying EBITA, investors should refer to the information set forth under "Presentation of Currency and Financial Information".

Overview

General

BAE Systems is a global defense and security company. BAE Systems delivers a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services. Since 1999, through a series of strategic mergers, acquisitions and disposals, BAE Systems has transformed itself from a group focused primarily on the manufacture of military and commercial aircraft in the United Kingdom to become a premier global defense and security company. BAE Systems has home markets across the globe, in Australia, India, the Kingdom of Saudi Arabia, the United Kingdom and the United States.

Acquisitions and Joint Ventures

In addition to pursuing organic growth, BAE Systems has continued to make progress in developing its business through targeted acquisitions. BAE Systems completed a number of acquisitions in 2011 to date and in 2010 and 2009. Notably, and in line with BAE Systems' strategy, recent acquisitions have been made in Services and Electronic Systems, specifically in the areas of high technology electronic and electro-optic systems, Cyber & Intelligence and Military Services. BAE Systems continually examines the options for its business and reviews its portfolio to ensure it remains aligned to BAE Systems' strategy.

On March 21, 2011, BAE Systems acquired ETI A/S ("*ETI*") for cash consideration of DKK 1.2 billion (£135 million). ETI is a leading Danish Cyber & Intelligence company that provides advanced technology products and services to government and commercial clients worldwide. On February 18, 2011, BAE Systems acquired Norkom Group plc, a provider of innovative counter-fraud and anti-money laundering solutions to the global financial services industry, for cash consideration of €209 million (£177 million). Also in February 2011, BAE Systems completed its acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, a leading provider of security and counter threat capabilities to the United States government, for a cash consideration of approximately $291 million (£180 million).

In July 2010, BAE Systems completed its acquisition of Atlantic Marine Holding Company ("*Atlantic Marine*"), a naval services business, for $372 million (£245 million). The acquisition complements BAE Systems' existing ship repair and upgrade capabilities serving the United States Navy.

In October 2009, BAE Systems acquired VT Group plc's 45% shareholding in BVT Surface Fleet Limited for total consideration including transaction costs of £348 million, creating a wholly-owned subsidiary, BAE Systems Surface Ships Limited. The acquisition followed an agreement with the United Kingdom Ministry of Defence in July 2009 defining a Terms of Business Agreement that set out a 15-year partnering arrangement, including lead roles for the business on defined surface shipbuilding and support programs.

Divestitures and Sales

In June 2011, BAE Systems sold its remaining shareholding in Saab AB for SEK1,553 million (£152 million). That sale followed BAE Systems' sale in June 2010 of the first half of its non-strategic 20.5% shareholding in Saab AB for a cash consideration of SEK1,041 million (£92 million). On May 26, 2011, BAE Systems announced that it had agreed the sale of its Regional Aircraft Asset Management business. The disposal subsequently completed on July 15, 2011. On January 10, 2011, BAE Systems sold its Swiss-Photonics AG group, which was part of the Land & Armaments operating group, for cash consideration of approximately $10.9 million, including cash held in the disposed business.

Currency Exchange Rate Fluctuations

BAE Systems' business is exposed to a number of foreign currencies, the most significant being the U.S. dollar. BAE Systems' objective is to reduce its exposure to volatility in earnings and cash flows from movements in foreign currency exchange rates.

BAE Systems is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. To mitigate this risk, BAE Systems' policy is to hedge all material firm transactional exposures, unless otherwise approved as an exception by the Treasury Review Management Committee, as well as to manage anticipated economic cash flows over the medium term. BAE Systems aims, where possible, to apply hedge accounting treatment for all derivatives that hedge material transactional foreign currency exposures.

BAE Systems is also exposed to movements in foreign currency exchange rates in respect of the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. BAE Systems does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of overseas subsidiaries and equity accounted investments that it regards as long-term investments. Hedges are, however, undertaken in respect of investments that are not considered long-term or core to BAE Systems' business.

Recent Developments

On July 28, 2011, BAE Systems announced that it commenced a share repurchase program of up to £500 million.

In September 2011, BAE Systems announced the sale of its Advanced Ceramics business in the United States for cash consideration of approximately $7 million. On July 15, 2011, the sale of BAE Systems' Regional Aircraft Asset Management business was completed for cash consideration of approximately $190 million. Also in July 2011, the sale of BAE Systems' U.S. Composite Structures business was completed for cash consideration of approximately $33 million.

Following recent severe weather along the east coast of the United States, BAE Systems is assessing the implications of serious flood damage at its Johnson City, New York electronics facility, forming part of BAE Systems' Electronic Systems business.

Results of Operations for the Six Months Ended June 30, 2011 Compared with the Six Months Ended June 30, 2010

The following table presents BAE Systems' sales and Underlying EBITA by operating group for the six months ended June 30, 2011 and 2010.

	Six Months Ended June 30,			
	2011		2010[1]	
	Sales[2]	Underlying EBITA[3]	Sales[2]	Underlying EBITA[3]
	(In £ millions)			
Electronics, Intelligence & Support	2,573	298	2,624	296
Land & Armaments	1,846	180	3,074	316
Programmes & Support	3,140	285	3,035	316
International	1,862	221	2,078	218
HQ & Other Businesses	78	(16)	74	(49)
Subtotal	9,499	968	10,885	1,097
Less Intra-Operating Group Sales	(270)		(303)	
Total	9,229	968	10,582	1,097

(1) Restated following the classification of the Regional Aircraft line of business as a discontinued operation. See note 4 to the BAE Systems Interim Financial Statements.
(2) Includes share of equity accounted investments.
(3) Earnings before amortization and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Group Results of Operations

Sales

Sales decreased in the first half of 2011 by 13% to £9,229 million, from £10,582 million in the first half of 2010. On a like-for-like basis, after adjusting for the impact of exchange translation and acquisitions and disposals, sales were 13% lower in the first half of 2011 compared with the first half of 2010, largely driven by the anticipated land vehicle volume adjustment in the Land & Armaments operating group.

Underlying EBITA

Management uses an underlying profit measure to monitor the year-on-year profitability of BAE Systems, which is defined as earnings before amortization and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. The definition is consistent with the profit measure disclosed in note 2 to the BAE Systems Interim Financial Statements on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of BAE Systems' performance with reference to their materiality and nature. For the six months ended 2011 and 2010, non-recurring items comprised a loss from disposal of a business and regulatory penalties.

Underlying EBITA decreased by 12% to £968 million in the first half of 2011, compared with £1,097 million in the first half of 2010. Underlying EBITA for the first half of 2011 includes a charge of £160 million taken in respect of expected costs related to the Omani Offshore Patrol Vessel ("*OPV*") contract. As part of the termination settlements arising from the Government of the United Kingdom's Strategic Defence and Security Review ("*SDSR*") in 2010, there was an increased and accelerated level of rationalization costs recovered, amounting to £125 million in the first half of 2011. Return on sales, defined as Underlying EBITA expressed as a percentage of sales, increased to 10.5% in the first half of 2011 from 10.4% in the first half of 2010.

Loss on Disposal of Businesses

Loss on disposal of businesses was £6 million in the first half of 2011, reflecting a loss on the disposal of the Swiss-Photonics business, which was part of the Land & Armaments operating group. There was no gain or loss on the disposal of businesses for the first half of 2010.

Regulatory Penalties

Regulatory penalties were £49 million in the first half of 2011, compared with £18 million in the first half of 2010. Regulatory penalties in the first half of 2011 consisted of a fine agreed by BAE Systems with the U.S. Department of State to be paid in respect of alleged civil violations of U.S. defense export control regulations. Regulatory charges in the first half of 2010 reflected the U.S. dollar exchange rate movement on payment of the global settlement of the regulatory investigation by the U.S. Department of Justice.

Amortization of Intangible Assets

Amortization of intangible assets decreased by 40% to £126 million in the first half of 2011, compared with £211 million in the first half of 2010, mainly reflecting the profile of vehicle deliveries under the completed Family of Medium Tactical Vehicles ("*FMTV*") contract.

Impairment of Intangible Assets

Impairment of intangible assets totaled £22 million in the first half of 2011, compared with £8 million in the first half of 2010. Impairment of intangible assets in the first half of 2011 relates to charges taken for goodwill impairment on the Surface Ships business.

Net Financial Expense

Net financial expense was £62 million in the first half of 2011, a decrease of £4 million from £66 million in the first half of 2010. Net financial expense in the first half of 2011 includes £41 million relating to the early redemption of debt in June 2011 in connection with the disposal of the Regional Aircraft Asset Management business in July 2011.

A net credit of £55 million arose in the first half of 2011 from pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements. A similar net credit of £30 million arose in the first half of 2010.

Taxation Expense

The taxation expense of £203 million in the first half of 2011 reflects an effective tax rate for the period of 26%, compared with 30% in the first half of 2010. The effective tax rate in the first half of 2011 is based on profit before taxation, excluding regulatory penalties of £49 million, goodwill impairment of £22 million and loss on disposal of businesses of £6 million. The effective tax rate for the first half of 2011 was lower than previously expected as a result of agreements on prior year tax audits and settlements reached on outstanding items.

Earnings Per Share

Underlying earnings is defined as earnings excluding amortization and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives and non-recurring items. Underlying earnings per share from continuing operations for the first half of 2011 decreased by 4% to 19.2p, compared with 19.9p in the first half of 2010.

Basic earnings per share from continuing operations, defined in accordance with IAS 33, *Earnings Per Share*, for the first half of 2011 were 14.5p, representing a decrease of 7% from 15.6p in the first half of 2010.

Results of Operations by Operating Group

Electronics, Intelligence & Support

In the first half of 2011, the Electronics, Intelligence & Support ("*EI&S*") operating group had Underlying EBITA of £298 million on sales of £2,573 million, representing a £2 million (0.7%) increase in Underlying EBITA from £296 million and a £51 million (1.9%) decrease in sales from £2,624 million in the first half of 2010. EI&S generated an operating cash inflow, defined as net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments and assets contributed to Trust, of £226 million in the first half of 2011, compared to £267 million in the first half of 2010. Sales decreased by 2% on a like-for-like basis in the first half of 2011 compared to the first half of 2010, primarily reflecting the completed F-22 and Advanced Threat Infrared Countermeasures production programs.

Land & Armaments

In the first half of 2011, the Land & Armaments operating group had Underlying EBITA of £180 million on sales of £1,846 million, representing a £136 million (43.0%) decrease in Underlying EBITA from £316 million and a

£1,228 million (40.0%) decrease in sales from £3,074 million in the first half of 2010. Land & Armaments generated an operating cash inflow of £28 million in the first half of 2011, compared to £465 million in the first half of 2010. As expected, sales decreased by 38% on a like-for-like basis in the first half of 2011 compared to the first half of 2010, reflecting the lower level of Bradley reset activity and the completed FMTV program.

Programmes & Support

In the first half of 2011, the Programmes & Support operating group had Underlying EBITA of £285 million on sales of £3,140 million, representing a £31 million (9.8%) decrease in Underlying EBITA from £316 million and a £105 million (3.5%) increase in sales from £3,035 million in the first half of 2010. Return on sales in the first half of 2011 decreased to 9.1% from 10.4% in the first half of 2010. The lower Underlying EBITA in the first half of 2011 reflects a £160 million charge in respect of the Omani OPV contract, which was partially offset by £125 million relating to increased and accelerated rationalization costs recovered from the United Kingdom Ministry of Defence.

International

In the first half of 2011, the International operating group had Underlying EBITA of £221 million on sales of £1,862 million, representing a £3 million (1.4%) increase in Underlying EBITA from £218 million and a £216 million (10.4%) decrease in sales from £2,078 million in the first half of 2010. Return on sales in the first half of 2011 increased to 11.9% from 10.5% in the first half of 2010, resulting primarily from increased return on sales from the MBDA business. The International operating group had an operating cash outflow of £175 million in the first half of 2011, down from an outflow of £553 million in the first half of 2010, which reflects the expected utilization of advance funding on the Saudi Salam program in the first half of 2010. Revisions to the Salam program, which are expected to be concluded in 2011, are expected to bias sales to the second half of 2011.

HQ & Other Businesses

In the first half of 2011, the HQ & Other Businesses operating group reported a loss of £16 million on sales of £78 million, compared with a loss of £49 million on sales of £74 million in the first half of 2010. HQ & Other Businesses had an operating cash outflow of £147 million in the first half of 2011, compared with an operating cash outflow of £470 million in the first half of 2010. The HQ & Other Businesses operating group completed the sale of its Regional Aircraft Asset Management line of business in July 2011.

Results of Operations for the Year Ended December 31, 2010 Compared with the Year Ended December 31, 2009

The following table presents BAE Systems' sales and Underlying EBITA by operating group for the years ended December 31, 2010 and 2009.

	Year Ended December 31,			
	2010		2009[(1)]	
	Sales[(2)]	Underlying EBITA[(3)]	Sales[(2)]	Underlying EBITA[(3)]
	(In £ millions)			
Electronics, Intelligence & Support	5,653	668	5,637	575
Land & Armaments	5,930	604	6,738	604
Programmes & Support	6,680	529	6,298	670
International	4,534	478	3,828	419
HQ & Other Businesses	278	(65)	254	(71)
Subtotal	23,075	2,214	22,755	2,197
Less Intra-Operating Group Sales	(683)		(765)	
Total	22,392	2,214	21,990	2,197

(1) Restated following the sale of half of BAE Systems' 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation. See note 9 to the BAE Systems 2010 Annual Financial Statements.
(2) Includes share of equity accounted investments.
(3) Earnings before amortization and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Group Results of Operations

Sales

Sales in 2010 increased by 1.8% to £22,392 million from £21,990 million in 2009. Like-for-like sales, after adjusting for the impact of exchange translation and acquisitions and disposals, decreased by 1.9%, primarily driven by a lower level of land vehicle sales in the United States. The decrease in like-for-like sales was partially offset by increased Typhoon deliveries and support activities in the Kingdom of Saudi Arabia. U.S.-led businesses were responsible for 51% of sales in 2010, down from 55% in 2009. Sales generated from BAE Systems' home markets were 92% in both 2010 and 2009.

Underlying EBITA

Management uses an underlying profit measure to monitor the year-on-year profitability of BAE Systems, which is defined as earnings before amortization and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. The definition is consistent with the profit measure disclosed in note 3 to the BAE Systems 2010 Annual Financial Statements on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of BAE Systems' performance with reference to their materiality and nature. In 2010 and 2009, non-recurring items included profit from disposal of businesses, pension accounting gain and regulatory penalties.

Underlying EBITA increased by 0.8% to £2,214 million in 2010, compared with £2,197 million in 2009. The increase in Underlying EBITA includes a favorable exchange translation of £25 million. A charge of £100 million was taken in 2010 in respect of the terminated Trinidad and Tobago ship contract. Return on sales was 9.9% in 2010 and 10.0% in 2009. Excluding the £100 million charge related to the Trinidad and Tobago ship contract, return on sales in 2010 was 10.3%. U.S.-led businesses accounted for 56% of Underlying EBITA in 2010, up from 52% in 2009.

Profit on Disposal of Businesses

In 2009, profit on disposal of businesses was £68 million, including £58 million from the finalization of the accounting gain arising from the disposal of BAE Systems' interests in businesses contributed to the BVT Surface Fleet joint venture. Profit on disposal of businesses was £1 million in 2010.

Pension Accounting Gain

In 2009, pension accounting gain was £261 million, resulting from pension benefit restructuring in the United States. Pension accounting gain in 2010 was £2 million.

Regulatory Penalties

Regulatory penalties were £18 million in 2010, compared with £278 million in 2009. Regulatory penalties in 2009 reflect the global settlement of the regulatory investigations by the United States Department of Justice and the United Kingdom's Serious Fraud Office. Regulatory penalties in 2010 reflect the U.S. dollar exchange rate movement on payment of the global settlement of the regulatory investigation by the U.S. Department of Justice.

Amortization of Intangible Assets

Amortization of intangible assets increased by £106 million in 2010 to £392 million, from £286 million in 2009, primarily reflecting the profile of vehicle deliveries under the FMTV contract.

Impairment of Intangible Assets

Impairment of intangible assets totaled £125 million in 2010, down from £973 million in 2009. Impairment of intangible assets in 2010 includes £70 million relating to the Surface Ships business, primarily arising from the underperformance of the ex-VT Group export ship contracts. The £973 million charge in 2009 was primarily driven by the non-award of the follow-on FMTV production contract (£592 million) and weaker outlook for the U.S.-based Products Group business (£264 million).

Net Financial Expense

Net financial expense decreased to £194 million in 2010 from £698 million in 2009. The underlying interest charge in 2010 was £191 million, compared with £193 million in 2009. A net expense of £3 million arose in 2010 from pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements. The £504 million decrease in net finance expense between 2009 and 2010 resulted primarily from a net expense of £505 million in 2009 that arose from movements in exchange rates on the unhedged element of an intercompany loan from the United Kingdom to the United States business. That loan has been capitalized.

Taxation Expense

The taxation expense of £461 million in 2010 reflects an effective tax rate of 29%, compared with 28% in 2009. The effective tax rate in 2010 is based on profit before taxation, excluding goodwill impairment of £84 million and regulatory penalties of £18 million. The effective tax rate in 2009 is based on profit before taxation, excluding goodwill impairment of £725 million and regulatory penalties of £278 million.

Underlying Earnings

Underlying earnings is defined as earnings excluding amortization and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives and non-recurring items. In 2010, underlying earnings per share from continuing operations increased by 1.7% to 40.8p, compared with 40.1p in 2009. The effect of the £100 million charge taken in 2010 in respect of the terminated Trinidad and Tobago ship contract, net of tax, amounts to an underlying earnings per share reduction of 2.1p. Excluding that charge, underlying earnings per share from continuing operations in 2010 increased by 7.0% compared with 2009.

Basic earnings per share from continuing operations, defined in accordance with IAS 33, *Earnings per Share*, increased to 28.9p in 2010, compared with a loss of 2.3p in 2009.

Results of Operations by Operating Group

Electronics, Intelligence & Support

In 2010, the EI&S operating group had Underlying EBITA of £668 million on sales of £5,653 million, representing a £93 million (16.2%) increase in Underlying EBITA from £575 million and a £16 million (0.3%) increase in sales from £5,637 million in 2009. On a like-for-like basis, sales in 2010 decreased by 2.4% compared with 2009, primarily reflecting the impact of contracting delays caused by extended Continuing Resolution funding (which provides funding only for existing federal programs at current or reduced levels) at the end of 2009. Return on sales increased to 11.8% in 2010 from 10.2% in 2009, driven primarily by good program execution on certain maturing programs and ongoing cost reduction and efficiency programs. The EI&S operating group generated an operating cash inflow of £568 million in 2010, up from £380 million in 2009, reflecting good working capital management.

Land & Armaments

In 2010, the Land & Armaments operating group had Underlying EBITA of £604 million on sales of £5,930 million, representing unchanged Underlying EBITA and a £808 million (12.0%) decrease in sales from £6,738 million in 2009. On a like-for-like basis, sales in 2010 decreased 13.7% compared with 2009, reflecting a lower level of land vehicle activity, primarily FMTV and Bradley vehicles. Underlying EBITA in 2009 included £42 million in costs associated with the unsuccessful Mine Resistant Ambush Protected ("*MRAP*") All-Terrain Vehicle ("*ATV*") bid. Return on sales increased to 10.2% in 2010 from 9.0% in 2009, benefiting both from performance on the FMTV and Bradley programs and from continuing rationalization and efficiency activities. The Land & Armaments operating group generated an operating cash inflow of £858 million in 2010, up from £480 million in 2009, reflecting good working capital management.

Programmes & Support

In 2010, the Programmes & Support operating group had Underlying EBITA of £529 million on sales of £6,680 million, representing a £141 million (21.0%) decrease in Underlying EBITA from £670 million and a £382 million (6.1%) increase in sales from £6,298 million in 2009. On a like-for-like basis, sales in 2010 were broadly unchanged from 2009. Underlying EBITA in 2010 includes a £100 million charge in respect of the terminated Trinidad and Tobago OPV program. Return on sales decreased to 7.9% in 2010 from 10.6% in 2009, driven primarily by the £100 million charge in respect of the terminated Trinidad and Tobago OPV program and the impact of higher pension service costs arising from a fall in the discount rates applied to pension liabilities.

Order intake decreased to £4.1 billion in 2010 from £8.8 billion in 2009. The decrease was primarily driven by long-term orders in 2009 for the production of Typhoon Tranche 3A aircraft and support for Typhoon, Harrier, Type 45 and Spearfish and Sting Ray torpedoes.

International

In 2010, the International operating group had Underlying EBITA of £478 million on sales of £4,534 million, representing a £59 million (14.1%) increase in Underlying EBITA from £419 million and a £706 million (18.4%) increase in sales from £3,828 million in 2009. The increase in sales was predominantly a result of increased activity in the Saudi British Defence Co-operation Programme ("*SBDCP*") in the Kingdom of Saudi Arabia and progress on the Landing Helicopter Dock program in Australia.

Return on sales decreased to 10.5% in 2010 from 10.9% in 2009 due to the low margin being traded on increased activity in the early stages of the Saudi Salam and Landing Helicopter Dock programs, which was partially offset by increased return on sales from the MBDA business. The International operating group had an operating cash inflow of £195 million in 2010, down from an inflow of £813 million in 2009, reflecting the expected utilization of advance funding on the Saudi Salam program in 2010.

HQ & Other Businesses

In 2010, the HQ & Other Businesses operating group reported a loss of £65 million on sales of £278 million, compared with a loss of £71 million on sales of £254 million in 2009. Operating cash outflow in 2010 was £665 million, compared with an outflow of £366 million in 2009. 2010 operating cash outflow includes the payment of a £266 million regulatory penalty to the United States Department of Justice and additional contributions in respect of United Kingdom pension schemes totaling £326 million. Contributions in respect of United Kingdom pension schemes were £310 million in 2009.

Liquidity and Capital Resources

The following table sets forth a reconciliation of Cash inflow/(outflow) from operating activities as included in the BAE Systems Financial Statements to Net cash/(debt) (as defined by BAE Systems) for the six months ended June 30, 2011 and 2010 and the years ended December 31, 2010 and 2009. The information provided below is also provided by BAE Systems in its Half-Yearly Report and Presentation 2011 (Interim Management Report section) and 2010 Annual Report (Group Performance section), respectively. Copies of the Half-Yearly Report and Presentation 2011 and the 2010 Annual Report can be obtained through the website maintained by BAE Systems at http://www.baesystems.com. Information on BAE Systems' website or contained in the Half-Yearly Report and Presentation 2011 and the 2010 Annual Report is not incorporated by reference into this Offering Memorandum.

	June 30,		December 31,	
	2011	2010	2010	2009
	(In £ millions)			
Cash inflow/(outflow) from operating activities	176	(185)	1,535	2,232
Capital expenditure (net) and financial investment	(146)	(143)	(364)	(489)
Dividends received from equity accounted investments	6	24	71	77
Assets contributed to Trust	(25)	(25)	(25)	(225)
Cash held for charitable contribution to Tanzania	—	—	(30)	—
Operating business cash flow	11	(329)	1,187	1,595
Electronics, Intelligence & Support	226	267	568	380
Land & Armaments	28	465	858	480
Programmes & Support	56	(50)	227	285
International	(175)	(553)	195	813
HQ & Other Businesses	(147)	(470)[1]	(665)	(366)[2]
Discontinued operations	23	12[1]	4	3[2]
Operating business cash flow	11	(329)	1,187	1,595
Interest	(96)	(83)	(173)	(186)
Income from financial assets as fair value through profit or loss	4	—	—	—
Taxation	(117)	(257)	(352)	(350)
Free cash inflow	(198)	(669)	662	1,059
Acquisitions & disposals	(382)	90	(88)	(253)
Debt acquired on acquisition of subsidiary	—	—	—	(1)
Cash classified as held for sale	(15)	—	—	—
(Purchase)/issue of equity shares (net)	(11)	(466)	(520)	(20)
Equity dividends paid	(359)	(335)	(574)	(534)
Dividends paid to non-controlling interests	(18)	(25)	(32)	(5)
Cash inflow/(outflow) from matured derivative financial instruments	38	(82)	(123)	36
Movement in cash collateral	(3)	11	11	(11)
Other non-cash movements	9	87	32	(157)
Foreign exchange translation	53	(227)	(20)	262
Movement in cash on customers' account[3]	6	11	7	(12)
Total cash (outflow)/inflow	(880)	(1,605)	(645)	364
Opening net (debt)/cash as defined by BAE Systems	(242)	403	403	39
Closing net (debt)/cash as defined by BAE Systems	(1,122)	(1,202)	(242)	403
The components of net cash as defined by BAE Systems are as follows:				
Debt-related derivative financial assets	37	108	45	39
Other investments — current	274	246	260	211
Cash and cash equivalents	1,742	2,492	2,813	3,693
Loans — non-current	(1,822)	(2,978)	(2,133)	(2,840)
Loans and overdrafts — current	(1,011)	(800)	(920)	(453)
Less: Cash on customers' account[3]	(10)	(9)	(16)	(20)
Less: Assets held in Trust	(287)	(261)	(261)	(227)
Less: Cash held for charitable contribution in Tanzania	(30)	—	(30)	—
Less: Cash classified as held for sale	(15)	—	—	—
Closing net cash/(debt) as defined by BAE Systems	(1,122)	(1,202)	(242)	403

(1) Restated following the classification of the Regional Aircraft line of business as a discontinued operation. See note 4 of the BAE Systems Interim Financial Statements.
(2) Restated following the sale of half of BAE Systems' 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation. See note 9 of the BAE Systems 2010 Annual Financial Statements.
(3) Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to BAE Systems' performance. It is included within trade and other payables in BAE Systems' balance sheet.

Cash inflow from operating activities was £176 million in the first half of 2011, up from a cash outflow of £185 million in the first half of 2010. Cash inflow from operating activities in all of 2010 was £1,535 million, down from £2,232 million in 2009. The lower cash inflow in 2010 was primarily the result of a £266 million payment to the United States Department of Justice in the first half of 2010 and contributions in excess of service costs for the United Kingdom and United States pension schemes totaling £554 million, up from £475 million in 2009.

The decrease in cash outflow from net capital expenditure and financial investment from £489 million in 2009 to £364 million in 2010 was the result of £94 million in expenditures in 2009 for new residential and office facilities in Saudi Arabia.

Dividends from equity accounted investments in the first half of 2011 were primarily from Advanced Electronics Company and Eurofighter GmbH, totaling £6 million in the first half of 2011, down from £24 million in the first half of 2010. Dividends from equity accounted investments in 2010 and 2009 were primarily from MBDA, FNSS, Air Astana, Advanced Electronics Company and Eurofighter GmbH.

Assets contributed to Trust comprises payments made into Trust for the benefit of BAE Systems' main pension scheme. These payments were £25 million in each of the first halves of 2011 and 2010, £25 million for all of 2010 and £225 million in 2009.

An agreement with the United Kingdom Serious Fraud Office in February 2010 provided for a payment of £30 million by BAE Systems for the benefit of the people of Tanzania, less any penalty imposed by the court in connection with the agreed basis of settlement. A penalty of £500,000 (together with costs of £225,000) was imposed by the court in December 2010. The remaining balance of £29.5 million (together with interest) will be applied by BAE Systems for the benefit of the people of Tanzania in accordance with the applicable BAE Systems policies, including those relating to business conduct and the making of charitable contributions.

Taxation payments decreased £140 million to £117 million in the first half of 2011, from £257 million in the first half of 2010, driven primarily by timing differences on United States tax payments between the two periods. Taxation payments were £352 million in 2010 and £350 million in 2009.

In the first half of 2011, the net cash outflow in respect of acquisitions and disposals of £382 million includes the acquisitions of L-1 Identity Solutions, Inc.'s Intelligence Services Group, Norkom Group plc, ETI A/S, Fairchild Imaging, Inc. and stratsec.net Pty Limited (totaling £524 million), and deferred consideration paid relating to the 2010 acquisition of OASYS Technology, LLC (£13 million). Cash outflow for acquisitions in the first half of 2011 was offset by the proceeds from the disposal of BAE Systems' residual shareholding in Saab AB in June 2011 (£152 million).

In 2010, the net cash outflow in respect of acquisitions and disposals of £88 million includes the acquisitions of Atlantic Marine and OASYS Technology (totaling £260 million), offset by the disposal of half of BAE Systems' 20.5% shareholding in Saab AB (£92 million) and an initial payment of A$112.5 million (£65 million, net of legal fees) received from the former owners of the Tenix Defence business relating to the resolution of outstanding issues arising from BAE Systems' 2008 acquisition of Tenix Defence. In 2009, the net cash outflow of £253 million mainly reflects £315 million, net of £33 million cash acquired, paid to acquire VT Group's 45% interest in BVT, offset by £70 million in deferred consideration received relating to the 2008 disposal of a 50% interest in Flagship Training.

The net purchase of equity shares of £520 million in 2010 includes 144 million shares purchased under BAE Systems' share buyback program at a cost of £500 million (excluding transaction costs of £3 million). That share buyback program was completed in July 2010.

BAE Systems has financed part of its investment in the United States through an intercompany loan. As a consequence of movements in the U.S. dollar and Euro exchange rates during 2010, there was a cash outflow from matured derivative financial instruments of £123 million, compared with an inflow of £36 million in 2009, from rolling hedges on balances with BAE Systems' subsidiaries and equity accounted investments. There was a cash inflow from matured derivative financial instruments of £38 million in the first half of 2011, up from an outflow of £82 million in the first half of 2010.

Foreign exchange translation primarily arises in respect of BAE Systems' U.S. dollar-denominated borrowing.

Liquidity

BAE Systems had cash and short-term investments at June 30, 2011 of £2,001 million excluding cash held for sale, compared with £3,073 million at December 31, 2010. This, together with an undrawn committed Revolving Credit Facility ("*RCF*") of £2.0 billion (which is syndicated amongst BAE Systems' core relationship banks), is available to meet expected general corporate funding requirements. The RCF provides standby funding for BAE Systems' U.S. Commercial Paper program. As of December 31, 2010, BAE Systems had £144 million of commercial paper outstanding. Following renegotiation in December 2010, the RCF is contracted until 2015. The RCF remained undrawn throughout 2010 and the first half of 2011 and through the date of this Offering Memorandum.

The net proceeds from this offering will be used for general corporate purposes, including the repayment of indebtedness.

BAE Systems adopts a conservative approach to the investment of its surplus cash. It is deposited with strong financial institutions for short periods. Bank counterparty credit risk is monitored closely on a systematic and ongoing basis. A credit limit is allocated to each institution taking account of its market capitalization, credit rating and credit default swap price. For internal credit risk assessment purposes, all transactions are marked-to-market and any resultant exposure is allocated against the credit limit.

Generally, excluding the impact of acquisition or disposal financing and share repurchases, net cash/debt (as defined by BAE Systems) is driven by the operational performance of BAE Systems' subsidiaries and equity accounted investments, and the level of receipts on major contracts. Historically, the net cash/debt position of BAE Systems has been at its best at the year end.

The maturity of BAE Systems' borrowings is as follows:

	Six Months Ended June 30, 2011[(1)]	**Year Ended December 31, 2010[(2)]**
	£m	**£m**
Less than one year	1,003	903
Between one and five years	863	1,162
More than five years	930	943
Loans and overdrafts — current and non-current	2,796	3,008

(1) The carrying amount of loans and overdrafts at June 30, 2011 includes debt-related derivative financial assets of £37 million presented as other financial assets on BAE Systems' balance sheet.

(2) The carrying amount of loans and overdrafts at December 31, 2010 includes debt-related derivative financial assets of £45 million presented as other financial assets on BAE Systems' balance sheet.

BAE Systems' non-current borrowings as at June 30, 2011 are as follows:

	June 30, 2011
	£m
Euro-Sterling £100 million 10¾% bond, repayable 2014	100
US$500 million 4.95% bond, repayable 2014	309
US$750 million 5.2% bond, repayable 2015	466
Albertville Hangar Bond, repayable 2018	6
US$1 billion 6.375% bond, repayable 2019	632
US$500 million 7.5% bond, repayable 2027	309
	1,822

A more detailed analysis of BAE Systems' loans and overdrafts as at December 31, 2010 is provided in note 19 to the BAE Systems 2010 Annual Financial Statements.

BAE Systems believes that its current cash balances, together with its existing credit lines and other available sources of liquidity, and expected cash flow from its operating activities will be sufficient for the foreseeable future to fund its working capital requirements and operations, permit anticipated capital expenditures and make required payments of principal and interest on its debt.

Capital structure

BAE Systems funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings. All of BAE Systems' material borrowings are arranged by the central treasury department and funds raised are lent onward to operating subsidiaries as required. Surplus funds are lent back to the central treasury department where appropriate. BAE Systems' objective is to maintain a balance between the continuity, flexibility and cost of debt funding through the use of borrowings from a range of markets with a range of maturities, currencies and rates of interest, reflecting BAE Systems' risk profile.

Details of BAE Systems' debt are included in note 19 to the BAE Systems 2010 Annual Financial Statements. In connection with the disposal of the Regional Aircraft Asset Management business, which completed in July 2011, BAE Systems redeemed $514 million (£318 million) of debt in June 2011, which had been secured against the aircraft disposed of. During August 2010, a $500 million 4.75% bond was repaid. This repayment was pre-financed as part of $1.5 billion raised in the United States bond market in 2009. It remains BAE Systems' intention to ensure the business is funded conservatively and to be proactive in accessing the bank and capital markets in achieving this aim.

Capital Expenditure

Capital expenditure during the six months ended June 30, 2011 and the year ended December 31, 2010 was primarily funded by cash from business operations.

Set out below is a summary of the capital expenditure information for BAE Systems for the years ended December 31, 2010 and 2009:

	Year Ended December 31,	
	2010(1)	2009(1)
	£m	£m
Electronics, Intelligence & Support	116	123
Land & Armaments	99	84
Programmes & Support	119	109
International	61	142
HQ & Other Businesses	42	64
Total capital expenditure	437	522

(1) Includes intangible assets, property, plant and equipment and investment property.

Major capital expenditure in 2009 included £94 million in respect of new residential and office facilities in Saudi Arabia.

Insurance

BAE Systems operates a policy of partial self-insurance, with the majority of cover placed in the external market. BAE Systems continues to monitor its insurance arrangements to ensure the quality and adequacy of cover.

Credit rating

Three credit rating agencies, Moody's Investors Service, Standard and Poor's Ratings Services and Fitch's Investors Service, publish credit ratings for BAE Systems. During 2010, all three maintained the outlook for their ratings as stable.

As of the date of this Offering Memorandum, BAE Systems' long-term credit ratings provided by these agencies were as follows:

Rating agency	Rating	Outlook	Category
Moody's	Baa2	Stable	Investment grade
Standard & Poor's	BBB+	Stable	Investment grade
Fitch	BBB+	Stable	Investment grade

The Board continues to view the maintenance of an investment grade credit rating as important to the efficient operation of BAE Systems' activities.

Moody's is not established in the European Union and has not applied for registration under Regulation (EC) No. 1060/2009. Each of Standard & Poor's and Fitch is established in the European Union and has applied for registration under Regulation (EC) No. 1060/2009, although notification of the corresponding registration decision has not yet been provided by the relevant competent authority.

Pension Schemes

BAE Systems operates pension plans for its qualifying employees in the United Kingdom, the United States and other countries. The principal plans in the United Kingdom and the United States are funded defined benefit plans, and the assets are held in separate trustee administered funds. The plans in other countries are unfunded or defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate any deficit under IAS 19. BAE Systems also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of BAE Systems' U.S. subsidiaries.

At present, there is an actuarial deficit between the aggregate value of projected liabilities of BAE Systems' defined benefit pension schemes and the value of the assets that the schemes hold. During the first half of 2011, the IAS 19 deficit increased by £225 million to £4,328 million at June 30, 2011. BAE Systems' share of IAS 19 deficit excluding BAE Systems' share of amounts allocated to equity accounted investments and other participating employers at June 30, 2011 was £3,505 million.

BAE Systems has put into place and is implementing deficit recovery plans in line with the agreements reached with pension scheme trustees based on actuarial advice and the schemes' valuation results. The current deficit recovery plan agreed with the trustees of BAE Systems' main United Kingdom pension scheme runs until April 2026 and includes annual lump sum contributions of £40 million until 2016. In addition, as part of the agreed deficit recovery plan, BAE Systems contributed a further £25 million into Trust both in 2010 and in the first half of 2011. The cumulative contributions into Trust totaling £275 million, plus fair value gains of £12 million, are reported within other investments (£274 million) and cash and cash equivalents (£13 million) at June 30, 2011. The use of these assets is restricted under the terms of the Trust. BAE Systems considers these contributions to be equivalent to the other lump sum contributions it makes into BAE Systems' pension schemes. BAE Systems also made an additional contribution of $250 million to its United States pension scheme in 2009.

During 2010, BAE Systems made an incremental lump sum contribution of £51 million into the BAE Systems 2000 Pension Plan in advance of the finalization of discussions between the trustees and BAE Systems to determine the funding implications of the 2010 triennial valuation. The deficit recovery plan in respect of the 2000 Pension Plan includes lump sum contributions of £15 million in 2011 and £77 million in 2012, and annual lump sum contributions of £54 million thereafter.

BAE Systems also made contributions to the United Kingdom pension schemes totaling £157 million following the £500 million share buyback program that completed in July 2010. In July 2011, BAE Systems commenced a further share repurchase program of up to £500 million. Consistent with the 2010 program, BAE Systems anticipates accelerated pension deficit funding of a similar amount in the final quarter of 2011, following discussions with pension scheme trustees.

Funding deficits are expected to increase primarily due to lower discount rates. This has led to an estimated increase in the deficit to be funded of approximately £1 billion under United Kingdom pension schemes as of 2011 as compared with the anticipated 2011 funding deficits that had been estimated at the time of the last actuarial valuations in 2007/2008, part of which is being funded by the deficit recovery plan in respect of the 2000 Pension Plan mentioned above. Discussions with the trustees regarding the implications for deficit funding are ongoing.

Additional details concerning BAE Systems' retirement benefit plans are provided in note 1 and note 21 to the BAE Systems 2010 Annual Financial Statements.

Critical Accounting Policies

BAE Systems' significant accounting policies are outlined in note 1 to the BAE Systems Annual Financial Statements. Not all of these significant accounting policies require management to make difficult, subjective or complex judgments or estimates.

The following is intended to provide an understanding of those policies that management considers critical because of the level of complexity, judgment or estimation involved in their application and their impact on the consolidated financial statements. These judgments involve assumptions or estimates in respect of future events, which can vary from what is anticipated. However, the directors believe that the consolidated financial statements in the BAE Systems Annual Financial Statements reflect appropriate judgments and estimations, and provide a true and fair view of BAE Systems' financial performance and position over the relevant period.

Revenue Recognition

Long-term Contracts (IAS 11, *Construction Contracts*)

Revenue on long-term contracts is recognized when performance milestones have been completed and accepted by the customer. No profit is recognized on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved.

Owing to the complexity of many of the contracts undertaken by BAE Systems, the cost estimation process requires significant judgment. It is based upon the knowledge and experience of BAE Systems' project managers, engineers, finance and commercial professionals, and uses BAE Systems' contract management processes. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the contract include the nature and complexity of the work to be performed, availability and productivity of labor, the effect of change orders, availability of materials, performance of subcontractors, and availability of and access to government-furnished equipment.

Cost and revenue estimates, and judgments, are reviewed and updated at least quarterly, and more frequently as determined by events or circumstances. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognized immediately as an expense. Contract costs comprise directly attributable costs, including an allocation of direct overheads. Indirect overheads are only regarded as contract costs when their recovery is explicitly allowed for under the terms of the contract. Indirect costs are otherwise treated as a period cost and expensed as incurred. Material changes in one or more of these estimates, while not anticipated, would affect the profitability of individual contracts.

Other (IAS 18, *Revenue*)

Where goods are supplied, sales are recognized when the significant risks and rewards of ownership have been transferred to the buyer, recovery of consideration is probable, there is no continuing management involvement and revenue and costs can be reliably measured.

Where services are rendered, sales are recognized in proportion to the stage of completion when the stage of completion of the services, and the related revenue and costs, can be measured reliably.

Additional details are in note 1 to the BAE Systems 2010 Annual Financial Statements.

Retirement Benefit Plans (IAS 19, *Employee Benefits*)

For defined benefit retirement plans, 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. Actuarial gains and losses are recognized in full in the period in which they occur, and are recognized in the statement of comprehensive income. Past service cost is recognized immediately to the extent the benefits are already vested, or otherwise is recognized on a straight-line basis over the average period until the benefits become vested.

The retirement benefit obligations recognized in the balance sheet represent the present value of the defined benefit obligations as adjusted for unrecognized past service cost and as reduced by the fair value of scheme assets.

The main assumptions made in accounting for BAE Systems' post-retirement plans relate to the expected return on investments within BAE Systems' plans, the rate of increase in pensionable salaries, the rate of increase in the retail price index, the mortality rate of plan members and the discount rate applied in discounting liabilities. For each of these assumptions, there is a range of possible values and, in consultation with BAE Systems' actuaries, management decides the point within that range that most appropriately reflects BAE Systems' circumstances. Small changes in these assumptions can have a significant impact on the size of the deficit calculated under IAS 19.

BAE Systems has allocated an appropriate share of the pension deficit to its equity accounted investments and other participating employers using a consistent and reasonable method of allocation which represents, based on current circumstances, the directors' best estimate of the proportion of the deficit anticipated to be funded by these entities. BAE Systems' share of the pension deficit allocated to equity accounted investments is included on the balance sheet within equity accounted investments.

The valuing of assets and liabilities at a point in time rather than matching expectations of assets and liabilities over time has no impact on short-term cash contributions to the pension plans, which are calculated based on separate independent actuarial valuations.

Additional details are in notes 1 and 21 to the BAE Systems 2010 Annual Financial Statements.

Intangible Assets (IFRS 3, *Business Combinations*)

From January 1, 2010, BAE Systems adopted IFRS 3 on a prospective basis. Acquisitions prior to that date are accounted for in accordance with IFRS 3 (2004).

Goodwill arising on the acquisition of subsidiaries is capitalized and included in intangible assets. Goodwill on acquisition of joint ventures and associates is included in equity accounted investments. Goodwill is not amortized, but is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment review calculations require the use of estimates related to the future profitability and cash-generating ability of the acquired businesses.

Other acquired intangible assets are identified and valued in line with internationally used models. These models require the use of estimates which may differ from actual outcomes.

Other intangible assets are amortized over their estimated useful lives. Future results are impacted by the amortization periods adopted and, potentially, any differences between estimated and actual circumstances related to individual intangible assets.

Additional details are in notes 1 and 11 to the BAE Systems 2010 Annual Financial Statements.

Treasury Policy

BAE Systems' treasury activities are overseen by the Treasury Review Management Committee ("*TRMC*"). Two executive directors are members of the TRMC, including BAE Systems' Finance Director who chairs the Committee. The TRMC also has representatives with legal and taxation expertise.

BAE Systems operates a centralized treasury department that is accountable to the TRMC for managing treasury activities in accordance with the framework of treasury policies and guidelines approved by the Board. It is an overriding policy that trading in financial instruments for the purpose of profit generation is prohibited, with all financial instruments being used solely for risk management purposes.

Other key policies are:

- to maintain a balance between continuity, flexibility and cost of debt funding through the use of borrowings from a range of markets with a range of maturities, currencies and rates of interest reflecting BAE Systems' risk profile;
- to maintain adequate undrawn committed borrowing facilities;
- to mitigate the exposure to interest rate fluctuations on borrowings and deposits through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilizing derivative instruments, mainly interest rate swaps; and

- to hedge all material firm transactional exposures, unless otherwise approved as an exception by the TRMC, as well as to manage anticipated economic cash flows over the medium term.

Within this policy framework the treasury department's principal responsibilities are:

- to manage BAE Systems' core funding and liquidity;
- to manage exposure to interest rate movements;
- to manage exposure to foreign currency movements;
- to control and monitor bank credit risk and credit capacity utilization; and
- to manage BAE Systems' relationship with debt capital market investors, banks and rating agencies.

All treasury policies are being kept under close review given the volatility in the financial markets.

The treasury department transacts with a number of counterparty banks and financial institutions, and adopts a systematic approach to the control and monitoring of counterparty credit risk. BAE Systems has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at December 31, 2010 of £2,813 million was invested with 24 different financial institutions. The system assigns a maximum exposure based on the counterparty's size, a composite credit rating and credit default swap price. These limits are regularly monitored and updated.

BAE Systems, through its internal audit department, monitors compliance against the principal policies and guidelines (including the utilization against credit limits) and any exceptions found are reported to the TRMC.

Further disclosure on financial instruments is set out in note 30 to the BAE Systems 2010 Annual Financial Statements.

BUSINESS

Transformation of BAE Systems

Since 1999, through a series of strategic mergers, acquisitions and disposals, BAE Systems has transformed itself from a group focused primarily on the manufacture of military and commercial aircraft in the United Kingdom to become a premier global defense and security company. BAE Systems delivers a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services. BAE Systems has five home markets — Australia, India, the Kingdom of Saudi Arabia, the United Kingdom and the United States. As of December 31, 2010, BAE Systems employed 98,200 employees and in 2010 generated sales of £22,392 million and Underlying EBITA of £2,214 million through its wholly-owned operations and equity accounted investments. On a restated basis, after giving effect to the classification of the Regional Aircraft line of business as a discontinued operation, BAE Systems had sales of £22,275 million and Underlying EBITA of £2,179 million in 2010.

The Issuer was incorporated on December 31, 1979 and is the parent holding company of the BAE Systems group of companies. In November 1999, the Issuer (then known as British Aerospace Public Limited Company) merged with the Marconi Electronic Systems ("*MES*") business of The General Electric Company, p.l.c., and the resulting entity was renamed BAE Systems plc. The Issuer is a public limited company registered in England and Wales under the Companies Acts 1948 to 1980 with registered number 1470151.

The U.S.-based segment of BAE Systems continues to evolve to meet the ever-changing needs and requirements of markets and customers. In this challenging U.S. defense and security environment, the business remains focused on delivering affordable solutions across its operating segments which compete in electronics, services and platform markets. Internal realignments and cost-cutting measures have been implemented to increase effectiveness, efficiency and agility in responding to customers' needs for defense and security products and services.

In addition to organic growth over the past decade, the United States business has also made a series of acquisitions which have established it as a major defense company in the United States defense market, the largest defense market in the world. Following the formation of BAE Systems in 1999, the focus in the United States was on growing the business, and key acquisitions included:

- In September 2000, BAE Systems completed the $510 million acquisition of Lockheed Martin Controls Systems ("*LMCS*"), a designer and producer of flight control systems and full authority digital engine controls. BAE Systems combined LMCS with its Aircraft Control Systems business to form a new Integrated Control systems division.

- In November 2000, BAE Systems completed its acquisition of Lockheed Martin Aerospace Electronic Systems for a cash cost of approximately $1,670 million. This acquisition established BAE Systems as one of the leading suppliers of electronic warfare systems in the world. It also consolidated its position as a supplier of the systems and components to prime defense contractors in the United States, and as a leading supplier to the United States Department of Defense.

In 2005, the business embarked on its strategic objective to grow its position in the land market. Material acquisitions included:

- In June 2005, BAE Systems completed the acquisition of United Defense Industries, Inc., a leading producer of military ground combat vehicles and a supplier of artillery systems, naval weapon systems and missile launchers and precision munitions, for a total consideration of approximately $3,794 million.

- In July 2007, BAE Systems acquired Armor Holdings, Inc., a manufacturer of tactical wheeled vehicles and leading provider of vehicle and individual armor systems and survivability technologies for the military and for the law enforcement and commercial security markets. The total consideration for the Armor Holdings acquisition was £1,696 million and further strengthened the business of the Land & Armaments group.

In addition to these major acquisitions, further investments were made to enhance the electronics market position. In 2004, five acquisitions were completed at an aggregate cost of $709 million. The company acquired National Sensor Systems in 2006, OASYS Technology in 2010, and Fairchild Imaging, Inc. in 2011 for an aggregate cost of approximately $121 million.

In the services market, BAE Systems' position was strengthened through acquisitions which included added capability to provide military and technical services for platforms and products over their lifecycle, as well as IT and cyber service offerings.

BAE Systems' acquisitions in the United States services market have included: MTC Technologies, Inc., which was acquired for cash consideration of $375 million in 2008, and the L-1 Intelligence Services Group, which was acquired for $291 million in 2011. In the maritime support services domain, four Atlantic Marine Holding Company businesses were acquired for $372 million in 2010. The integration of Atlantic Marine's Mayport and Jacksonville, Florida; Moss Point, Mississippi; and Mobile, Alabama operations complemented BAE Systems' existing ship repair and upgrade capabilities serving the United States Navy and commercial maritime customers.

Outside the United States, BAE Systems acquired Detica, a specialist business with expertise in information exploitation, security and resilience, threat intelligence and customer insight, in September 2008 for consideration of £543 million. The acquisition of Detica positions BAE Systems for contracting opportunities in the intelligence and security and cyber market for both government and commercial customers in the United Kingdom and other international markets. Further acquisitions to strengthen BAE Systems' footprint in Cyber & Intelligence have included Norkom Group plc, a provider of innovative anti-money laundering solutions to counter financial crime to the global financial services industry, ETI A/S, a leading Danish provider of advanced technology products and services to government and commercial clients worldwide and stratsec.net Pty Limited, an information security company with offices in Australia, Malaysia and Singapore.

BAE Systems continually examines the options for its business and reviews its portfolio to ensure it remains aligned to BAE Systems' strategy.

Organization

BAE Systems reports based on the following principal operating groups:

Electronics, Intelligence & Support. The Electronics, Intelligence & Support (EI&S) operating group provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for U.S. national security and federal markets and ship repair and modernization services. The operating group is managed out of the United States and had 31,700 employees as of June 30, 2011. The operating group comprises three lines of businesses: Electronic Systems, Intelligence & Security and Support Solutions. Sales and Underlying EBITA of the Electronics, Intelligence & Support operating group (£5,653 million and £668 million, respectively) represented approximately 25% and 29%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

Land & Armaments. The Land & Armaments operating group designs, develops, produces, supports and upgrades armored combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products. The operating group is headquartered in the United States and had 14,200 employees as of June 30, 2011. Sales and Underlying EBITA of the Land & Armaments operating group (£5,930 million and £604 million, respectively) represented approximately 26% and 27%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

Programmes & Support. The Programmes & Support operating group primarily comprises BAE Systems' U.K.-based air, maritime and Cyber & Intelligence activities. The operating group is headquartered in the United Kingdom and had 30,300 employees as of June 30, 2011. Sales and Underlying EBITA of the Programmes & Support operating group (£6,680 million and £529 million, respectively) represented approximately 29% and 23%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

International. The International operating group comprises BAE Systems' businesses in Australia, India and Saudi Arabia, together with interests in the pan-European MBDA joint venture and Air Astana. The operating group had 17,500 employees as of June 30, 2011. Sales and Underlying EBITA of the International operating group (£4,534 million and £478 million, respectively) represented approximately 20% and 21%, respectively, of BAE Systems' sales and Underlying EBITA for 2010.

In addition, the HQ & Other Businesses operating group comprises the head office and United Kingdom shared services activity, including research centers and property management.

Changes to BAE Systems' external reporting segments are planned to improve the alignment of reporting with both markets served and management of operations.

For the year ended December 31, 2010, BAE Systems had sales of £22,392 million, compared with 2009 sales of £21,990 million. Underlying EBITA for 2010 was £2,214 million compared with £2,197 million in 2009. For 2010, BAE Systems had profit for the year of £1,027 million, compared with a loss from continuing operations of £61 million in 2009. On a restated basis, after giving effect to the classification of the Regional Aircraft line of business as a discontinued operation, BAE Systems had sales of £22,275 million, Underlying EBITA of £2,179 million and operating profit of £1,601 million in 2010.

As at December 31, 2010, BAE Systems had net assets of £5,403 million. BAE Systems had a closing order book of approximately £39.7 billion as of December 31, 2010, which includes its share of equity-accounted investments' order books and is stated after the elimination of intra-group orders. On a restated basis, after giving effect to the classification of the Regional Aircraft line of business as a discontinued operation and after the elimination of intra-group orders, BAE Systems had a closing order book of approximately £39.5 billion as of December 31, 2010, including equity-accounted investments.

Strategy

BAE Systems' vision provides a clear definition of the future state that it wishes to attain. It is: "*To be the premier global defense and security company*." While this vision defines the destination, it is BAE Systems' commitment to Total Performance that guides its actions for the benefit of all stakeholders. This is embedded in the BAE Systems mission: "*To deliver sustainable growth in shareholder value through our commitment to Total Performance*." It is the mission that describes BAE Systems' overall goal and the philosophy that underpins its activities. Total Performance is demonstrated in every aspect of the way BAE Systems does business — Customer Focus, Financial Performance, Programme Execution and Responsible Behavior, all together.

By embodying the four elements of Total Performance wherever it operates, BAE Systems believes it will deliver the growth in shareholder value that will make it the premier global defense and security company.

BAE Systems' strategy provides the framework that defines the direction and shape of BAE Systems over the long term. This enables BAE Systems to prioritize the deployment of its resources within a challenging environment. BAE Systems' strategy is well established and has delivered strong growth. To address evolving challenges and maximize BAE Systems' resilience in the current environment, BAE Systems has reviewed and refined its strategy to ensure it remains robust, fit for purpose and continues to deliver value.

At the core of BAE Systems' strategy is the creation of long-term, sustainable value for its shareholders, and leadership in three market segments — Services, Electronic Systems and Platforms. BAE Systems delivers its strategy through its strategic objectives, strategic actions and integrated business plans. The strategic objectives are championed by the Executive Committee and apply across all of BAE Systems' businesses. The strategic actions are championed by the relevant Executive Committee member and are delivered by the businesses either separately or jointly. Both are underpinned by BAE Systems' integrated business plans.

BAE Systems' strategic objectives are to:

- *Operate and grow in the defense and security markets in the segments of Services, Electronic Systems and Platforms.* In the services market segment, BAE Systems provides a range of support and services in the areas of defense and security — from equipment, facilities and infrastructure to intelligence gathering. In the electronics systems market segment, BAE Systems designs, develops, manufactures and integrates a diverse portfolio of mission critical electronic and control systems. In the platforms market segment, BAE Systems designs, develops, manufactures and integrates a broad range of defense systems and equipment for the air, land and surface and sub-surface maritime domain.

- *Grow in existing home markets and develop new home markets.* BAE Systems continues to benefit from a broad and diverse market base. BAE Systems' home markets are those where it operates indigenous businesses in market segments where there are good sustainable growth prospects. Currently, Australia, India, the Kingdom of Saudi Arabia ("*KSA*"), the United Kingdom and the United States of America are designated as home markets. BAE Systems will also target further home markets in countries that match its established criteria. The economic strength and growing budgets of markets in South America and Asia make them particularly suitable.

- *Grow its export business.* Historically BAE Systems has been a strong exporter, and there is renewed support from both the United Kingdom and United States governments for defense export efforts. BAE Systems has strengthened its in-country presence in its key markets, and this approach has improved the number and quality of export opportunities produced.

Additionally, in response to the market environment, BAE Systems has been driving efficiencies and reducing the cost base across its businesses to ensure its continued global competitiveness and protect the quality of its earnings.

BAE Systems' strategic objectives are enabled through the following strategic actions:

- *Invest and grow in Services, including Military & Technical Services and Cyber & Intelligence.* Services continues to be developed through a combination of organic investment in capability development and acquisitions. In Military & Technical Services, BAE Systems' acquisition of Atlantic Marine — a vessel maintenance, repair, overhaul and conversion, marine fabrication and ship construction services provider — enhanced its ability to support current and future United States Navy home-porting strategies and broaden its customer base. Recent acquisitions to strengthen BAE Systems' footprint in Cyber & Intelligence include L-1 Identity Solutions, Inc.'s Intelligence Services Group, a leading provider of security and counter threat capabilities to the United States government, Norkom Group plc, a provider of innovative anti-money laundering solutions to counter financial crime to the global financial services industry, ETI A/S, a leading Danish provider of advanced technology products and services to government and commercial clients worldwide and stratsec.net Pty Limited, an information security company with offices in Australia, Malaysia and Singapore.

- *Invest and grow in Electronic Systems.* Electronic Systems continues to be developed through organic investment in rapidly growing technologies as well as through acquisitions. Recent acquisitions include the 91.3% outstanding equity not already held by BAE Systems in Fairchild Imaging, Inc., a provider of solid-state electronic imaging components, cameras and systems for aerospace, industrial, medical and scientific imaging applications, and OASYS Technology, a specialist electro-optical systems and sub-assemblies provider for military applications.

- *Sustain its Platform positions.* In the air domain the platform position is underpinned by combat aircraft production, and in-service support for United Kingdom and export programs. Typhoon aircraft have been supplied to the United Kingdom and the Kingdom of Saudi Arabia and additional international opportunities are being pursued in a number of countries, including India, Oman and Japan. BAE Systems is also seeking to develop market positions in unmanned air systems. This includes the Taranis unmanned combat air vehicle demonstrator program and also the joint (with Dassault Aviation) demonstration to the United Kingdom and French governments of a solution of their requirement for medium altitude long endurance aircraft. The United Kingdom maritime business is underpinned by the Type 45 destroyer, Queen Elizabeth class carriers and Astute class submarine manufacturing programs, the 15-year Terms of Business Agreement ("*ToBA*"), services contracts and the design of the Vanguard class successor submarine and Type 26 global combat ship. The Australian maritime business continues to progress its contracted work on the Landing Helicopter Dock and the Air Warfare Destroyer programs. In the global land domain, opportunities exist to compete for sustainment and upgrade work on existing platforms as well as securing key new domestic programs and pursuing export opportunities.

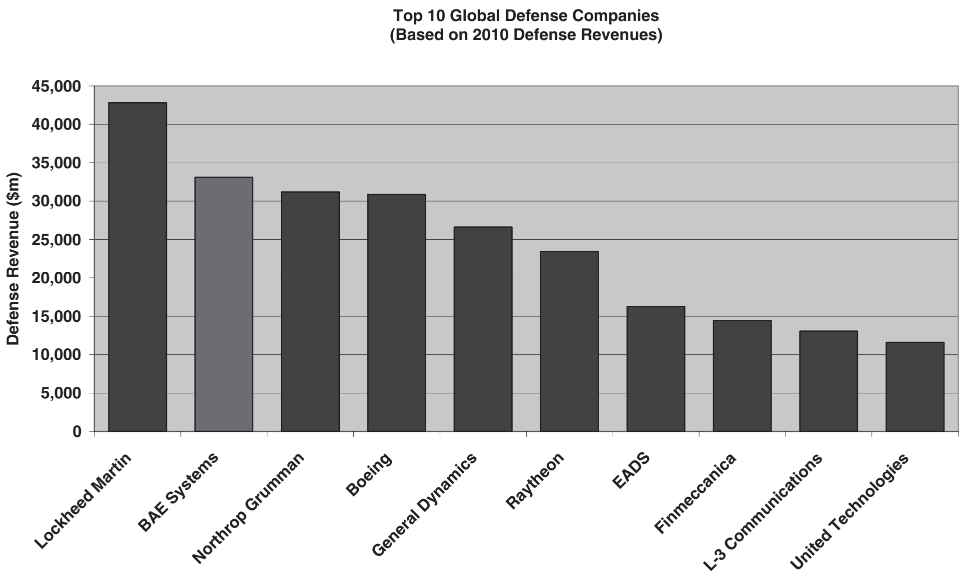
- *Implement the home market strategy to grow its business.* In the KSA, BAE Systems is seeking to sustain its long-term presence through delivering current programs and industrialization, and developing new business in support of the Saudi military and paramilitary forces. In Australia, BAE Systems will continue to work with its customers to identify and deliver cost and service improvements. In India, BAE Systems is making progress towards capturing opportunities to address the future requirements of its defense and security customers. For a description of the United Kingdom and United States home markets, see the "*Home Markets*" section below.

- *Develop new home markets and grow its export business.* BAE Systems is committed to broadening its home market base and to exporting to selected defense markets.

- *Implement rationalization and efficiency programs.* BAE Systems is committed to driving efficiencies and reducing the cost base in its businesses to ensure continued global competitiveness. This has been a recent focus for BAE Systems and will continue to be so.

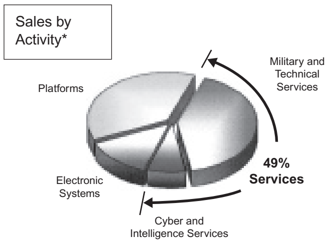
Home Markets

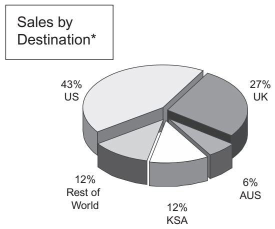
BAE Systems is a global defense and security company. BAE Systems delivers a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services. In 2010, BAE Systems was the second largest global defense supplier. The following table sets forth BAE Systems' global market position among defense companies:

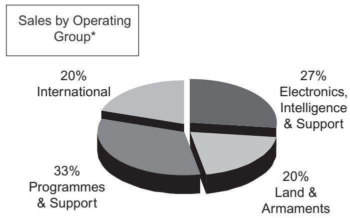


Source: Defense News

The following charts set forth BAE Systems' sales by operating activity, sales by destination and sales by operating group as of June 30, 2011.







* Sales excluding the HQ & Other Businesses operating group, before the elimination of intra-group sales.

United States

The United States remains the largest single defense market with 2009 defense spending of \$666 billion (£426 billion). The 2010 Quadrennial Defense Review ("*QDR*") identified growth in investment allocations and confirmed strategic priorities. BAE Systems is a large and high-performing part of the United States defense industrial base and is a major supplier to the United States Department of Defense. BAE Systems believes that it is well positioned to support its United States customers with a balance of products, technologies and services. The United States business encompasses a diverse range of customers and contracts with relatively low exposure to any single program. The United States Department of Defense is BAE Systems' largest customer, with sales in 2010 of £7,696 million.

Outlook

After exceptional growth in the last decade, there is significant uncertainty as to the level of future defense spend in the United States with a range of options for national deficit reduction being considered. Accordingly, the United States Department of Defense is likely to experience significant reductions to the current Five Year Defense Plan. There is expected to be some near-term disruption in trading as the United States administration again operates federal budgets under a Continuing Resolution. However, the United States government remains committed to protecting the size, reach and fighting strength of the military, and has committed to substantial investments in high priority capabilities and programs.

Any increases in procurement funding for particular programs are expected to be largely funded through new cost efficiencies, as operations and maintenance funding is expected to occupy an increasing proportion of the baseline budget.

In recognition of the growing importance of affordability and efficiencies, BAE Systems streamlined the organization of its United States business in 2010 to reduce costs and improve flexibility. With the Land & Armaments market impacted by lower demand for new vehicles, BAE Systems continues to rationalize its facilities and other costs to sustain profitability and compete more effectively for development, production, upgrade and Military & Technical Services contracts.

The Cyber & Intelligence market segment is a priority area for further investment by the United States government and represents one of the opportunities for growth in the United States, bringing BAE Systems to new markets and customers.

Opportunities

BAE Systems continues to benefit from its presence in capability and product sectors that are expected to grow against the general downturn and wider market pressures. BAE Systems has invested in distinctive capabilities that provide competitive advantage. In Services, the acquisition of Atlantic Marine enhanced the ability of BAE Systems' ship repair business to support maritime maintenance and modernization. The acquisition of OASYS Technology enhanced BAE Systems' product offerings in growing markets for Electronic Systems, as did the acquisition of Fairchild Imaging, Inc. In February 2011, BAE Systems completed the acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, which expanded its existing presence in the United States intelligence community.

BAE Systems will continue to focus on strengthening its current positions in these growing sectors of the market.

United Kingdom

BAE Systems is the largest defense company in the United Kingdom and the number one supplier to the United Kingdom Ministry of Defence, based upon sales to the Ministry of Defence in 2009.

BAE Systems has a key role in supporting the United Kingdom armed forces and the nation's security and intelligence capabilities. Together, the 2010 National Security Strategy ("*NSS*") and Strategic Defence and Security Review ("*SDSR*") have defined the areas for future United Kingdom spend in security and defense and have confirmed that BAE Systems' strategy for the United Kingdom market is focused on the appropriate areas. In defense, the business has a secure backlog of contracted business across air, maritime and land platforms, including significant Military & Technical Services contracts. In Cyber & Intelligence, the business continues to play a formative role supporting customers in the growing intelligence, civil government and commercial markets.

Outlook

In the air domain, the SDSR committed the United Kingdom to modernize and upgrade the capabilities of Typhoon aircraft, and to procure F-35 aircraft for operation from the Queen Elizabeth class aircraft carriers. In addition, the United Kingdom and France are expected to develop ideas for closer co-operation on Unmanned Aircraft Systems. BAE Systems believes that these factors will contribute to the future sustainment of BAE Systems' combat air capability.

In the maritime domain, BAE Systems' surface warship design, build and support capability is sustained by a 15-year Terms of Business Agreement ("*ToBA*"). The SDSR's commitment to the construction of two Queen Elizabeth class aircraft carriers underpins that capability in the near and medium term, as does the Type 26 Global Combat Ship program in the longer term. The future of BAE Systems' submarine business is underpinned by the government's commitment to the procurement of seven Astute class submarines, and the retention and planned renewal of a submarine-launched continuous nuclear deterrent.

The NSS outlined and prioritized the "different and more complex range of threats from a myriad of sources" that the United Kingdom faces, and identified an additional £650 million of investment to be made in the next four years in the strengthening of national cyber security as part of that response. BAE Systems believes that it is well placed to access growth in the emerging security market through its investments in Detica and elsewhere.

Opportunities

Across all domains, BAE Systems has been working with the Ministry of Defence to reduce costs and deliver military capability more effectively. Broad service offerings will be a key contributor to delivering additional savings and efficiencies. BAE Systems believes that it is well positioned to expand these service offerings in support of the United Kingdom customer.

BAE Systems believes that its investment in Cyber & Intelligence positions it for growth in this expanding market segment. BAE Systems is committed to delivering technologies and services to assist the government and commercial sectors to detect and defend against cyber attacks, prevent fraud and money laundering, and ensure secure delivery of services. For example, during 2010, BAE Systems launched the Detica Treidan™ cyber threat detection service and is working with a number of clients, including major private sector organizations, to detect and stop sophisticated intrusions into their IT systems.

Other home markets

Australia

Australia's 2009 defense budget was $24 billion (£15 billion) and, as its largest defense contractor, BAE Systems believes that it is well placed to provide the Australian Defence Force ("*ADF*") and security community with a full range of products and services.

BAE Systems is the largest defense company in Australia. It supplies total capability across mission systems, air defense, land combat systems, maintenance, logistics support, and intelligence, surveillance and reconnaissance. In January 2011, BAE Systems acquired stratsec.net, an information security company, adding to BAE Systems' capabilities and footprint in the growing market segment of Cyber & Intelligence.

Outlook

The Australian government has detailed an expansive acquisition program for platforms and systems over the next decade, and has committed to average real growth in the defense budget of 3% annually to 2017-18, with further growth beyond in order to meet the defense and security objectives outlined in its 2009 Defence White Paper. An important contributor to this growth will be savings and efficiencies in Australia's military sustainment expenditure emerging from the ten-year Strategic Reform Programme, which will be re-invested in the acquisition program. This is expected to generate new opportunities for service offerings in Military & Technical Services.

Opportunities

BAE Systems expects strong opportunities for Military & Technical Services to the ADF in both the air and maritime domains. Cyber & Intelligence also represents an important focus for the Australian government.

BAE Systems believes that it is well placed to offer a range of solutions that are sourced both from indigenous capability within Australia and capability sourced from elsewhere in BAE Systems. For example, the business has recently experienced success in the Cyber & Intelligence market segment through the transfer of Detica's United Kingdom capability into BAE Systems Australia.

Saudi Arabia

Regional tensions continue to dictate that defense and security remain a high priority for the Kingdom of Saudi Arabia ("*KSA*"). In 2009, defense expenditure in KSA was 10.9% of GDP.

BAE Systems acts as the prime contractor for the UK/KSA government-to-government defense agreement and also holds certain direct contracts with the Saudi government. Progress is ongoing to modernize the Saudi armed forces in line with the 2005 UK/KSA Understanding Document, and BAE Systems continues to support the operational capability of the Royal Saudi Air Force ("*RSAF*") and Royal Saudi Naval Forces ("*RSNF*") through the Saudi British Defence Co-operation Programme ("*SBDCP*").

Outlook

Regional tensions combined with enduring high oil prices have resulted in robust budgets. The linking of defense and security procurement to indigenous industrial development and in-Kingdom job creation for Saudi nationals will continue as a strategic objective for the KSA government. BAE Systems continues to invest in Saudi industry to help deliver on this requirement.

Opportunities

BAE Systems is seeking to extend its activities to support all Saudi military and paramilitary forces. In the air domain, availability contracting and additional support on the Salam Typhoon contract represent opportunities for the business. In the land and maritime domains, there are a number of near-term direct program prospects for vehicle artillery systems and maritime equipment.

The security market continues to mature, and near-term opportunities are expected in Intelligence, Surveillance and Reconnaissance.

India

India's 2009 defense expenditure was $29 billion (£19 billion) and is expected to grow in the future in line with the country's economy.

India is BAE Systems' newest home market, building on BAE Systems' long-standing relationship with Hindustan Aeronautics Limited ("*HAL*") and Rolls-Royce, supplying 66 Hawk Advanced Jet Trainer ("*AJT*") aircraft to the Indian Air Force. BAE Systems also has a 40% interest in BAeHAL Software Limited, a joint venture with HAL, specializing in aerospace software and engineering services. In 2010, BAE Systems secured a new order with HAL for a further 57 Hawk aircraft, and established Defence Land Systems India Private Limited, a land systems joint venture with Mahindra & Mahindra Limited which is currently developing and marketing several vehicles with the support of BAE Systems' businesses across the world.

Outlook

The Indian government has embarked upon a modernization program across the air, maritime and land domains, involving the acquisition of new aircraft, missiles, artillery, combat vehicles and naval vessels, and development of capabilities in command, control, communications and intelligence gathering. The Indian security market is less mature, but growing, as ameliorating the threat of terrorism and internal insurgency is an increasing priority for the Indian government.

Currently, approximately 70% of India's defense requirements are sourced externally. The Indian government has a stated desire to reverse this situation and is looking increasingly to source its defense capabilities from indigenous Indian companies, partnered with foreign suppliers where necessary.

Opportunities

BAE Systems is committed to a program of investment and technology transfer in support of its strategy to create indigenous capability in the Indian defense and security market, and BAE Systems believes that significant order opportunities exist.

In the air domain, BAE Systems continues to support EADS in the promotion of Typhoon for the Indian Air Force Medium Multi-Role Combat Aircraft competition, as well as working with HAL on the supply of Hawk AJT aircraft. In land, India is trialing the M777 howitzer in advance of a potential purchase.

BAE Systems believes opportunities also exist to import capability from other areas of BAE Systems to meet growing requirements in the security and land domains.

Potential Home Markets

BAE Systems will also target further home markets in countries that match its established criteria. The economic strength and growing budgets of markets in South America and Asia make them particularly suitable.

Operating Groups

BAE Systems reports based on the following operating groups: Electronics, Intelligence & Support, Land & Armaments, Programmes & Support, International and HQ & Other Businesses. Changes to BAE Systems' external reporting segments are planned to improve the alignment of reporting with both markets served and management of operations.

The following charts set forth sales and Underlying EBITA for the operating groups for the six months ended June 30, 2011 and 2010 and the years ended December 31, 2010 and 2009.

Sales and Underlying EBITA By Operating Group

	Six Months Ended June 30,							
	2011				2010(1)			
Operating Group	Sales	% Total Sales(2)	Underlying EBITA	% Total Underlying EBITA(2)	Sales	% Total Sales(2)	Underlying EBITA	% Total Underlying EBITA(2)
	(In £ millions, except percentages)							
Electronics, Intelligence & Support	2,573	27%	298	30%	2,624	24%	296	26%
Land & Armaments	1,846	20%	180	18%	3,074	29%	316	27%
Programmes & Support	3,140	33%	285	29%	3,035	28%	316	28%
International	1,862	20%	221	23%	2,078	19%	218	19%
HQ & Other Businesses	78		(16)		74		(49)	
Less Intra-Operating Group Sales	(270)		—		(303)		—	
	9,229		968		10,582		1,097	

(1) Restated following the classification of the Regional Aircraft line of business as a discontinued operation.

(2) Percentages exclude HQ & Other Businesses and the elimination of intra-group sales.

	Year Ended December 31,							
	2010				2009(1)			
Operating Group	Sales	% Total Sales(2)	Underlying EBITA	% Total Underlying EBITA(2)	Sales	% Total Sales(2)	Underlying EBITA	% Total Underlying EBITA(2)
	(In £ millions, except percentages)							
Electronics, Intelligence & Support	5,653	25%	668	29%	5,637	25%	575	25%
Land & Armaments	5,930	26%	604	27%	6,738	30%	604	27%
Programmes & Support	6,680	29%	529	23%	6,298	28%	670	30%
International	4,534	20%	478	21%	3,828	17%	419	18%
HQ & Other Businesses	278		(65)		254		(71)	
Less Intra-Operating Group Sales	(683)		—		(765)		—	
	22,392		2,214		21,990		2,197	

(1) Restated following the sale of half of BAE Systems' 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation.

(2) Percentages exclude HQ & Other Businesses and the elimination of intra-group sales.

Closing Order Book by Operating Group

A summary of the total closing order book as of June 30, 2011 and as of December 31, 2010 for each of BAE Systems' operating groups is set forth in the table below:

	June 30, 2011	December 31, 2010[(1)]
	(in £ billions)	
Operating Group		
Electronics, Intelligence & Support	4.5	4.8
Land & Armaments	5.3	5.9
Programmes & Support	20.1	21.1
International	8.4	9.1
HQ & Other Businesses	0.1	0.1
Less Intra-Group Order Book	(1.5)	(1.5)
Total Closing Order Book	36.9	39.5

(1) Restated following the classification of the Regional Aircraft line of business as a discontinued operation.

The closing order book represents the estimated remaining sales value of work BAE Systems is to perform or equipment BAE Systems is to deliver. BAE Systems includes an order in its order book when a firm funded contract exists with the customer. For contracts where the pricing is not fixed but subject to a limit of liability, the value of the order included in the order book is not greater than the limit of liability. In other cases, BAE Systems includes a provisional price or, if unavailable, an estimated price, which is later updated when pricing details become provisional or fixed.

Electronics, Intelligence & Support

The Electronics, Intelligence & Support ("*EI&S*") operating group, with approximately 31,700 employees as of June 30, 2011 and headquartered in the United States, provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for United States national security and federal markets and ship repair and modernization services. The group comprises three lines of business: Electronic Systems, Intelligence & Security and Support Solutions.

Electronic Systems

The Electronic Systems business was established in July 2011 through the combination of the legacy Electronic Solutions and Platform Solutions operations. This new electronics business is a leading provider of cost-competitive, technology-centered solutions for commercial and defense electronics markets offering a broad portfolio of mission critical electronic systems from flight and engine controls to electronic warfare and night vision systems, surveillance and reconnaissance sensors, secure networked communications and power and energy management systems. Core capabilities span a global leadership role in aircraft survivability systems, including integrated threat warning, electronic countermeasure, command and control disruption systems, SIGINT detection, exploitation, manipulation and targeting of signals for airborne, maritime and ground platforms; expertise in day/night surveillance, targeting for soldiers and vehicles and precision guidance for weapon systems; and support of a wide range of platforms, including fixed- and rotary-wing aircraft and ground vehicles, with particular expertise in vehicle management systems, engine controls, human-machine interfaces and power and propulsion management systems.

Some of the current programs in the Electronic Systems business include:

- electronic warfare ("*EW*") suites for F-35 aircraft;
- thermal weapon sights under a five-year, indefinite delivery, indefinite quantity contract, with orders since 2004 exceeding $1 billion;

- continued orders for Common Missile Warning Systems to protect United States Army helicopters and aircraft from heat-seeking missiles, and the recent unveiling of Boldstroke™, an integrated aircraft survivability system for protecting aircraft from infrared-guided missiles and other threats;
- in commercial avionics, new programs include high integrity flight controls for regional aircraft and business jets;
- in defense avionics, the business continues to pursue strategic military opportunities for new applications of key technologies, while remaining focused on producing mission upgrade and support for platforms such as F-35, F-15, F-18 and Typhoon aircraft;
- through its FADEC International joint venture, the business has been selected by GE to develop and produce the Full-Authority Digital Electronic Control for CFM International's next generation engine, the LEAP-X, designed to power future narrow body commercial aircraft; and
- the business continues to market its power and energy management products to capitalize on growth opportunities, winning 60% of the hybrid drive opportunity arising from the United Kingdom Green Bus Funds, and is expanding its HybriDrive® series system to additional original equipment manufacturers in the transit bus market, including the next generation HybriDrive® parallel system to the United States and European truck markets.

Intelligence & Security

The Intelligence & Security business continues to provide United States intelligence, defense, homeland security and law enforcement agencies with a range of intelligence analysis, operational support and analytic tools and information technology products and services. These provide information to predict, prevent and protect against individual, physical and cyber security threats. Core capabilities include: integrated cybersecurity and information technology solutions; intelligence analysis, analytic tools and knowledge management to directly support deployed warfighter operations and high-level United States government decision makers; and identity management and biometrics to rapidly identify relevant information and help secure United States borders.

Support Solutions

The Support Solutions business provides seamless, onsite management of military and government customer operations and also delivers a wide range of services in engineering, systems integration, ship repair and military and technical services for military and commercial customers throughout the product lifecycle, anywhere in the world.

The business addresses the needs of the United States Department of Defense and federal civilian customers with core capabilities including expertise as a leading provider of non-nuclear ship repair and overhaul services, which has resulted in securing more than $1 billion in multi-ship, multi-option contracts to repair and overhaul mission critical United States Navy ships over the next five years. Further, as an industry leader in systems development and integration, Support Solutions has been engaged to design, install, integrate and test various communications systems for ten United States Navy Littoral Combat Ships. Thus, while the business provides sustainment services to extend the viability of existing land and maritime platforms at home and in theater, it also specializes in modernizing those platforms to meet evolving threats.

Land & Armaments

The Land & Armaments operating group, with approximately 14,200 employees as of June 30, 2011 and headquartered in the United States, designs, develops, produces, supports and upgrades armored combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products.

Land & Armaments was formed in 2005 by combining the acquired United Defense Industries operations with the existing Land Systems group (formed by the integration of RO Defence and Alvis in 2004). In June 2007, the Land & Armaments land business was further enhanced by the acquisition of Armor Holdings, particularly in the tactical wheeled vehicle sector and technology in the areas of armor and survivability.

Land & Armaments' core capabilities include: global leadership in the design, production and service support of armored combat and tactical vehicles; breakthrough technologies, systems integration, flexible manufacturing and logistics support throughout the product lifecycle; and advanced technologies that focus on enhancing survivability, lethality and mobility. In addition to the United States, the Land & Armaments operating group has operations in the United Kingdom, South Africa and Sweden, and markets its products in more than two dozen countries.

In the United States, the business continues to focus on its Heavy Brigade Combat Team positions, supporting customers' requirements in relation to Bradley Fighting Vehicles, the M109 Family of Vehicles, M88 Recovery Vehicles and mine resistant ambush protected vehicles. The business also continues to pursue vehicle platforms such as the Ground Combat Vehicle program.

The business also specializes in a wide range of gun systems for ship protection and shore support. The business received a recent contract to deliver 40 Mk 38 Mod 2 gun systems in the first year of a four-year contract, which brings the total number of these systems in the United States Navy's fleet to more than 220. The business also received a recent award for Mk 41 Vertical Launching System mechanical modules, together with related equipment and services, for CG 47 and DDG 51 class surface combatant ships, and Aegis Ashore requirements for the Missile Defense Agency's Ground Ballistic Missile Defense program.

The United States business also designs and produces integrated survivability technologies, such as body armor and active protection systems that are intended to provide improved soldier survivability and combat vehicle performance. This segment of the United States business has developed a number of survivability products for the United States military, including: Small Arms Protective Insert ("*SAPI*") plates, Modular Lightweight Load-carrying Equipment ("*MOLLE*"), the Up-Armored High Mobility Multipurpose Wheeled Vehicle ("*UAH*"), commercial armored vehicles, the Cockpit Air Bag System ("*CABS*"), and the UH-60 Black Hawk crashworthy armored crew seat.

The Land & Armaments U.K.-based business designs and produces products for combat vehicles, artillery and munitions markets around the world. Its products include Archer, BVs10 Viking, CV90, M777, Terrier and Warrior.

In 2008, the Munitions business secured a 15-year partnering agreement with growth potential to £3 billion from the United Kingdom Ministry of Defence ("*MoD*") covering the supply of approximately 80% of general munitions consumed by United Kingdom Armed Forces, including small arms and medium-calibre ammunition, mortar bombs, tank ammunition and artillery shells. Under the contract, BAE Systems also agreed to invest over £120 million in new, highly-automated facilities. In 2011, the business continues to perform well under this United Kingdom partnership, and its investments resulted in the 2011 opening of a high technology production facility in Washington and a laboratory complex at the Glascoed site to bring increased capability and flexibility for the testing of high explosive munitions.

The Weapons business designs, manufactures, develops, markets and maintains smart weapon systems within the fields of intelligent ammunition, artillery systems, combat vehicle turrets, naval guns and air defense systems. Production for the M777 155mm lightweight howitzer program continues for United States, Canadian and other armed forces customers. The M777 system has been deployed in both Iraq and Afghanistan operations, and recent orders for additional M777 howitzers for the United States Marine Corps and United States Army will take total cumulative orders since product launch to over 1,000 systems.

The Vehicles business designs, manufactures, integrates and supports combat vehicles. Its primary products include main battle tanks, infantry fighting vehicles, armored engineer vehicles, armored all-terrain vehicles, military vehicles, military bridging and logistical support. The segment also provides advanced training systems to support military vehicles and systems. The business secured significant work supporting operations in Iraq and Afghanistan, particularly in carrying out urgent operational upgrades to vehicles to protect against rapidly-evolving threats.

The Sweden-based business, which includes the legacy Hägglunds and Bofors product lines, designs, manufactures and markets military vehicle systems, including infantry fighting vehicles, armored all-terrain vehicles and turret systems, indirect fire systems and naval gun systems. The Swedish business continues to restructure in order to better match future strategic demands and export opportunities. Recent contracts have been secured for continued deliveries of CV90 vehicles to support customers in the Netherlands, Denmark and Sweden, as well as spares supply for Dutch CV9035 infantry fighting vehicles, the production of Archer 155mm self-propelled artillery gun systems for Sweden and Norway and Mk 110 naval gun systems for United States Navy Littoral Combat Ships.

In South Africa, the business conducts its operations through Land Systems South Africa, a company jointly owned by BAE Systems (75%) and the South African Black Economic Empowerment Group, DGD Technologies (Pty) Ltd (25%). It comprises three businesses: Land Systems OMC, Land Systems Gear Ratio and Land Systems Dynamics. The business continues to build on the success of its RG family of mine resistant ambush protected vehicles and offers a range of tactical wheeled vehicle solutions to customers worldwide.

In June 2011, FNSS, a 49% owned joint venture with Nurol Group of Turkey, signed a $559 million (£348 million) letter of offer and acceptance from DEFTECH of Malaysia for the design, development and manufacture of 257 armored wheeled vehicles and integrated logistics support for the Malaysian armed forces.

Programmes & Support

The Programmes & Support operating group, with 30,300 employees as of June 30, 2011, comprises BAE Systems' United Kingdom-based air, maritime and Cyber & Intelligence Services activities. BAE Systems' United Kingdom-based air, maritime and Cyber & Intelligence Services activities are conducted through its Military Air & Information, Maritime and Detica businesses.

A significant proportion of the revenues of the Programmes & Support operating group is from programs under which it acts as a prime contractor, either on its own or as part of a consortium, or as a supplier of specified products or systems for another contractor, whether a prime contractor or otherwise. These programs are large, and require considerable up-front investment during the design and development phase, which is typically funded by the customer. Given their size, the number of such contracts available in the United Kingdom and elsewhere is limited. As these programs move through the initial development and design phase and into the production and product support phase, BAE Systems typically receives payment against contract milestones. These programs tend to have long lives, as customers prefer to keep the equipment in service through maintenance, modification and upgrades rather than to develop new platforms, given the significant capital costs involved in developing and producing replacement programs. BAE Systems also looks for export opportunities for many of its major programs, since export sales allow BAE Systems to realize additional revenue from each program without having to incur significant additional design and development costs.

Military Air & Information

Military Air & Information ("*MAI*") is a through-life business delivering advanced military air capability to its customers in the United Kingdom and internationally. MAI is a leader in the development, delivery and support of military air platforms, components and technologies through its products. MAI also provides information superiority through the delivery of actionable intelligence and information, and the provision of innovative information systems and services. MAI has capabilities in prime contracting, systems integration, rapid engineering, manufacturing, maintenance, repair and upgrade and military training. MAI is responsible for delivering a range of military programs, including the Typhoon, Hawk and autonomous air vehicles, and participates in the F-35 Lightning II program. In addition, it is responsible for through-life support to Hawk, Tornado, Typhoon and VC-10 aircraft as well as contributing to the support of E-3D Sentry.

Military Air & Information is comprised of three through-life businesses: Combat Air; Defence Information, Training & Services; and F-35.

Combat Air

The Combat Air business covers four key areas: Aircraft Programmes, Support, International Markets and Autonomous Systems & Future Capability. Through the Aircraft Programmes and Support businesses, Combat Air is responsible for all activity associated with BAE Systems' subcontract responsibilities to Eurofighter Jagdflugzeug GmbH ("*Eurofighter GmbH*") and the four core nations responsible for Typhoon (Germany, Spain, Italy and United Kingdom), in addition to its operations at RAF Coningsby, which are focused on maximizing mission effectiveness.

BAE Systems is the United Kingdom shareholder of Eurofighter GmbH, the joint venture established to be the prime contractor for the Typhoon program, one of BAE Systems' largest projects. The Typhoon is a fourth-generation combat aircraft designed to meet the defense requirements of the United Kingdom, German, Spanish and Italian governments. Eurofighter GmbH holds the Typhoon Programme prime contract from NETMA (the NATO agency representing the four core nation customers). BAE Systems, EADS Deutschland GmbH ("*EADS-D*"), EADS Construcciones Aeronautics S.A. ("*EADS-C*") and Alenia currently hold 33%, 33%, 13% and 21%, respectively, of Eurofighter GmbH's shares. The respective production workshares of the four shareholder companies are 36.3% for BAE Systems, 30.0% for EADS-D, 13.7% for EADS-C and 20.0% for Alenia.

The program entered the production phase in January 1998, when the four partner nations entered into contracts providing a framework agreement for the procurement of 620 aircraft: 232 to be delivered to the United Kingdom, 180 for Germany, 121 for Italy and 87 for Spain. 496 of the 620 aircraft have so far been ordered.

Aircraft Programmes The Aircraft Programmes business is responsible for the production of front fuselages and a number of other significant components for all contracted Typhoon deliveries and final assembly of United Kingdom and Kingdom of Saudi Arabia aircraft. Aircraft Programmes is also responsible for contracted upgrade programs associated with Typhoon in line with Eurofighter GmbH workshare.

Typhoon production aircraft are being delivered in three "tranches". Separate prime contracts and subcontracts are entered into among the shareholders for each tranche. The primary difference between Tranche 1 aircraft and Tranche 2 aircraft is that the Tranche 2 aircraft have a new suite of computers and enhanced air-to-ground capabilities. Tranche 1 comprises 148 aircraft, Tranche 2 comprises 236 aircraft and Tranche 3A comprises a contract for 112 aircraft. Delivery of Typhoon aircraft to the four partner nations continues with a cumulative total of 107 aircraft delivered to the United Kingdom (including those for onward delivery to the Kingdom of Saudi Arabia) and 221 to the other European partner nations. All Tranche 1 aircraft have been delivered and Tranche 2 deliveries commenced in October 2008. Recently, the four partner nations in the Typhoon program have agreed to slow production rates to help ease their budget pressures.

In the United Kingdom Royal Air Force ("*RAF*") Typhoons are operational in Air Defence and Quick Reaction Alert roles, and have a multirole capability. Work has also commenced on further air-to-ground capability enhancements. BAE Systems expects production to continue toward the end of the decade, and potentially beyond, followed by continuing upgrade and modification work to keep pace with technical advances.

Support The Combat Air Support business is responsible for the in-service support of the United Kingdom's Typhoon and Tornado fleets as well as some support of International legacy platforms. Support of the United Kingdom's Typhoon fleet is covered under a suite of integrated logistic support contracts through the European consortium. In March 2009, BAE Systems was awarded a £430 million Typhoon Availability Service contract by the United Kingdom Ministry of Defence under a partnering arrangement under which BAE Systems will maintain and support the RAF's Typhoon aircraft for a period of up to five years.

Under the Tornado ATTAC (Availability Transformation: Tornado Aircraft Contract), the business is delivering platform availability for training and frontline operations while reducing costs until the Tornado GR4's out-of-service date, currently anticipated to be in or around 2018.

The announcement of the SDSR in 2010 resulted in the earlier than planned retirement of the Harrier fleet and the termination of the Nimrod MRA4 program, which eliminated some opportunity for longer term military air support activity and reduced residual production activity. BAE Systems has also seen a reduction in certain support requirements for Tornado.

International Markets International Markets covers all Typhoon international contracts and business acquisition opportunities. It covers Royal Saudi Air Force ("*RSAF*") Programmes and Kingdom of Saudi Arabia Home Market Support which, under the leadership of the International operating group's BAE Systems Saudi Arabia, includes supply chain responsibilities for the Tornado and Typhoon, weapons and role equipment.

In addition to the orders from the United Kingdom, Germany, Spain and Italy, orders for Typhoon have been received from the governments of Austria (15 aircraft) and the Kingdom of Saudi Arabia (72 aircraft). All contracted aircraft have been delivered to Austria and deliveries to the Kingdom of Saudi Arabia began in June 2009. 24 Typhoons delivered to the Kingdom of Saudi Arabia are being diverted from the United Kingdom Royal Air Force's Tranche 2 uptake. Eurofighter GmbH and its partner companies are also pursuing a number of additional Typhoon opportunities, including India, Oman, Japan, Qatar and Malaysia.

Autonomous Systems & Future Capability The Autonomous Systems & Future Capability business is responsible for addressing emerging global opportunities created by autonomous systems and related and supporting technologies. The 2010 Anglo-French Declaration on Defence and Security Co-operation stated both nations' intentions to develop a next generation Medium Altitude Long Endurance ("*MALE*") Unmanned Air Surveillance System and to jointly assess requirements and options for the next generation of Unmanned Combat Air Systems ("*UCAS*"). Current unmanned programs are centered on Taranis, a key enabler to the United Kingdom Ministry of Defence's evaluation of future UCAS requirements, and Telemos, a joint BAE Systems-Dassault initiative building on BAE Systems' Mantis demonstrator. Telemos is aimed at meeting the stated Anglo-French MALE UCAS requirement.

The business is also charged with maintaining BAE Systems' position as a leader in military aircraft technologies.

Defence Information, Training & Services

The Defence Information, Training & Services business covers two key areas: Defence Information Services and Training Services.

Defence Information Services The Defence Information Services business is responsible for the delivery of information superiority through actionable intelligence and information, and the provision of innovative information systems and services. Its key program is Falcon, a modern, secure communications infrastructure for deployed formations and operating bases for the United Kingdom armed forces. International opportunities for Falcon-derived products are currently being pursued in Australia and India. Defence Information Services is also involved in delivering the mission system of the Queen Elizabeth Carrier program and the integration of the information environment for the F-35 Lightning II aircraft. In the air domain, the Defence Information Services business is involved in developing mission and information management capabilities in support of unmanned air vehicles and is leading the provision of ground control infrastructure for the Taranis program.

Training Services The Training Services business is focused on modeling, analyzing, designing, building and delivering training solutions and platforms to military customers around the world. This includes the Hawk platform. The Hawk family of jet trainers and light combat aircraft have been ordered by customers such as the United Kingdom and United States Navy (the T-45A Goshawk navalized version manufactured by Boeing), and over 800 aircraft have been delivered. The Hawk aircraft has been steadily updated and upgraded over its life. Major international customers for Hawk include South Africa and India. In July 2010, India ordered an additional 57 Hawks for assembly in country following a previous order for 66 Hawks. Support under the UK Hawk Support program, and provision of synthetic training to RAF pilots in relation to Hawk, continues at

RAF Valley. The Training & Services business is supporting the BAE Systems Inc.-led bid for the United States Air Force T-X program for a new advanced trainer aircraft, as well as pursuing opportunities in Saudi Arabia and elsewhere.

F-35

BAE Systems is involved in the development and manufacture of the F-35 Lightning II, a fifth-generation combat aircraft. The single engine, single seat F-35 is being produced in three variants: a conventional take-off and landing ("*CTOL*") variant for the United States Air Force and international partners, an aircraft carrier ("*CV*") variant for the United States Navy and the United Kingdom armed forces, and a short take-off and vertical landing ("*STOVL*") variant for the United States Marine Corps and Italy.

The prime contract was awarded to Lockheed Martin in October 2001. It is anticipated that the United States, the United Kingdom, Italian, Australian, Canadian, Danish, Dutch, Norwegian and Turkish armed forces participating in the F-35 Lightning II program will together purchase approximately 3,500 aircraft. BAE Systems anticipates that there is further potential export market for the F-35 Lightning II with Israel and prospectively Japan and South Korea. MAI participation in the F-35 Lightning II includes the aft fuselage and horizontal and vertical stabilizers, and other aircraft systems, all of which will create business opportunities in the global sustainment environment.

All three F-35 Lightning II aircraft variants, CTOL, STOVL and CV, are now in manufacture. At the end of August 2011 the first CTOL variant F-35s were delivered to the United States Air Force.

BAE Systems Maritime

BAE Systems Maritime was formed on January 1, 2011 to bring together BAE Systems' United Kingdom naval businesses under a single management team. Maritime comprises three separate business units: Surface Ships, Submarines and Mission Systems. Operational locations include Glasgow, Barrow in Furness, Cowes, Filton, Frimley and Portsmouth.

Maritime operates within the naval design, build and integration and services markets. An integral part of business within both of these sectors is the provision of mission and combat systems products and services. For design, build and integration programs, this includes the architecture and development of combat management systems and the provision of products (radars and torpedoes). Within the services sector, this includes the provision of class management, equipment management, maintenance and upgrade and synthetic training solutions.

Design, build and integration programs for surface ships and submarines accounted for approximately three quarters of revenues for the year ended December 31, 2010. Major United Kingdom programs include Astute Class submarines, Type 45 Destroyers and Queen Elizabeth Class aircraft carriers. In addition, Surface Ships (formally BVT Surface Fleet) is completing a Corvette program for Oman. The futures of the submarine and surface ship businesses are underpinned by the retention and planned renewal of a submarine-launched continuous nuclear deterrent and by the Type 26 Global Combat Ship program, respectively.

Services revenues are derived from the delivery of surface warship support, naval base and dockyard services at Portsmouth Naval Base, the provision of through-life product services for radar and torpedoes and the provision of training solutions for surface and sub-surface platforms and systems. Warship support revenues are generated through 'Class Output Management' contracts and the Warship Support Modernisation initiatives ("*WSMi*") contract. Class Output Management for the Royal Navy's Type 45 Destroyers is provided exclusively by BAE Systems; four of these vessels have now been accepted by the MoD and two remain in build. Management of the majority of the Royal Navy legacy fleet is shared with Babcock under the Surface Ship Support Alliance agreement.

Surface Ships

The Surface Ships business is underpinned by the 15-year Terms of Business Agreement with the United Kingdom Ministry of Defence signed in July 2009. The agreement establishes Surface Ships as the exclusive provider of complex warships for the Ministry of Defence, provides an incentivized framework for business restructuring post completion of the Queen Elizabeth Class aircraft carriers program and ensures the sustainment of the business's key industrial capability (facilities and staff) across the new build and in-service support sectors.

Good progress continues to be made on the first of class of the new aircraft carriers with the first block being delivered on time to the assembly and integration facility on Rosyth in August 2011. First steel cut for the second ship was made in May 2011.

The Type 45 program continues to progress to schedule, with the fourth ship being accepted off contract by the MoD in August 2011. With four ships now under management, the Class Output Management contract is delivering required levels of availability while preparing the ships for operational service.

Delivery of naval base and dockyard services for the Royal Navy at Portsmouth under the WSMi contract continues to perform well. Activities performed under the WSMi contract and class output management contracts for Type 45 and legacy ships are due to be consolidated in 2013 under the Maritime Support Delivery Framework ("*MSDF*").

BAE Systems has concluded that it will incur significantly higher than planned costs to complete the Oman Offshore Patrol Vessel ("*OPV*") program. As a consequence, a charge of £160 million pre-tax was taken in June 2011.

An arbitration process between BAE Systems and the Government of Trinidad and Tobago, in respect of the cancelled OPV program, is underway and the main tribunal hearing is scheduled for 2012.

Submarines

Submarine Solutions is undertaking the design, build, testing and commissioning of the 7,500 ton Astute Class nuclear powered submarines for the Royal Navy. Boat 1 has now been accepted by the MoD and Boat 2 is due to be accepted in 2012. Boat 3 is on contract and BAE Systems is working towards agreeing the remainder of a seven boat program, with Boat 4 planned to be contracted in 2012.

Submarine Solutions is engaged in the design of the Successor to the Vanguard Class Submarine. The submarine carries the United Kingdom's nuclear deterrent. The program has progressed through Initial gate with Main gate expected in 2016.

Mission Systems

Mission Systems provides electronic systems integration, software, sensors, command and information systems, underwater weapons, through-life support solutions, training technologies, engineering and manufacturing. These activities can be summarized in three categories as follows:

- Mission/Combat Systems Integration — for example, the provision of the mission systems for the Royal Navy's Queen Elizabeth Class aircraft carriers.
- Product Services — for example, support of torpedoes under the Torpedo Capability Contract for the Royal Navy, and the support contract for the Sampson multi-function radars (supplied by Mission Systems) on the Royal Navy's Type 45 destroyers.
- Training Services — for example, the training to the Royal Navy provided through the Mission Systems Maritime Composite Training System at HMS Collingwood and Royal Naval Base Devonport.

Detica

Detica helps government and commercial clients collect and manage information to reveal intelligence, maintain security, manage risk and strengthen resilience in today's complex operating environment. Detica provides mission-critical cyber security solutions, information technology, intelligence and analytical tools, and support solutions to the intelligence & defense, law-enforcement, financial services and telecommunications sectors and across central government.

Detica offers a range of core services from developing business strategies and enterprise architectures to the delivery of managed IT services and the design of mission-critical electronics. Detica has developed a range of products based on its intellectual property, including Detica NetReveal®, a counter-fraud software product, Detica Treidan™, an advanced cyber security service, and Detica DataRetain™, a communications data retention solution. The acquisition of Norkom and ETI in early 2011 strengthened Detica's product portfolio for tackling fraud and delivering intelligence.

International

The International operating group comprises BAE Systems' businesses in three of its home markets, the Kingdom of Saudi Arabia ("*KSA*"), Australia and India, together with a 37.5% interest in the pan-European MBDA missile manufacturing joint venture and a 49% shareholding in Air Astana. The operating group had 17,500 employees as of June 30, 2011.

Saudi Arabia

BAE Systems is the prime contractor for the UK/KSA government-to-government defense cooperation agreement and also holds direct contracts with the KSA government. Progress remains ongoing to modernize the KSA armed forces in line with the 2005 UK/KSA Understanding Document and BAE Systems also continues to support the operational capability of the Royal Saudi Air Force ("*RSAF*") and the Royal Saudi Naval Force ("*RSNF*") through the Saudi British Defence Cooperation Programme ("*SBDCP*"). BAE Systems is seeking to extend its activities to support the other Saudi armed and paramilitary forces. Specifically, in the land and maritime domains there are a number of near-term direct program prospects for both vehicle artillery systems and maritime equipment. The security market continues to mature, and near-term opportunities are expected in Intelligence, Surveillance and Reconnaissance.

Of the 72 Typhoon aircraft contracted under the Salam program entered into in 2007, 24 have been delivered to the RSAF on schedule. BAE Systems remains in negotiations regarding possible changes to the program and formalization of price escalation.

The three-year Typhoon support solution contract agreed in 2009 continues to provide increased levels of capability to the RSAF, and performance against the flying program remains in line with contract. Discussions have started on the next phase of the support contract, which is scheduled to commence in the second half of 2012.

Discussions with the customer continue regarding the next five-year phase of the SBDCP, which commences in 2012.

The upgrade of the RSAF Tornado fleet to the Tornado Sustainment Programme standard is currently performing ahead of schedule, with 56 of the contracted 81 aircraft delivered back into the fleet as of the end of September 2011.

All 200 of the Tactica vehicles have now been accepted by the Saudi Arabia National Guard. The separate Tactica vehicle support contract continues to perform in line with expectations.

The Command, Control, Communications, Computers and Intelligence ("*C4i*") program remains challenging and agreement on the design completion has not been finalized. Discussions are ongoing with the customer to identify a mutually acceptable way forward.

Australia

BAE Systems is the largest defense company in Australia. BAE Systems supplies total capability across mission systems, air defense, land combat systems, maintenance, logistics support and Intelligence, Surveillance and Reconnaissance. In January 2011, BAE Systems acquired stratsec.net, an information security company, adding to BAE Systems' capabilities and footprint in the growing market segment of Cyber & Intelligence.

BAE Systems Australia has the prime contract for the supply of two Landing Helicopter Dock ships to the Royal Australian Navy. Construction of the Landing Helicopter Dock hulls remains on schedule with the first ship being launched in February 2011 by the subcontractor, Navantia, in Spain. Construction of the first superstructure blocks has begun in Australia, along with facilities to enable initial weapons and combat systems testing to begin.

In the Air Warfare Destroyer program, BAE Systems continues to work with the end customer and prime contractor to establish a way forward on a revised contractual scope and schedule. Given the high loading in the shipyard, some of BAE Systems' contracted scope of work may be moved to third-party shipyards.

India

India's 2009 defense spend was $29 billion and is in the future expected to continue to grow in line with the country's economy (estimated over 8% in 2011). The Indian government has embarked upon a modernization program across the air, land and maritime domains involving acquisition of new aircraft, missiles, artillery, combat vehicles and naval vessels and development of the country's capabilities in command, control, communications and intelligence gathering. The Indian security market is evolving as the threat of terrorism and internal insurgency continues.

Currently, approximately 70% of India's defense requirements are sourced via imports. The Indian government has a stated desire to reverse this situation and is looking increasingly to source its defense capabilities from indigenous Indian companies, where necessary, partnered with foreign suppliers. In 2010 India formally amended its procurement procedures to reflect this approach.

Typhoon was downselected by the Indian government in the Medium Multi-Role Combat Aircraft program as one of two preferred aircraft. The final selection process for a contract to supply 126 aircraft is underway.

Defence Land Systems India, BAE Systems' 26%-owned joint venture with Mahindra & Mahindra Limited, won the first order for its new vehicle, the Mine Protected Vehicle India, and is awaiting the results of a bid in the substantial Future Infantry Combat Vehicle competition.

BAE Systems is actively pursuing an opportunity to supply up to 145 M777 howitzers to the Indian Army, but withdrew from a competition for the 155mm towed howitzer following changes to the customer's requirements and specifications.

MBDA

MBDA is a leading missile systems company jointly owned by BAE Systems (37.5%), EADS (37.5%) and Finmeccanica S.p.A (25%). MBDA provides integrated missile system solutions for air, land and sea forces. In the United Kingdom, MBDA is the Ministry of Defence's designated lead contractor and is managing its complex weapons sector under the Defense Industrial Strategy.

MBDA provides missiles to European platforms such as the Typhoon, Mirage 2000, Tornado, Rafale, Gripen, Tiger, Lynx and NH 90 and to non-European platforms such as the F-16 and F/A-18. MBDA will also provide missiles for the F-35 Lightning II.

MBDA also provides missile system solutions for European warships, such as the Daring class of Type 45 destroyers and the Franco-Italian Horizon and FREMM frigates. In addition, MBDA is acting as the prime contractor or principal partner in the development of European collaborative programs such as Meteor and SCALP.

Air Astana

Air Astana is a successful joint venture between the government of the Republic of Kazakhstan (51%) and BAE Systems (49%). The airline provides domestic and international air services from Kazakhstan and continues to trade profitably.

HQ & Other Businesses

The HQ & Other Businesses operating group, with 1,900 employees as of June 30, 2011, comprises the head office and United Kingdom shared services activity, including research centers and property management.

Research and Development

BAE Systems is engaged in leading edge R&D programs in support of the Services, Electronic Systems and Platforms that it provides to its customers. BAE Systems' R&D activities cover a wide range of programs, and include technological innovations and techniques to improve the manufacturing and service of products.

Application of this research is managed through business-focused research and development programs. BAE Systems funds strategic R&D across the business, particularly in the Electronic Systems, Cyber & Intelligence and Military Services market segments. Customers fund directly much of the near-term product development work undertaken by BAE Systems. Total research and development expenditure during 2010 amounted to £1,298 million (compared with £1,211 million during 2009), of which £270 million (compared with £278 million in 2009) was funded by BAE Systems.

Regulatory

General

As a defense company, BAE Systems is subject to various laws and regulations that are particular to the defense industry in the United Kingdom, the United States and other countries. These include restrictions on sales, export and sharing of technology and the disclosure of information. In addition, many of BAE Systems' acquisitions, disposals and joint ventures have been subject to review by the competition authorities in the United Kingdom, the United States and the European Union.

Like other companies that derive a substantial portion of their sales from contracts for defense-related products, BAE Systems is subject to business risks that include changes in governmental appropriations, national defense policies and regulations, and availability of government funds. These factors and other risks could materially adversely affect BAE Systems' business with governments in the future.

In February 2010, BAE Systems announced a global settlement of certain regulatory investigations with the United States Department of Justice ("*DoJ*") and the United Kingdom Serious Fraud Office ("*SFO*").

Pursuant to the settlement with the SFO, BAE Systems pleaded guilty to one charge of breach of duty to keep accounting records in relation to payments made to a former marketing adviser in connection with the sale of a radar system by BAE Systems to Tanzania in 1999. That agreement provided for a payment of £30 million by BAE Systems for the benefit of the people of Tanzania less any penalty imposed by the court in connection with the agreed basis of settlement. A penalty of £500,000 (together with costs of £225,000) was imposed by the court in December 2010. The remaining balance of £29.5 million (together with interest) will be applied by

BAE Systems for the benefit of the people of Tanzania in accordance with the applicable BAE Systems policies, including those relating to business conduct and the making of charitable contributions.

Pursuant to the settlement with the DoJ, BAE Systems pleaded guilty to one charge of conspiring to make false statements to the United States Government relating to certain regulatory filings and undertakings. In March 2010, BAE Systems paid a fine of $400 million (£266 million) in respect of the settlement with the DoJ. BAE Systems also made additional commitments concerning its ongoing compliance and, pursuant to those commitments, appointed an independent monitor for a period of up to three years to monitor its compliance with such commitments.

In May 2011, BAE Systems and the United States Department of State reached a civil settlement in connection with violations of the United States defense export control regulations that were the subject of the earlier settlement with the DoJ mentioned above. Under the agreement with the Department of State, BAE Systems agreed to pay a fine of up to $79 million (£49 million) in respect of alleged civil violations. The fine is payable over a period of three years, subject to a reduction of up to $10 million (£6 million) in respect of the cost of enhanced export control compliance measures already implemented by BAE Systems and planned for implementation during the four-year period from the settlement date. In addition, a limited number of BAE Systems' U.K.-originated export programs will be subjected to enhanced administrative review, which is not expected to adversely impact BAE Systems' current or future export programs. BAE Systems also agreed to make additional commitments concerning its ongoing compliance and, pursuant to those commitments, appointed a special compliance officer for a period of up to three years to monitor its compliance with such commitments.

In recent years, BAE Systems has systematically enhanced its compliance policies and processes. In particular, BAE Systems undertook to act on all 23 recommendations of the Woolf Committee within three years. The Woolf Committee was appointed by BAE Systems' Board of Directors to deliver an independent report on the company's ethics policies and processes and to make recommendations aimed at achieving a leadership position in ethical business conduct. The Woolf Committee's report was issued in May 2008. On September 30, 2011, BAE Systems published a report entitled "Our Response to the Woolf Committee Recommendations" that included a description of the steps BAE Systems has taken since 2008 to implement all 23 recommendations of the Woolf Committee. Such statements were independently assured by Deloitte LLP to be, in its opinion, fairly stated in all material respects as of September 30, 2011.

United Kingdom

As a consequence of the merger between British Aerospace and the former Marconi Electronics Systems businesses in 1999, BAE Systems gave certain undertakings to the United Kingdom Secretary of State for Trade and Industry (now the Secretary of State for Business, Enterprise and Regulatory Reform). In February 2007, the United Kingdom Department for Trade and Industry released BAE Systems from the majority of these undertakings and agreed to new undertakings ("*2007 Undertakings*") following United Kingdom Office of Fair Trading advice to the United Kingdom Department of Trade and Industry that "there had been a change in circumstances" justifying release of such undertakings due to changes in the defense sector since 2000. Compliance with the 2007 Undertakings is monitored by a compliance officer.

United States

BAE Systems, BAE Systems, Inc. and BAE Systems Holdings, Inc. entered into a Special Security Agreement dated November 8, 2010 with the United States Department of Defense regarding the management of BAE Systems, Inc. in order to comply with the U.S. government's national security requirements.

Australia

BAE Systems and certain of its wholly-owned Australian subsidiaries entered into an Overarching Deed with the Commonwealth of Australia dated June 19, 2008 regarding the management of the BAE Systems' Australian business in order to protect the Commonwealth of Australia's national security and other interests following the acquisition by BAE Systems of Tenix Defence Holdings Pty Ltd.

Government Contracts

Some government contracts, including United States and United Kingdom government contracts, are, by their terms, subject to termination by the contracting government either for its convenience or default by the contractor. Fixed-price contracts typically provide for payment upon termination for items delivered to and accepted by the government, and, if termination is for convenience, for payment of fair compensation of work performed plus the costs of settling and paying claims by terminated subcontractors, other settlement expenses, and a reasonable profit on the costs incurred. Typically, however, if a contract termination is for default (i) the contractor is paid an amount agreed upon for completed and partially completed products and services accepted by the government, (ii) the government is not liable for the contractor's costs with respect to unaccepted items, and is entitled to repayment of advance payments and progress payments, if any, related to the terminated portion of the contract, and (iii) the contractor may be liable for excess costs incurred by the government in procuring undelivered items from another source.

In addition to the right of governments to terminate contracts, many government contracts, particularly in the United States, are conditional upon the continuing appropriation of funds by legislative bodies. Most notably, funds for United States government contracts are often appropriated for particular projects on a fiscal year basis, even though contract performance may take many years to complete. Consequently, at the outset of a major program, the contract may be partially funded, and additional monies are normally committed to the contract by the procuring agency only as appropriations are made by the relevant legislative body for future fiscal years.

Environmental, Health and Safety (EHS) Regulation and Liability

BAE Systems is subject to comprehensive EHS laws and regulations in each of the countries in which it operates. Such laws and regulations impose standards with respect to air emissions, wastewater discharges, the use, handling and storage of hazardous wastes and materials, remediation of soil and ground water contamination and the prevention of pollution. Violations of and/or liabilities under such laws and regulations can result in substantial costs, including fines, penalties or other sanctions, investigation and cleanup costs, and third-party claims for property damage or personal injury. Although EHS requirements are most highly developed and restrictive in the United Kingdom, continental Europe, the United States and Australia, such requirements are developing rapidly in other countries as well. Increasing EHS regulation exposes BAE Systems to increasing capital and operating costs associated with compliance, remediation and protection of human health and the environment.

BAE Systems has a long history of industrial operations and may incur liability for the cost of investigation and cleanup if contamination is discovered at one of its current or former facilities, in some circumstances even if such contamination was caused by a prior owner or other third party. BAE Systems also may incur liability if contamination is discovered at a landfill or other locations where it may have sent wastes for disposal, even where historic disposal practices were conducted in accordance with all applicable requirements at the time of disposal. BAE Systems and its subsidiaries have been identified as responsible parties for investigation and remediation costs at certain contaminated sites, including at and/or in the vicinity of current and former shipyard sites. Based upon currently available information about the nature and extent of the contamination, as well as the likely participation of other responsible parties, BAE Systems does not believe that the cost of the environmental cleanup for these sites will have a material adverse effect on its financial condition. See note 22 to the BAE Systems 2010 Annual Financial Statements for further details.

Employees

At June 30, 2011, BAE Systems' workforce amounted to approximately 95,600 employees, including share of equity accounted investments. At that date, in the United Kingdom, approximately 50% of professional staff and 95% of manufacturing/operations staff were members of trade unions and, in the United States, BAE Systems had approximately 3,500 employees represented by labor unions. In Australia, approximately 2,150 employees were members of trade unions, and local site-based collective bargaining arrangements apply.

On September 27, 2011, BAE Systems announced nearly 3,000 potential job losses within its Military Air & Information and Shared Services businesses and at its Head Office in response to changes in key programs and the need to maintain competitiveness. While BAE Systems believes that its labor relations are good, such potential reductions in the workforce can increase the likelihood of industrial action causing workforce disruption such as a strike. Significant industrial action at BAE Systems' sites could, depending on the severity and extent of the action, adversely affect BAE Systems' businesses.

The table below shows BAE Systems' number of employees by operating group, including its share of equity accounted investments, at June 30, 2011.

Employees by Operating Group	At June 30, 2011
Electronics, Intelligence & Support	31,700
Land & Armaments	14,200
Programmes & Support	30,300
International	17,500
HQ & Other Businesses	1,900
Total Employees	95,600

BAE Systems has adopted various share-based incentive plans for directors, management and employees. These plans are described in the remuneration report appearing elsewhere in this Offering Memorandum and in note 25 to the BAE Systems 2010 Annual Financial Statements. BAE Systems also operates pension plans for its qualifying employees in the United Kingdom, the United States and other countries. See note 21 to the BAE Systems 2010 Annual Financial Statements and note 6 to the BAE Systems Interim Financial Statements.

Real and Intellectual Property

Real Property

BAE Systems owns or leases approximately 4.7 million square meters of buildings in the United Kingdom, the United States and Australia and approximately 3,600 hectares of land in the United Kingdom. BAE Systems believes that its main facilities are adequate for its present needs and, as supplemented by planned improvements and construction, are expected to remain adequate for the foreseeable future.

Intellectual Property

The use of intellectual property rights enables BAE Systems to prevent competitors from exploiting protected technologies and imitating protected brands. BAE Systems' Operational Framework mandates a policy to protect BAE Systems' intellectual property (including patents, copyrights and trademarks) through appropriate use and observance of intellectual property law, so that returns made from the investment in research and development and technological innovation and commercial and business innovations are adequately safeguarded.

BAE Systems does not believe that the loss of any single patent or trademark would have a material adverse effect on its operations or financial condition. In addition, it is BAE Systems' policy to ensure that the resources associated with the protection and exploitation of intellectual property are deployed efficiently and in a manner that seeks to obtain the appropriate level of protection for such assets.

Legal Proceedings

BAE Systems is involved in a number of claims and arbitrations that have arisen in the ordinary course of business. BAE Systems believes that it has made adequate provisions to cover current or contemplated general and specific litigation risks. See note 22 to the BAE Systems 2010 Annual Financial Statements for further details. Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided. BAE Systems is not aware of any pending or threatened legal or arbitration proceedings involving any BAE Systems company that may have a material adverse effect on BAE Systems' financial position as a whole.

Except as set forth under "*Business — Regulatory — General*", BAE Systems is not, and, during the 12 months preceding of the date of this document, has not been, involved in any governmental, legal or arbitration proceeding (including any such proceedings which are pending or threatened of which it is aware) which may have or have had in the recent past significant effects on the financial position or profitability of BAE Systems.

MANAGEMENT

Board of Directors, Chairman and Chief Executive Officer of the Issuer

The Board of Directors presently consists of thirteen directors, three of whom are executives of the Issuer and ten of whom (including the Chairman) serve in a non-executive capacity.

The Board of Directors is scheduled to meet seven times each year, with additional meetings called on an ad hoc basis. All directors receive regular information on BAE Systems' operational and financial performance. Among other things, each year the Board of Directors formally reviews BAE Systems' business plan, strategy, management resources, investor relations, corporate social responsibility matters and risk management. The Board of Directors has agreed to a schedule of matters that are reserved to it for decision.

The Board of Directors has established five committees: the Audit Committee, the Corporate Responsibility Committee, the Nominations Committee, the Remuneration Committee and the Non-Executive Directors' Fees Committee.

The Audit Committee reviews the effectiveness of BAE Systems' financial reporting, internal control policies and procedures for the identification, assessment and reporting of risk. Additionally, among other things, the Audit Committee makes recommendations to the Board of Directors on the appointment of the auditors, reviews significant financial reporting issues and judgments and is also responsible for monitoring the integrity of BAE Systems' financial statements.

The Corporate Responsibility Committee assists the Board of Directors in overseeing the development of strategy and policy on social, environmental and ethical matters. In addition, the Corporate Responsibility Committee monitors and reviews BAE Systems' performance in managing social, environmental, ethical and reputational risks.

The Nominations Committee is responsible for matters relating to the engagement of the directors. This includes identifying and nominating candidates for both Executive and Non-Executive directorship vacancies for the Board of Directors' approval.

The Remuneration Committee is responsible for setting, among other things, the remuneration of the Executive Directors. This includes approving any employee share-based incentive schemes and performance conditions to be used for such schemes. The Remuneration Committee also sets the remuneration of the Chairman.

The Non-Executive Directors' Fees Committee is responsible for deciding all matters relating to fees payable to Non-Executive Directors.

The Board of Directors initially appoints directors, who serve until the next Annual General Meeting ("*AGM*"), at which time the Issuer's Articles of Association require the new directors to retire and seek re-election. In addition, all directors are required to stand down and seek re-election at least once every three years. The Board of Directors has, however, elected to comply with the U.K. Corporate Governance Code's requirement for the whole Board of Directors to seek re-election on an annual basis.

Name	Age	Position
Dick Olver	64	Chairman
Executive Directors		
Ian King	55	Chief Executive
Linda Hudson	61	President & Chief Executive Officer of BAE Systems, Inc.
Peter Lynas	53	Group Finance Director
Non-Executive Directors		
Paul Anderson	66	Company Director
Harriet Green	49	Company Director
Michael Hartnall	69	Company Director
Lee McIntire	62	Company Director
Sir Peter Mason	65	Company Director
Roberto Quarta	62	Company Director
Paula Rosput Reynolds	55	Company Director
Nick Rose	54	Company Director
Carl Symon	65	Company Director

Executive Directors

Ian King, Chief Executive. Mr. King was appointed as Chief Executive on September 1, 2008, having originally been appointed to the Board of Directors as Chief Operating Officer, U.K. and Rest of the World, at the beginning of 2007. He was previously Group Managing Director of BAE Systems' Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Immediately prior to the BAe/MES merger he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems. He is a non-executive director and Senior Independent Director of Rotork plc.

Linda Hudson, President and Chief Executive Officer of BAE Systems, Inc. Ms. Hudson was appointed to the Board of Directors as President and CEO of BAE Systems, Inc. in 2009. She was previously President of BAE Systems' U.S.-based Land & Armaments operating group. She joined BAE Systems in 2006 from General Dynamics, where she had worked since 1992 in a variety of roles culminating in her appointment as Corporate Vice President and President, Armament and Technical Products.

Peter Lynas, Group Finance Director. Mr. Lynas, a qualified accountant (FCCA), was appointed to the Board of Directors as Group Finance Director in April 2011, having previously served for a number of years as Director — Financial Control, Reporting & Treasury. He joined GEC-Marconi in 1985 having previously worked for other companies in the United Kingdom and Europe. After progressing through a number of management positions he was appointed Group Finance Director of GEC's Marconi Electronic Systems business, which was acquired subsequently by British Aerospace in 1999 to form BAE Systems.

Non-Executive Directors

Dick Olver, Chairman. Mr. Olver was appointed as Chairman in 2004. A chartered civil engineer with extensive experience in managing complex international engineering projects, he held a variety of senior management positions in the oil industry, culminating in his appointment to the board of BP p.l.c. as CEO of Exploration and Production in 1998. He was subsequently appointed deputy group chief executive of BP in 2003, stepping down from that position when he assumed the chairmanship of BAE Systems. Mr. Olver chairs the Board of Directors' Nominations Committee and the Non- Executive Directors' Fees Committee. He is a Business Ambassador for U.K. Trade & Investment, and a member of the Prime Minister's India/UK CEO Forum. He is also a member of the Multinational Chairman's Group and the Trilateral Commission, a Fellow of the Royal Academy of Engineering and Chairman of the Education for Engineering (E4E) Policy Group. He is a former director of Thomson Reuters plc.

Paul Anderson, Non-Executive Director. Mr. Anderson has extensive global business experience in the energy and mining sectors. He spent more than 20 years in two spells at Duke Energy corporation and its predecessor companies, culminating in his appointment as chairman, president and chief executive officer. He was subsequently chairman of Spectra Energy Corporation until 2009 and in the intervening period he served as managing director and chief executive officer of the newly merged BHP Billiton. He is a non-executive director of Spectra Energy Corporation and BP p.l.c. and a former non-executive director of Qantas Airways Limited. Mr. Anderson chairs the Corporate Responsibility Committee and was appointed a Non-Executive Director in 2009.

Harriet Green OBE, Non-Executive Director. Ms. Green is chief executive officer and executive director of Premier Farnell plc, a leading, high-service, multi-channel technology distribution group. She has significant global business experience having run volume distribution businesses on four continents, including Asia Pacific for Arrow Electronics, as well as having functional responsibility for worldwide marketing, suppliers and strategy. Ms. Green was appointed a Non-Executive Director in 2010.

Michael Hartnall, Non-Executive Director. A Fellow of the Institute of Chartered Accountants in England and Wales, Mr. Hartnall is a former finance director of Rexam plc where, in addition to his finance responsibilities, he gained considerable exposure to mergers and acquisitions activity. Prior to that he held senior positions with a number of manufacturing companies. He is a non-executive director of Lonmin plc and a former non-executive director of Elementis plc. Mr. Hartnall was appointed a Non-Executive Director in 2003.

Lee McIntire, Non-Executive Director. Mr. McIntire is chairman and chief executive of CH2M HILL, a leader in consulting, design, design-build, operations, risk management and program management for public and private clients. Prior to joining CH2M HILL, he was an executive at Bechtel Group Inc., where he served on the board of directors and was executive vice president for the parent company. Mr. McIntire was appointed a Non-Executive Director in 2011.

Sir Peter Mason KBE, Non-Executive Director. Sir Peter Mason is the non-executive chairman of Thames Water and senior independent director of subsea 7 S.A., an international offshore engineering, construction and services contractor. He was formerly chairman and chief executive of Balfour Beatty Limited and chief executive of AMEC plc. Sir Peter is the Board of Directors' Senior Independent Director and was appointed a Non-Executive Director in 2003.

Roberto Quarta, Non-Executive Director. Mr. Quarta's management experience spans a broad range of manufacturing and service businesses with global operations. He is a partner in the private equity firm Clayton, Dubilier & Rice and serves as chairman of Rexel SA, one of the world's largest electrical products distributors, which is one of the firm's portfolio businesses. He is a non-executive director of IMI plc and Foster Wheeler AG. He was previously chairman of Italtel, chairman and chief executive of BBA Group plc, an executive director of BTR plc and a non-executive director of PowerGen plc and Equant NV. He was appointed a Non-Executive Director in 2005.

Paula Rosput Reynolds, Non-Executive Director. Ms. Rosput Reynolds is chief executive officer and president of the business advisory group PreferWest, LLC. She had previously spent over 20 years in the energy sector in a variety of operational roles, culminating in her appointment as president and chief executive officer of AGL Resources in 2002. She subsequently served as president and chief executive officer of Safeco Corporation (Safeco), an insurance company located in Seattle, Washington, until its acquisition by Liberty Mutual Group in 2008. She was then appointed as vice chairman and chief restructuring officer of American International Group Inc. (AIG) from October 2008 to September 2009, overseeing AIG's divestiture of assets and serving as chief liaison with the Federal Reserve Bank of New York. She is a director of Delta Airlines, Inc. and Anadarko Petroleum Corporation. She is a former non-executive director of Coca-Cola Enterprises, Inc. and Air Products and Chemicals Inc. She was appointed a Non-Executive Director in 2011.

Nick Rose, Non-Executive Director. Mr. Rose was until recently chief financial officer of Diageo plc. He held the position for over ten years and, in addition to his finance responsibilities, he was also responsible for supply, procurement, strategy and IT on a global basis. His financial experience has encompassed a number of roles since joining Diageo's predecessor company, Grand Metropolitan, in 1992, including group treasurer and group controller, having spent his earlier career with Ford Finance. He is a non-executive director of BT Group plc and a former non-executive director of Moët Hennessy SNC and Scottish Power plc. Mr. Rose chairs the Audit Committee and was appointed a Non-Executive Director in 2010.

Carl Symon, Non-Executive Director. Mr. Symon has an extensive background in global business operations and management, retiring in 2001 after a long career at IBM during which he held senior executive positions in the United States, Canada, Latin America, Asia and Europe, including serving as chairman and chief executive of IBM UK Limited. He is a non-executive director of BT Group plc and Rexam PLC, and a former non-executive director of Rolls-Royce Group plc and former chairman of HMV Group plc. Mr. Symon chairs the Remuneration Committee and was appointed a Non-Executive Director in 2008.

The business address of each of the directors is c/o 6 Carlton Gardens, London, SW1Y 5AD, United Kingdom.

There are no actual or potential conflicts of interest between the duties to BAE Systems of any of the directors and his/her private interests and/or other duties.

Remuneration

Remuneration for Executive Directors consists of base salary, an incentive designed to reward annual performance on both financial and non-financial metrics, three long-term incentive plans based on share awards (one of which relates solely to the U.S.-based Executive Director), and retirement and other benefits. All Executive Directors are required to establish and maintain a minimum personal shareholding equal in value to 200% of base salary. As a minimum, a holding equal to 100% of base salary must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes or long-term incentive schemes, by using 50% of the shares that vest or 50% of the options that are exercised on each occasion. Thereafter, Executive Directors are required to increase their personal shareholding gradually, on each occasion using 25% of the shares that vest or 25% of the options exercised each year, until a personal shareholding equal to 200% of annual base salary is achieved and maintained.

The Executive Directors (other than Ms. Hudson) have contracts requiring BAE Systems to give not less than 12 months' notice of termination. Ms. Hudson's contract of employment automatically renews for one-year periods from December 31 each year, unless one party gives notice of non-renewal. Separately there is a 90-day termination provision. Messrs. King and Lynas are required to give not less than 12 months' notice of termination. No Executive Director has provisions in his or her service contract that relate to a change of control of BAE Systems. In 2010, BAE Systems paid a total of £6,045,000 in salary, bonuses and benefits (but excluding any shares or share option-based benefits) to its Chairman and Executive Directors, including payments made to Mr. George Rose, who retired as BAE Systems' Group Finance Director in March 2011. The Executive Directors are also members of group pension schemes. Messrs. King and Lynas have a normal retirement age of 62 and Ms. Hudson has a normal retirement age of 65.

It is the Board of Directors' policy that Non-Executive Directors do not have service contracts, but do have letters of appointment detailing the basis of their appointment. The Nominations Committee proposes candidates, and the Board of Directors appoints them based on their experience to provide independent judgment on issues of strategy, performance, resources and standards of conduct. The Non-Executive Directors' Fees Committee agrees on the level of fees payable to Non-Executive Directors after reviewing practice in other comparable companies. Non-Executive Directors do not participate in the annual incentive scheme or long-term incentive plans and do not receive retirement benefits. In the year ended December 31, 2010, BAE Systems paid a total of £696,000 in compensation to its Non-Executive Directors.

For more information, see the BAE Systems' Remuneration Report included on page A-13 of this Offering Memorandum.

Audit Committee

The current members of BAE Systems' Audit Committee are:

Nick Rose (Chairman)
Sir Peter Mason
Paula Rosput Reynolds

All members of the Audit Committee are independent Non-Executive Directors. The Audit Committee has requested that the Chief Executive, Group Finance Director, Director Financial Control & Reporting and the head of internal audit normally attend its meetings. Each year, the Audit Committee holds individual meetings without group executives present, without the head of internal audit present, solely with the head of internal audit present, and also solely with the external auditors present.

BAE Systems' external auditors and head of internal audit have direct access to the Chairman of the Audit Committee.

The Audit Committee may obtain at BAE Systems' expense independent professional advice on any matters covered by its terms of reference.

The Audit Committee's tasks include the following:

- reviewing the effectiveness of BAE Systems' financial reporting, internal control policies and procedures for the identification, assessment and reporting of risk;
- monitoring the integrity of BAE Systems' financial statements;
- reviewing significant financial reporting issues and judgments;
- monitoring the role and effectiveness of the internal audit function, including approving the appointment or removal of the head of internal audit;
- approving, in conjunction with the Corporate Responsibility Committee, an annual program of internal audit work;
- considering and making recommendations to the Board of Directors on the appointment of the auditors;
- agreeing on the scope of BAE Systems' external auditors' annual audit program and reviewing the output;
- keeping the relationship with BAE Systems' external auditors under review, including the terms of their engagement and fees, their independence and expertise, resources and qualification, and assessing the effectiveness of the audit process; and
- developing and implementing policy on the engagement of the auditors to supply non-audit services.

Corporate Governance

BAE Systems complied throughout 2010 with the provisions of the Combined Code Principles of Good Governance and Code of Best Practice (the "*Combined Code*"), except as regards paragraph B.2.1 of the Combined Code in that between January 1, 2010 and February 8, 2010 the membership of the Remuneration Committee consisted of two independent Non-Executive Directors and the Chairman of BAE Systems (who had been independent on appointment to the position of Chairman). The Remuneration Committee met once during this period and the only decision made concerning directors' remuneration was to introduce clawback provisions into BAE Systems' executive share plans.

Special Share

BAE Systems has issued one Special Share. The Special Share is held on behalf of the Secretary of State for Business, Innovation and Skills (the "*Special Shareholder*"). Certain provisions of BAE Systems' Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in BAE Systems, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any Executive Chairman are British.

The holder of the Special Share is entitled to attend a general meeting, but the Special Share carries no right to vote or any other rights at any such meeting, other than to speak in relation to any business in respect of the Special Share. Subject to the relevant statutory provisions and BAE Systems' Articles of Association, on a return of capital on a winding up, the holder of the Special Share shall be entitled to repayment of the £1 capital paid up on the Special Share in priority to any repayment of capital to any other members.

The holder of the Special Share has the right to require BAE Systems to redeem the Special Share at par or convert the Special Share into one ordinary share at any time.

DESCRIPTION OF SECURITIES

The following is a summary of the material provisions of the Fiscal and Paying Agency Agreement and the Securities, each as defined below. The summary does not purport to be complete and is qualified in its entirety by reference to all of the provisions of the Fiscal and Paying Agency Agreement and the Securities, copies of which will be available for inspection during normal business hours at any time after the closing date at the offices of the Fiscal and Paying Agent. Any capitalized term used herein but not defined shall have the meaning assigned to such term in the Fiscal and Paying Agency Agreement.

General

BAE Systems plc (the "*Issuer*") is offering $350,000,000 aggregate principal amount of its 3.50% Notes due 2016 (the "*2016 Notes*"), $500,000,000 aggregate principal amount of its 4.75% Notes due 2021 (the "*2021 Notes*") and $400,000,000 aggregate principal amount of its 5.80% Notes due 2041 (the "*2041 Notes*" and together with the 2016 Notes and the 2021 Notes, the "*Securities*"). The 2016 Notes, the 2021 Notes and the 2041 Notes will mature on October 11, 2016, October 11, 2021 and October 11, 2041, respectively (in each case, the "*Stated Maturity Date*" of the respective Series (as defined below)), and upon surrender will be repaid at 100% of the principal amount thereof together with any unpaid and accrued interest. Application has been made to the UK Listing Authority for the Securities to be admitted to the Official List and to the London Stock Exchange for the Securities to be admitted to trading on the Market. The 2016 Notes, the 2021 Notes and the 2041 Notes each constitute a separate series of debt securities to be issued under the Fiscal and Paying Agency Agreement (each a "*Series*") but will be treated as a single class for all purposes under the Fiscal and Paying Agency Agreement.

Principal (and premium, if any) of and interest (and any Additional Amounts, if any) on the Securities are payable in U.S. dollars, or in such other coin or currency of the United States of America as at the time of payment is legal tender for the payment of public and private debts. Interest on the Securities will be payable semi-annually in arrears on each April 11 and October 11, commencing on April 11, 2012, and until the principal amount has been paid or made available for payment, to holders of Securities at the close of business on the respective Record Date (as defined below). Interest on the Securities shall be calculated on the basis of a 360-day year of twelve 30-day months. The Securities will not be entitled to the benefit of any sinking fund. A "*Business Day*" for the Securities shall be a day which is not, in London or New York City, a Saturday, Sunday, a legal holiday or a day on which banking institutions are authorized or obligated by law to close.

The aggregate principal amount of Securities issuable under the Fiscal and Paying Agency Agreement (as defined below) is unlimited. The Issuer may from time to time without the consent of the holders of the Securities issue further debt securities having the same terms and conditions as the Securities so that the further issue is consolidated and forms a single Series of notes with the 2016 Notes, the 2021 Notes or the 2041 Notes, as applicable, having the same terms, other than issue date, interest commencement date, issue price and in some cases, the first interest payment date; *provided* that, unless issued under a separate CUSIP number, such additional debt securities will be fungible with the applicable outstanding Securities for U.S. federal income tax purposes. The period of the resale restrictions applicable to any Securities previously offered and sold in reliance on Rule 144A under the Securities Act shall automatically be extended to the last day of the period of any resale restrictions imposed on any such additional Securities.

The Securities will be issued under a Fiscal and Paying Agency Agreement dated as of October 11, 2011 (the "*Fiscal and Paying Agency Agreement*") among the Issuer, Citibank N.A., London Branch, as Fiscal and Paying Agent (the "*Fiscal and Paying Agent*") and as registrar. This summary does not purport to be complete and is subject to, and qualified in its entirety by reference to, the Fiscal and Paying Agency Agreement and the Securities.

All Securities surrendered for payment or exchange shall be delivered to the Fiscal and Paying Agent. The Fiscal and Paying Agent shall cancel and may destroy all such Securities surrendered for payment or exchange, in accordance with its note destruction policy, and if Securities are destroyed, the Fiscal and Paying Agent shall deliver a certificate of destruction to the Issuer.

The Securities

The 2016 Notes will mature on October 11, 2016, the 2021 Notes will mature on October 11, 2021 and the 2041 Notes will mature on October 11, 2041. The 2016 Notes, the 2021 Notes and the 2041 Notes will bear interest from October 11, 2011, and interest will be payable semi-annually in arrears on each April 11 and October 11 (each such date, an "*Interest Payment Date*"), commencing April 11, 2012 at the rate of 3.50% per year (in the case of the 2016 Notes), 4.75% per year (in the case of the 2021 Notes) and 5.80% per year (in the case of the 2041 Notes), to the holders in whose names the 2016 Notes, the 2021 Notes or the 2041 Notes, as applicable, are registered at the close of business on the March 28 and September 27 preceding such Interest Payment Date (whether or not a Business Day), immediately preceding the related interest payment date, each such date, a "*Record Date.*"

If any Interest Payment Date or Stated Maturity Date (or the date of redemption) with respect to any Security falls on a day that is not a Business Day, the required payment of principal and/or interest will be made on the next succeeding Business Day as if made on the date such payment was due, and no interest will accrue on such payment for the period from and after such Interest Payment Date or Stated Maturity Date (or the date of redemption), as the case may be, to the date of such payment on the next succeeding Business Day.

Prescription

Amounts held by the Fiscal and Paying Agent for payment of the principal (and premium, if any) of and interest on any Securities need not be segregated from other funds except as required by law, and will be applied as set forth in the Fiscal and Paying Agency Agreement and in the Securities. Any amounts held by the Fiscal and Paying Agent for the payment of the principal (and premium, if any) of or interest on the Securities which remain unclaimed for two years after such principal (and premium, if any) or interest has become due and payable and paid to the Fiscal and Paying Agent shall be repaid to the Issuer upon its written request, and all liability of the Fiscal and Paying Agent with respect to such amounts shall cease. Any funds held by the Fiscal and Paying Agent will be held by it as a banker and not subject to the UK FSA Client Money Rules.

Rank

The Securities will constitute direct, unsecured and unsubordinated obligations of the Issuer and will rank *pari passu* among themselves and with all other existing and future direct, unsecured and unsubordinated obligations of the Issuer (except those obligations preferred by statute or operation of law). The Securities will effectively rank junior to any existing and future secured indebtedness of the Issuer to the extent of the assets securing such indebtedness and to any existing and future indebtedness of the Issuer's subsidiaries to the extent of the assets of such subsidiaries.

The Fiscal and Paying Agency Agreement contains no restrictions on the amount of additional indebtedness which may be incurred by the Issuer; however, the Fiscal and Paying Agency Agreement contains certain restrictions on the ability of the Issuer to secure certain of its indebtedness. See "*— Certain Covenants.*"

Governing Law

The Fiscal and Paying Agency Agreement and the Securities will be governed by the laws of the State of New York.

Optional Redemption

Each Series of Securities will be redeemable, at the option of the Issuer, in whole or in part, at any time upon giving not less than 30 nor more than 60 days' notice to the holders (which notice shall be irrevocable), at a redemption price equal to the greater of (i) 100% of the outstanding principal amount of the Securities to be redeemed plus accrued but unpaid interest, if any, to the date fixed by the Issuer for redemption and all Additional Amounts, if any, then due or (ii) the sum of the present values of the Remaining Scheduled Payments (as hereinafter defined) thereon discounted to the redemption date on a semi-annual basis (assuming a 360-day year consisting of twelve 30-day months) at the Treasury Rate plus 40 basis points, in the case of the 2016 Notes, the Treasury Rate plus 45 basis points, in the case of the 2021 Notes, or the Treasury Rate plus 45 basis points, in the case of the 2041 Notes. The Issuer shall determine the redemption price of the Securities and shall promptly notify the Fiscal and Paying Agent of the redemption price so determined.

"*Treasury Rate*" means, with respect to any redemption date, the rate per annum equal to the semi-annual equivalent yield to maturity of the Comparable Treasury Issue, assuming a price for the Comparable Treasury Issue (expressed as a percentage of its principal amount) equal to the Comparable Treasury Price for such redemption date.

"*Comparable Treasury Issue*" means the United States Treasury security selected by the Independent Investment Banker as having a maturity comparable to the remaining term of the Securities to be redeemed that would be utilized, at the time of selection and in accordance with customary financial practice, in pricing new issues of corporate debt securities of comparable maturity to the remaining term of such Securities.

"*Independent Investment Banker*" means the Reference Treasury Dealer appointed by the Fiscal and Paying Agent in consultation with the Issuer, or, at the option of the Fiscal and Paying Agent, by the Issuer.

"*Comparable Treasury Price*" means, with respect to any redemption date, (i) the average of the bid and asked prices for the Comparable Treasury Issue (expressed in each case as a percentage of its principal amount) on the third business day preceding such redemption date, as set forth in the daily statistical release (or any successor release) published by the Federal Reserve Bank of New York and designated "Composite 3:30 p.m. Quotations for U.S. Government Securities" or (ii) if such release (or any successor release) is not published or does not contain such prices on such business day, the average of the Reference Treasury Dealer Quotations on such redemption date.

"*Reference Treasury Dealer Quotations*" means, with respect to each Reference Treasury Dealer and any redemption date, the average, as determined by the Fiscal and Paying Agent, of the bid and asked prices for the Comparable Treasury Issue (expressed in each case as a percentage of its principal amount) quoted in writing to the Fiscal and Paying Agent by such Reference Treasury Dealer at 5:00 p.m. United States Eastern Standard Time on the third Business Day preceding such redemption date.

"*Reference Treasury Dealer*" means each of Deutsche Bank Securities Inc., Goldman, Sachs & Co. and Morgan Stanley & Co. LLC and their respective successors and two other nationally recognized investment banking firms that are Primary Treasury Dealers (as defined below) specified from time to time by the Issuer; *provided, however*, that if any of the foregoing shall cease to be a primary U.S. Government securities dealer in New York City (a "*Primary Treasury Dealer*"), the Issuer shall substitute therefor another nationally recognized investment banking firm that is a Primary Treasury Dealer.

"*Remaining Scheduled Payments*" means, with respect to the Securities to be redeemed, the remaining scheduled payments of the principal thereof to be redeemed and interest thereon that would be due after the related redemption date but for such redemption; *provided, however*, that, if such redemption date is not an Interest Payment Date with respect to such Securities, the amount of the next succeeding scheduled interest payment thereon will be reduced by the amount of interest accrued thereon to such redemption date.

Notice of any redemption will be given by the Issuer by first-class mail at least 30 days but no more than 60 days before the redemption date to the holders of the Securities to be redeemed and to the Fiscal and Paying Agent.

Unless the Issuer defaults in payment of the redemption price, on and after the redemption date interest will cease to accrue on the Securities or portions thereof called for redemption.

Additional Amounts

All payments of principal and interest (and premium, if any) by the Issuer in respect of the Securities shall be made without withholding or deduction for or on account of any present or future taxes, duties, assessments, or other governmental charges of whatsoever nature imposed or levied ("*Taxes*") by or on behalf of the United Kingdom or any political subdivision or taxing authority thereof or therein having power to tax, any jurisdiction in which the Issuer is organized, the jurisdiction of residence of the Issuer for tax purposes or any jurisdiction from or through which any amount is paid by the Issuer (or any political subdivision or taxing authority of or in any such jurisdiction) (a "*Taxing Jurisdiction*"), unless such withholding or deduction is required by law. If the Issuer is compelled by the law of a Taxing Jurisdiction to deduct or withhold such Taxes in respect of any amount to be paid by the Issuer on the Securities, then the Issuer shall pay such additional amounts ("*Additional Amounts*") as may be necessary to ensure that the amounts received by each holder of a Security after such withholding or deduction (including any withholding or deduction with respect to such Additional Amounts) shall equal the amount of principal (and premium, if any) and interest which such holder would have received in respect of each Security in the absence of such withholding or deduction; *provided, however,* that the Issuer shall not be required to make any payment of Additional Amounts to a holder for or on account of:

(a) any Tax which would not have been imposed but for (i) the existence of any present or former connection between such holder (or between a fiduciary, settlor, beneficiary, member or shareholder of, or possessor of a power over, such holder, if such holder is an estate, trust, partnership or corporation) and the Taxing Jurisdiction including, without limitation, such holder (or such fiduciary, settlor, beneficiary, member, shareholder or possessor) being or having been a domiciliary, national or resident thereof or being or having been present or engaged in trade or business therein or having or having had a permanent establishment therein or otherwise having or having had some connection with the Taxing Jurisdiction other than the holding or ownership of a Security or the collection of principal (and premium, if any) of and interest, if any, on, or the enforcement of, a Security or (ii) the presentation of a Security for payment (x) on a date more than 30 days after the date on which such payment became due and payable or the date on which payment thereof is duly provided for, whichever occurs later, except to the extent that the holder would have been entitled to such Additional Amounts if it had presented such Security for payment on the last day of such period of 30 days, or (y) by or on behalf of a holder who would have been able to avoid such withholding or deduction by presenting for payment to another Fiscal or Paying Agent in a member state of the European Union;

(b) any estate, inheritance, gift, sale, transfer, personal property or similar Tax;

(c) any Tax which is payable otherwise than by deduction or withholding from payments of (or in respect of) principal (and premium, if any) of, or any interest on the Securities;

(d) any Tax that is imposed or withheld by reason of the failure to comply by the holder or, if different, the beneficial owner of the Security or the payment in question with a request of the Issuer addressed to the holder (i) to provide information concerning the nationality, residence, identity or place of incorporation of the holder or such beneficial owner or (ii) to make any declaration or other similar claim to satisfy any information or reporting requirement, which in the case of (i) or (ii), is required or imposed by a statute, treaty, regulation or administrative practice of the Taxing Jurisdiction as a precondition to exemption from all or part of such Tax, *provided*, that the Issuer has given the holder or the beneficial owner at least 30 days' notice that the holder or beneficial owner will be required to provide such information, declaration or other reporting requirement; or

(e) any Tax where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to any law implementing or complying with, or introduced in order to conform to, European Council Directive 2003/48/EC, or any other European Union Directive implementing the conclusions of the ECOFIN Council Meeting of 26-27 November 2000 on the taxation of savings income, or any agreement between the European Community and any jurisdiction providing for equivalent measures;

nor shall Additional Amounts be paid with respect to any payment of the principal (and premium, if any) of, or any interest on, any Security to any holder of a Security who is a fiduciary or partnership or other than the sole beneficial owner of such payment to the extent such payment would be required by the laws of the United Kingdom (or any political subdivision or taxing authority thereof or therein) to be included in the income for tax purposes of a beneficiary or settlor with respect to such fiduciary or a member of such partnership or a beneficial owner who would not have been entitled to such Additional Amounts had it been the holder of such Security.

Within 60 days after the date of any payment of any Tax in respect of any payment under any Security pursuant to the provisions set forth above, the Issuer shall furnish to each holder of a Security the original tax receipt for the payment of such Tax (or, if such original tax receipt is not available, a duly certified copy of any original tax receipt) together with such other documentary evidence with respect to such payments as may be reasonably requested from time to time by any holder or beneficial owner of a Security.

The obligations of the Issuer set forth above shall survive the transfer or payment of a Security. The Issuer will pay any present or future stamp, court or documentary taxes or any other excise or property taxes, charges or similar levies which arise in any jurisdiction from the execution, delivery or registration of the Securities or any other document or instrument referred to therein, excluding any such taxes, charges or similar levies imposed by any jurisdiction outside of the United Kingdom except those resulting from, or required to be paid in connection with, the enforcement of the Securities or any other such document or instrument following the occurrence of any Event of Default (as defined herein).

Redemption for Taxation Reasons

The Securities of each Series may be redeemed, at the option of the Issuer, in whole but not in part, at any time upon giving not less than 30 nor more than 60 days' notice to the holders (which notice shall be irrevocable), at a redemption price equal to 100% of the principal amount thereof, together with accrued and unpaid interest to the date fixed by the Issuer for redemption (a "*Tax Redemption Date*") and all Additional Amounts, if any, then due and which will become due on the Tax Redemption Date, as a result of the redemption or otherwise, if the Issuer determines that, as a result of (i) any change in, or amendment to, the laws or treaties (or any regulation or rulings promulgated thereunder) of any Taxing Jurisdiction affecting taxation or (ii) any change in position regarding the application, administration or interpretation of such laws, treaties, regulations or rulings (including a holding, judgment or order by a court of competent jurisdiction), which change, amendment, application or interpretation becomes effective on or after the date of this Offering Memorandum, the Issuer is, or on the next Interest Payment Date would be, required to pay Additional Amounts with respect to the Securities of such Series, and the Issuer determines that such payment obligation cannot be avoided by the Issuer taking reasonable measures available to it. Notwithstanding the foregoing, no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Issuer would be obligated to make such payment or withholding if a payment in respect of the Securities were then due. Prior to the mailing of any notice of redemption of the Securities pursuant to the foregoing, the Issuer will deliver to the Fiscal and Paying Agent an opinion of a tax counsel reasonably satisfactory to the Fiscal and Paying Agent to the effect that the circumstances referred to in (i) or (ii) above exist along with a certificate signed by a duly authorized representative stating that the Issuer is entitled to effect the redemption and setting forth a statement of facts showing that the conditions precedent to the right to redeem have occurred. The Fiscal and Paying Agent shall accept such opinion and certificate as sufficient evidence of the satisfaction of the conditions precedent described above, in which event they shall be conclusive and binding on the holders of Securities.

Defeasance

The Issuer may discharge its obligation to comply with the covenants specified below under "— *Certain Covenants*" by depositing funds or obligations issued by the United States in an amount sufficient to provide for the timely payment of principal, interest and all other amounts due under all Series of the Securities with the Fiscal and Paying Agent provided that the Issuer delivers an opinion of independent tax counsel of recognized standing (an "*Opinion of Tax Counsel*") to the effect that holders of the Securities will not recognize income, gain or loss for U.S. Federal income tax purposes as a result of such deposit and defeasance of such obligations and will be subject to U.S. Federal income tax on the same amount and in the same manner and at the same time as would have been the case if such deposit and defeasance had not occurred. In addition to discharging these obligations, if the Issuer delivers to the Fiscal and Paying Agent an Opinion of Tax Counsel (in lieu of the Opinion of Tax Counsel referred to above) to the effect that (a) the Issuer has received from, or there has been published by, the Internal Revenue Service a ruling or (b) since the date of the Fiscal and Paying Agency Agreement there has been a change in applicable U.S. Federal income tax law, in either case to the effect that, and based thereon such Opinion of Tax Counsel shall confirm that, the holders of the Securities will not recognize income, gain or loss for Federal income tax purposes as a result of such deposit, defeasance and discharge and will be subject to Federal income tax on the same amount and in the same manner and at the same times, as would have been the case if such deposit, defeasance and discharge had not occurred, and (c) the trust resulting from the defeasance is a valid trust and will not constitute a regulated investment company under the United States Investment Company Act of 1940, as amended, then, in such event, the Issuer will be deemed to have paid and discharged the entire indebtedness on the Securities. In the event of any such defeasance and discharge of the Securities, holders of Securities would be able to look only to such trust fund for payment of principal (and premium, if any) of and interest on the Securities.

Amendments of Securities

The holders of the Securities of any Series may, with the written consent of the Issuer and, solely to the extent that the proposed amendments affect the Fiscal and Paying Agent or the performance of its duties under the Fiscal and Paying Agency Agreement, the Fiscal and Paying Agent (such consent from the Fiscal and Paying Agent not to be unreasonably withheld or delayed), modify, amend or supplement the terms of such Securities or the Fiscal and Paying Agency Agreement, in any way, and may make, take or give any request, demand, authorization, direction, notice, consent, waiver or other action provided by the Fiscal and Paying Agency Agreement or such Securities to be made, given or taken by holders of such Securities either (i) at any meeting of holders of such Securities duly called and held, by the affirmative vote, in person or by proxy, or (ii) with the written consent, in each case in (i) and (ii) above, of the holders of a majority in aggregate principal amount of such Securities then outstanding voting together as a single class; *provided, however*, that no such action, modification, amendment, or supplement may, without the written consent of the holders of the Securities affected thereby, (i) change the due date for the payment of the principal (and premium, if any) of or any installment of interest on the Securities, (ii) reduce the principal amounts of the Securities or the interest rate thereon or the premium payable upon redemption thereof, (iii) change the currency in which or change the required place at which payment with respect to principal (and premium, if any) or interest, if any, in respect of the Securities is payable to a place outside the United States, (iv) amend the procedures provided for or the circumstances under which the Securities may be redeemed, or (v) reduce the proportion of the principal amount of the Securities the consent of the holders of which is necessary to modify or amend the Fiscal and Paying Agency Agreement or the terms and conditions of the Securities or to make, take or give consent, waiver or other action provided thereby to be made, taken or given.

The Issuer and the Fiscal and Paying Agent may, without the vote or consent of any holder of Securities, amend the Fiscal and Paying Agency Agreement or the Securities for the purpose of (i) adding to the covenants of the Issuer for the benefit of the holders of Securities, (ii) surrendering any right or power conferred upon the Issuer, (iii) securing the Securities pursuant to the requirements thereof or otherwise, (iv) evidencing the succession of another corporation to the Issuer and the assumption by such successor of the covenants and obligations of the Issuer therein and in the Securities as permitted by the Fiscal and Paying Agency Agreement and the Securities, (v) modifying the restrictions on and procedures for resale and other transfers of the Securities to reflect any change in applicable law or regulation (or the interpretation thereof) or in practices relating to the resale or transfer of restricted securities generally, (vi) accommodating the issuance, if any, of Securities in book-entry form and matters related thereto, (vii) correcting or supplementing any defective provision contained in the Fiscal and Paying Agency Agreement or the Securities in a manner which does not adversely affect the interest of a holder of the Securities in any material respect, (viii) effecting any amendment which the Issuer and the Fiscal and Paying Agent may determine and which, as determined solely by the Issuer, shall not adversely affect the interest of any holder of the Securities in any material respect or (ix) making any modification which is of a minor or technical nature or correcting a manifest error.

Events of Default

Each of the following events will constitute an "*Event of Default*":

(i) the Issuer shall fail to pay when due the principal of the Securities of any Series within five Business Days following the date such payment is due;

(ii) the Issuer shall fail to pay an installment of interest on the Securities of any Series within 30 days following the date such payment is due;

(iii) the Issuer shall fail to perform or observe any other term, covenant or agreement contained in the Securities of any Series for a period of 60 days after written notice thereof shall have been given to the Issuer by the holders of not less than 25% in aggregate principal amount of the Securities;

(iv) (A) the repayment of any Borrowed Money (as hereinafter defined) of the Issuer or any Material Subsidiary is accelerated by reason of default and is not then paid within any period of grace applicable thereto (or if no grace period is specified and the default arises solely due to technical or administrative problems in making payments, within three Business Days or otherwise within five Business Days), or the principal amount of any Borrowed Money of the Issuer or any Material Subsidiary is not repaid on the due date therefor, or any guarantee in respect of the principal amount of any Borrowed Money is not honored, in each case within any period of grace applicable thereto (or if no grace period is specified and the default arises solely due to technical or administrative problems in making payments, within three Business Days or otherwise within five Business Days) and (B) the principal amount of such Borrowed Money is at least equal to the greater of (x) £25,000,000 (or the equivalent thereof in other currencies) in aggregate or (y) 0.5% of the BAE Group Total Assets. For the purposes of this clause (iv) "*Borrowed Money*" means (a) money borrowed and premiums and accrued interest which has become due and payable in respect thereof, (b) liabilities under or in respect of any acceptance or acceptance credit and (c) the principal and premium (if any) (and accrued interest which has become due and payable) for the time being outstanding on any notes, bonds or similar instruments, loan stock or other securities whether issued in whole or in part for cash or other consideration, together with guarantees of any of the aforesaid;

(v) a decree or order by a court having jurisdiction shall have been entered adjudging the Issuer a bankrupt or insolvent, or approving as properly filed a petition seeking reorganization of the Issuer under any Bankruptcy Law or any other similar applicable Federal, State or foreign law, and such decree or order shall have continued undischarged and unstayed for a period of 60 days; or a decree or order of a court having jurisdiction for the appointment of a receiver or liquidator or trustee or assignee in bankruptcy or insolvency of the Issuer or of the property of the Issuer or for the winding up or liquidation of the affairs of the Issuer shall have been entered and such decree or order shall have continued undischarged and unstayed for a period of 60 days; or

(vi) the Issuer shall institute proceedings to be adjudicated a voluntary bankrupt or shall consent to the filing of a bankruptcy proceeding against it, or shall file a petition or answer or consent seeking reorganization under any Bankruptcy Law or any other similar applicable Federal, State or foreign law, or shall consent to the filing of any such petition, or shall consent to the appointment of a receiver or liquidator or trustee or assignee in bankruptcy or insolvency of it or its property, or shall make a general assignment for the benefit of creditors, or shall admit in writing its inability to pay its debts generally as they become due.

In each and every such case (other than an Event of Default specified in clause (i) or (ii) above or an Event of Default specified in clauses (v) and (vi) above), the Fiscal and Paying Agent may (but is not required to), or at the direction or request of the holders of not less than a majority percent in aggregate principal amount of the Securities then outstanding shall, by notice in writing to the Issuer, declare the principal amount (and premium, if any) of and all accrued interest on all the Securities to be due and payable immediately. Upon any such declaration the same shall become and shall be immediately due and payable upon the date that such written notice is received by the Issuer, unless prior to such date all Events of Default in respect of all the Securities shall have been cured; *provided*, that if, at any time after the principal of such Securities shall have been so declared due and payable, and before any sale of property under any judgment or decree for the payment of the monies due shall have been obtained or entered as hereinafter provided, the Issuer shall pay or shall deposit with the Fiscal and Paying Agent a sum sufficient to pay all matured installments of interest and principal upon all the Securities which shall have become due otherwise than solely by acceleration (with interest on overdue installments of interest, to the extent permitted by law, and on such principal of each Security at the rate of interest specified therein, to the date of such payment or deposit) and such amount as shall be sufficient to cover reasonable compensation to the Fiscal and Paying Agent and each predecessor, their respective agents, attorneys and counsel, and all other documented expenses and liabilities reasonably incurred, and all advances made for documented expenses and legal fees reasonably incurred by the Fiscal and Paying Agent and each predecessor Fiscal and Paying Agent, and if any and all Events of Default, other than the nonpayment of the principal of the Securities then outstanding, which shall have become due solely by acceleration, shall have been cured, waived or otherwise remedied as provided in such Securities and the Fiscal and Paying Agency Agreement, then and in every such case, the holders of two-thirds in aggregate principal amount of such Securities then outstanding by written notice to the Issuer and to the Fiscal and Paying Agent may, on behalf of all of the holders of the Securities, waive all defaults and rescind and annul such declaration and its consequences but no such waiver or rescission and annulment shall extend to or shall affect any subsequent default, or shall impair any right consequent thereon. Actions by holders of Securities pursuant to this provision need not be taken at a meeting pursuant to the provisions regarding meetings of holders of the Securities. If an Event of Default specified in clauses (i) or (ii) above occurs, each holder may, by written notice to the Issuer and the Fiscal and Paying Agent, declare the principal (and premium, if any) of and all accrued interest on the Securities of such holder to be due and payable upon the date that written notice is received by or on behalf of the Issuer and the Fiscal and Paying Agent unless prior to such date all Events of Default in respect of such holder's Securities shall have been cured. If an Event of Default specified in clauses (v) or (vi) above occurs, the principal (and premium, if any) of and accrued interest on the Securities will be immediately due and payable without any declaration or other act on the part of any holder of Securities or other person.

Certain Covenants

So long as any amount remains unpaid on the Securities, the Issuer will comply with the terms of the covenants set forth herein.

Payment of Principal and Interest

The Issuer will duly and punctually pay the principal of (and premium, if any) and interest on the Securities in accordance with their terms.

Corporate Existence

Except as provided below in "— *Merger, Consolidation, Sale or Lease,*" the Issuer will do or cause to be done all things necessary to preserve and keep in full force and effect its corporate existence.

Merger, Consolidation, Sale or Lease

The Issuer will not, directly or indirectly, consolidate or merge with, or sell, lease or otherwise dispose of substantially all of its assets to, any other Person unless (i) the Issuer is the survivor in such transaction or the Issuer procures that the survivor is a corporation organized under the laws of England, the United States or a State thereof or the District of Columbia which expressly assumes in writing the Issuer's obligations under the Securities and (ii) immediately after giving effect to the transaction, no Event of Default, and no event which, after notice or lapse of time or both, would become an Event of Default, shall have occurred and be continuing.

Limitation on Liens

The Issuer will not, and will not permit any member of the BAE Group (as defined below) to, create or permit to exist any Lien (as defined below) upon any of its or their present or future assets or revenues to secure any of its present or future Relevant Borrowings (as defined below) without making effective provision whereby all of the Securities shall be directly secured equally and ratably with such Relevant Borrowings.

Information

So long as any Securities are outstanding, and except at such time as the Issuer is a reporting company under Section 13 or 15(d) of the Exchange Act, the Issuer shall either comply with the exemption from registration under the Exchange Act set forth in Rule 12g3-2(b) under the Exchange Act or, if at any time it is not so exempt, it shall provide the information required pursuant to Rule 144A(d)(4) under the Securities Act upon request of the holders of the Securities, a prospective purchaser of the Securities designated by such holder, a beneficial owner of such a Global Security or a prospective purchaser designated by such beneficial owner.

Definitions

The terms hereinafter set forth when used in connection with the covenants and events of default applicable to the Securities shall have the meanings set forth below.

For purposes of the following definitions, borrowings of any member of the BAE Group expressed in or calculated by reference to a currency other than pounds sterling or a combination of currencies including a currency or currencies other than pounds sterling shall (as regards the currency or currencies other than pounds sterling) be converted into pounds sterling by reference to the rates of exchange used for the conversion of such currencies in the Latest Consolidated Balance Sheet or, if no such conversion was so required for any relevant currency, by reference to the rate of exchange or approximate rate of exchange in effect on the date of the Latest Consolidated Balance Sheet.

"*BAE Group*" means the Issuer and its consolidated Subsidiaries.

"*BAE Group Total Assets*" means, at any time, the aggregate book value of the fixed and current assets and investments of the BAE Group as determined by reference to the Latest Consolidated Balance Sheet.

"*Bankruptcy Law*" means Title 11, United States Code, or any similar U.S. Federal or state law, any applicable English bankruptcy, insolvency, reorganization or other similar law of England, or any other similar foreign law for the relief of debtors.

"*Default*" means any event or condition the occurrence of which would, with the lapse of time or the giving of notice, or both, constitute an Event of Default.

"*Latest Consolidated Balance Sheet*" means the latest published annual consolidated balance sheet of the Issuer which has been audited and reported on by the Issuer's independent accountants (the "*Auditors*") in the full financial statements of the BAE Group.

"*Latest Consolidated Profit and Loss Account*" means the latest published annual consolidated profit and loss account of the Issuer which has been audited and reported on by the Auditors in the full financial statements of the BAE Group.

"*Lien*" means any lien, mortgage, charge, encumbrance or other security interest, provided that Liens shall not include: (i) in the case of a Subsidiary, any liens, mortgages, charges, encumbrances or other security interests in existence at the date it became a Subsidiary and which was not created in anticipation of such acquisition, and (ii) any security interests not falling within (i) above securing an amount in the aggregate not exceeding 3.5% of the BAE Group Total Assets.

"*Material Subsidiary*" means any Subsidiary which either by itself or together with its Subsidiaries accounts for more than 10% of the BAE Group Total Assets.

"*Person*" means an individual, partnership, corporation, undertaking, joint venture, trust or unincorporated organization, and a government or agency or political subdivision thereof.

"*Relevant Borrowings*" means any indebtedness for borrowed money of any member of the BAE Group in the form of, or represented by, bonds, notes, debentures or other securities which are or are to be quoted, listed or ordinarily dealt in or traded on any stock exchange, over-the-counter or other securities market (whether or not initially distributed by way of private placement), but excluding any such indebtedness which upon the issuance thereof had a stated maturity not exceeding one year.

"*Subsidiary*" means a subsidiary corporation or other Person which is required to be fully consolidated in the consolidated financial statements of the Issuer in accordance with the accounting principles under which the Issuer is required to produce its financial statements from time to time.

Book-Entry; Delivery and Form

Each Series of the Securities being offered hereby is being offered and sold only (i) to qualified institutional buyers ("*QIBs*") in reliance on Rule 144A and (ii) in offshore transactions in reliance on Regulation S.

Each Series of the Securities will be issued in fully registered form and only in denominations of $2,000 and integral multiples of $1,000 in excess thereof. Each Series of the Securities will be issued on the closing date only against payment in immediately available funds.

Summary of Provisions Relating to Securities in Global Form

The certificates representing each Series of the Securities will be issued in fully registered form without interest coupons. Securities of each Series sold in offshore transactions in reliance on Regulation S under the Securities Act will initially be represented by one or more permanent global Securities in definitive, fully registered form without interest coupons (each a "*Regulation S Global Security*") and will be deposited with the Fiscal and Paying Agent as custodian for, and registered in the name of, a nominee of The Depository Trust Company, as depositary ("*DTC*") for the accounts of its participants, including Euroclear and Clearstream. Prior to the 40th day after the later of the commencement of the offering of the Securities and the date of the Fiscal and Paying Agency Agreement, any resale or other transfer of such interests to U.S. persons shall not be permitted unless such resale or transfer is made pursuant to Rule 144A or Regulation S, as applicable, and in accordance with the certification requirements described below.

Securities of each Series sold in reliance on Rule 144A will be represented by one or more permanent global Securities in definitive, fully registered form without interest coupons (each, a "*Rule 144A Global Security*" and, together with the Regulation S Global Security, the "*Global Securities*") and will be deposited with the Fiscal and Paying Agent as custodian for, and registered in the name of a nominee of, DTC. Beneficial interests in a Rule 144A Global Security may be transferred to a person who takes delivery in the form of an interest in a Regulation S Global Security only upon receipt by the Fiscal and Paying Agent of written certifications (in the form(s) provided in the Fiscal and Paying Agency Agreement) and pursuant to the transfer restrictions related to a Rule 144A Global Security as described in this Offering Memorandum.

Each Global Security (and any Security issued in exchange therefor) will be subject to certain restrictions on transfer set forth therein described under "*Transfer Restrictions*". Except in the limited circumstances described below under "*— Summary of Provisions Relating to Certificated Securities*", owners of beneficial interests in the Global Securities will not be entitled to receive physical delivery of Certificated Securities (as defined below).

Ownership of beneficial interests in a Global Security will be limited to persons who have accounts with DTC ("*participants*") or persons who hold interests through participants. Ownership of beneficial interests in a Global

Security will be shown on, and the transfer of that ownership will be effected only through, records maintained by DTC or its nominee (with respect to interests of participants) and the records of participants (with respect to interests of persons other than participants). QIBs may hold their interests in a Rule 144A Global Security directly through DTC if they are participants in such system, or indirectly through organizations which are participants in such system.

Investors may hold their interests in a Regulation S Global Security directly through Euroclear and Clearstream, if they are participants in such systems, or indirectly through organizations that are participants in such systems. Euroclear and Clearstream will hold interests in the Regulation S Global Securities on behalf of their participants through DTC.

So long as DTC, or its nominee, is the registered owner or securityholder of a Global Security, DTC or such nominee, as the case may be, will be considered the sole owner or securityholder of the Securities represented by such Global Security for all purposes under the Fiscal and Paying Agency Agreement and the Securities. No beneficial owner of an interest in a Global Security will be able to transfer that interest except in accordance with DTC's applicable procedures, in addition to those provided for under the Fiscal and Paying Agency Agreement and, if applicable, those of Euroclear and Clearstream.

Payments of the principal of, and interest on, a Global Security will be made to DTC or its nominee, as the case may be, as the registered owner thereof. Neither the Issuer nor the Fiscal and Paying Agent will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial ownership interests in a Global Security or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

The Issuer expects that DTC or its nominee, upon receipt of any payment of principal or interest in respect of a Global Security, will credit participants' accounts with payments in amounts proportionate to their respective beneficial interests in the principal amount of such Global Security as shown on the records of DTC or its nominee. The Issuer also expects that payments by participants to owners of beneficial interests in such Global Security held through such participants will be governed by standing instructions and customary practices, as is now the case with securities held for the accounts of customers registered in the names of nominees for such customers. Such payments will be the responsibility of such participants.

Transfers between participants in DTC will be effected in the ordinary way in accordance with DTC rules and will be settled in same-day funds. Transfers between participants in Euroclear and Clearstream will be effected in the ordinary way in accordance with their respective rules and operating procedures.

Cross-market transfers between persons holding, directly or indirectly through DTC, on the one hand, and directly or indirectly through Euroclear or Clearstream participants, on the other, will be effected in DTC in accordance with DTC rules on behalf of the relevant European international clearing system by the relevant European depositary; however, those cross-market transactions will require delivery of instructions to the relevant European international clearing system by the counterparty in that system in accordance with its rules and procedures and within its established deadlines (European time). The relevant European international clearing system will, if the transaction meets its settlement requirements, deliver instructions to the relevant European depositary to take action to effect final settlement on its behalf by delivering or receiving securities in DTC, and making or receiving payment in accordance with normal procedures for same-day funds settlement applicable to DTC. Euroclear and Clearstream participants may not deliver instructions directly to the European depositaries.

Because of time zone differences, credits of securities received in Euroclear or Clearstream as a result of a transaction with a person that does not hold the Securities through Euroclear or Clearstream will be made during subsequent securities settlement processing and dated the business day following the DTC settlement date. Those credits or any transactions in those securities settled during that processing will be reported to the relevant Euroclear or Clearstream participants on that business day. Cash received in Euroclear or Clearstream as a result of sales of securities by or through a Euroclear participant or a Clearstream participant to a DTC participant will be received with value on the DTC settlement date, but will be available in the relevant Euroclear or Clearstream cash account only as of the business day following settlement in DTC.

The Issuer expects that DTC will take any action permitted to be taken by a securityholder (including the presentation of Securities for exchange as described below) only at the direction of one or more participants to whose account the DTC interests in a Global Security is credited and only in respect of such portion of the aggregate principal amount of Securities as to which such participant or participants has or have given such direction. However, if there is an Event of Default under the Securities, DTC will exchange the applicable Global Security for Certificated Securities, which it will distribute to its participants and which may be legended as set forth under the heading "*Transfer Restrictions.*"

The Issuer understands that DTC is a limited purpose trust company organized under the laws of the State of New York, a "*banking organization*" within the meaning of New York Banking Law, a member of the Federal Reserve System, a "*clearing corporation*" within the meaning of the Uniform Commercial Code and a "*Clearing Agency*" registered pursuant to the provisions of Section 17A of the Exchange Act. DTC was created to hold securities for its participants and facilitate the clearance and settlement of securities transactions between participants through electronic book-entry changes in accounts of its participants, thereby eliminating the need for physical movement of certificates and certain other organizations. Direct participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. Indirect access to the DTC system is available to others such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a participant, either directly or indirectly ("*indirect participants*").

Euroclear advises that it was created in 1968 to hold securities for participants of Euroclear and to clear and settle transactions among Euroclear participants through simultaneous electronic book-entry delivery against payment, thereby eliminating the need for physical movement of certificates and any risk from lack of simultaneous transfers of securities and cash. Euroclear includes various other services, including securities lending and borrowing, and interfaces with domestic markets in several countries. Euroclear is operated by Euroclear Bank S.A./N.V. (the "*Euroclear Operator*"), under contract with Euroclear Clearance Systems S.C., a Belgian cooperative corporation (the "*Euroclear Clearance System*"). All operations are conducted by the Euroclear Operator, and all Euroclear securities clearance accounts and Euroclear cash accounts are accounts with the Euroclear Operator, not the Euroclear Clearance System. The Euroclear Clearance System establishes policies for Euroclear on behalf of Euroclear participants. Euroclear participants include banks (including central banks), securities brokers and dealers and other professional financial intermediaries and may include the underwriters. Indirect access to Euroclear is also available to other firms that clear through or maintain a custodial relationship with Euroclear participants, either directly or indirectly. Euroclear is an indirect participant in DTC. The Euroclear Operator is a Belgian bank. The Belgian Banking Commission and the National Bank of Belgium regulate the Euroclear Operator.

Securities clearance accounts and cash accounts with the Euroclear Operator are governed by the Terms and Conditions Governing Use of Euroclear and the related Operating Procedures of the Euroclear System, and applicable Belgian law (collectively, the "*Terms and Conditions*"). The Terms and Conditions govern transfer of securities and cash within Euroclear, withdrawals of securities and cash from Euroclear, and receipts of payments with respect to securities in Euroclear. All securities in Euroclear are held on a fungible basis without attribution of specific certificates to specific securities clearance accounts. The Euroclear Operator acts under the Terms and Conditions only on behalf of Euroclear participants, and has no record of or relationship with persons holding through Euroclear participants. Distributions with respect to the Securities held beneficially through Euroclear will be credited to the cash accounts of Euroclear participants in accordance with the Terms and Conditions.

Clearstream advises that it is incorporated under the laws of Luxembourg and licensed as a bank and professional depositary. Clearstream holds securities for its participating organizations and facilitates the clearance and settlement of securities transactions among its participants through electronic book-entry changes in accounts of its participants, thereby eliminating the need for physical movement of certificates. Clearstream provides to its participants, among other things, services for safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Clearstream interfaces with domestic markets in several countries. Clearstream has established an electronic bridge with the Euroclear Operator, to facilitate the settlement of trades between Clearstream and Euroclear. As a registered bank in Luxembourg, Clearstream is subject to regulation by the Luxembourg Commission for the Supervision of the Financial Sector. Clearstream customers are recognized financial institutions around the world, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations. In the United States, Clearstream customers are limited to securities brokers and dealers and banks, and may include the Initial Purchasers of the Securities. Other institutions that maintain a custodial relationship with a Clearstream customer may obtain indirect access to Clearstream. Clearstream is an indirect participant in DTC.

Distributions with respect to Securities held beneficially through Clearstream will be credited to cash accounts of Clearstream participants in accordance with its rules and procedures.

Although DTC, Euroclear and Clearstream are expected to follow the foregoing procedures in order to facilitate transfers of interests in a Global Security among participants of DTC, Euroclear and Clearstream, they are under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued at any time. Neither the Issuer nor the Fiscal and Paying Agent will have any responsibility for the performance by DTC, Euroclear or Clearstream or their respective participants or indirect participants of their respective obligations under the rules and procedures governing their respective operations.

Summary of provisions relating to Certificated Securities

If DTC is at any time unwilling or unable to continue as a depositary for the Global Securities and a successor depositary is not appointed by the Issuer within 90 days, or if there shall have occurred and be continuing an Event of Default (as described below) with respect to the Securities, the Issuer will issue Certificated Securities in exchange for the Global Securities. Certificated Securities delivered in exchange for beneficial interests in any Global Security will be registered in the names, and issued in denominations of $2,000 or integral multiples of $1,000 in excess thereof, requested by or on behalf of the DTC or successor depositary (in accordance with its customary procedures). Holders of an interest in the Global Securities may receive Certificated Securities, which may bear the legend referred to under "*Transfer Restrictions*", in accordance with DTC's rules and procedures in addition to those provided for under the Fiscal and Paying Agency Agreement.

Except in the limited circumstances described above, owners of interests in the Global Securities will not be entitled to receive physical delivery of individual definitive certificates. The Securities are not issuable in bearer form.

Subject to such transfer restrictions, the holder of a Certificated Security bearing such a legend may transfer or exchange such Securities in whole or in part by surrendering them to the Fiscal and Paying Agent. Prior to any proposed transfer of Securities in certificated form, the holder may be required to provide certifications and other documentation to the Fiscal and Paying Agent as described above. In the case of a transfer of only part of a Security, the original principal amount of both the part transferred and the balance not transferred must be in authorized denominations, and new Securities will be issued to the transferor and transferee, respectively, by the Fiscal and Paying Agent. Upon the transfer, exchange or replacement of Certificated Securities not bearing the legend described above, the Fiscal and Paying Agent will deliver Certificated Securities that do not bear such legend.

Upon the transfer, exchange or replacement of Certificated Securities bearing the legend described above, or upon a specific request for removal of the legend from such Certificated Security, the Fiscal and Paying Agent will deliver only Certificated Securities bearing such legend or will refuse to remove such legend, as the case may be, unless there is delivered to the Issuer such satisfactory evidence, which may include an opinion of legal counsel of recognized standing, as may be reasonably required by the Issuer that neither the legend nor the restrictions on transfer set forth therein are required to ensure compliance with the provisions of the Securities Act.

Payment of principal and interest in respect of the Certificated Securities shall be payable at the office of agency of the Issuer in London which shall initially be the corporate trust office of the Fiscal and Paying Agent, at

Citibank, N.A., London Branch — Agency and Trust Services, Citigroup Centre, 25 Canada Square, Canary Wharf, London E14 5LB, United Kingdom, provided that at the option of the Issuer, payment may be made by wire transfer, direct deposit or check mailed to the address of the holder entitled thereto as such address appears in the Security register.

As long as the Securities remain outstanding, the Issuer agrees that it will ensure that it maintains a paying agent for the Securities in a member state of the European Union that is not obligated to withhold or deduct tax pursuant to European Council Directive 2003748/EC or any other European Union Directive implementing the conclusions of the ECOFIN Council meeting of 26-27 November 2000 on taxation of savings income or any law implementing or complying with, or introduced in order to conform to such Directive provided that the Issuer shall not under any circumstances be obliged to maintain a paying agent with a specified office in such member state unless at least one European member state does not require a paying agent making payments through a specified office in that member state to so withhold or deduct tax.

The Certificated Securities, at the option of the securityholder and subject to the restrictions contained in the Securities and in the Fiscal and Paying Agency Agreement, may be transferred or exchanged, upon surrender or exchange or registration for transfer at the office of the Fiscal and Paying Agent. Any Certificated Security surrendered for exchange or presented for registration of transfer shall be duly endorsed, or be accompanied by a written instrument of transfer in form satisfactory to the Fiscal and Paying Agent, duly endorsed by the holder thereof or his attorney duly authorized in writing. Securities issued upon such transfer will be executed by the Issuer and authenticated by the Fiscal and Paying Agent, registered in the name of the designated transferee or transferees and delivered at the office of the Fiscal and Paying Agent or mailed, at the request, risk and expense of, and to the address requested by, the designated transferee or transferees.

Payments of Interest and Principal

Payments of interest and principal (and premium, if any) to owners of a beneficial interest in Global Securities are expected to be made in accordance with the procedures of DTC, DTC Participants, Euroclear and Clearstream in effect from time to time as described above under "— *Book-Entry, Delivery and Form.*"

Interest payments will be made on the Securities on each April 11 and October 11 and at the Stated Maturity Date thereof and upon redemption. Interest payments (other than interest due at the Stated Maturity thereof or upon redemption) will be made to the holders of the Securities in whose names such notes are registered at the close of business on the applicable Record Date.

When and if the Securities are in certificated form, interest payments on the Securities (other than interest due at the Stated Maturity thereof or upon redemption) will be made on the relevant Interest Payment Date, subject to the second paragraph below, by the Fiscal and Paying Agent either (i) if the holder holds at least $10,000,000 in aggregate principal amount of the Securities of the applicable Series, by transfer of immediately available funds to such account at a bank in New York City (or at a bank in such other place as may be consented to by the Issuer) as such holder of Securities shall have designated at least ten calendar days prior to the relevant Interest Payment Date; or (ii) by check mailed, postage prepaid, payable to the order of the holder at its address appearing in the register of Securities maintained by the Issuer or to such other address as any holder shall designate to the Fiscal and Paying Agent in writing not later than ten calendar days prior to the Interest Payment Date. The Fiscal and Paying Agent shall have no responsibility to obtain wire transfer instructions from any holder. The Fiscal and Paying Agent will withhold taxes, if any, on interest to the extent that such Fiscal and Paying Agent has been instructed by the Issuer that any taxes should be withheld or to the extent required by law in accordance with then existing United Kingdom law.

Upon presentation of the Securities of a Series on or after the Stated Maturity Date thereof, the Fiscal and Paying Agent shall pay the principal amount of such Securities in accordance with such terms of the Securities together with accrued interest, if any, due at the Stated Maturity Date thereof in immediately available funds against presentation of the Securities at the office of the Fiscal and Paying Agent in London. The Fiscal and Paying Agent will cancel such Securities and, unless otherwise instructed by the Issuer, destroy such Securities. The

Fiscal and Paying Agent will withhold taxes, if any, on principal to the extent that such Fiscal and Paying Agent has been instructed by the Issuer that any taxes should be withheld or to the extent required by law in accordance with then existing United Kingdom law.

If any Interest Payment Date or the Stated Maturity Date (or the date of redemption) falls on a day that is not a Business Day, the payment will be made on the next Business Day with the same force and effect as if made on the date such payment was due, and no interest shall be payable in respect of any such delay.

The Issuer shall, not later than 10:00 a.m. New York City time on each date on which interest is payable on a Security, deposit with the Fiscal and Paying Agent, or as it shall direct, U.S. Dollars in immediately available funds sufficient to pay all interest due on the Securities on such date and shall, not later than 10:00 a.m. New York City time on the Stated Maturity Date of any Securities, deposit with the Fiscal and Paying Agent, or as it shall direct, U.S. Dollars in immediately available funds sufficient to pay the principal of and accrued interest, if any, on the Securities.

TAXATION

Prospective investors should consult their professional advisors on the possible tax consequences of buying, holding or selling any Securities under the laws of their country of citizenship, residence or domicile. The discussions that follow for each jurisdiction are based upon the applicable laws and interpretations thereof as in effect as of the date hereof, all of which laws and interpretations are subject to change or differing interpretations, which changes or differing interpretations could apply retroactively.

U.S. Taxation of U.S. Persons

The following discussion summarizes certain U.S. federal income tax considerations that may be relevant to the acquisition, ownership and disposition of the Securities. This discussion is based upon the provisions of the Internal Revenue Code of 1986, as amended (the "*Code*"), applicable U.S. Treasury Regulations promulgated thereunder, judicial authority and administrative interpretations, as of the date of this document, all of which are subject to change, possibly with retroactive effect, and may be subject to different interpretations. We cannot assure you that the Internal Revenue Service will not challenge one or more of the tax consequences described in this discussion, and we have not obtained, nor do we intend to obtain, a ruling from the Internal Revenue Service or opinion of counsel with respect to the U.S. federal tax consequences of acquiring, holding or disposing of the Securities.

In this discussion, we do not purport to address all tax considerations that may be important to a particular holder in light of the holder's circumstances or to certain categories of investors that may be subject to special rules, such as financial institutions, insurance companies, regulated investment companies, real estate investment trusts, tax-exempt organizations, dealers in securities or currencies, U.S. persons whose functional currency is not the U.S. dollar, U.S. expatriates, traders in securities that have elected the mark-to-market method of accounting for their securities, partnerships and other pass-through entities and holders of interests therein, U.S. persons subject to the alternative minimum tax, or persons who hold the Securities as part of a hedge, conversion transaction, straddle or other risk reduction transaction. This discussion is limited to holders who purchase the Securities in this offering at their "issue price" (the first price at which a substantial amount of the Securities is sold for cash other than to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers) and who hold the Securities as capital assets (generally, property held for investment). Except where specifically described below, this discussion does not address any U.S. federal tax consequences other than U.S. federal income tax consequences (such as the estate tax, gift tax or Medicare tax on net investment income). This discussion also does not address the tax considerations arising under the laws of any foreign, state, local or other jurisdiction or any income tax treaty.

If a partnership or other entity treated as a partnership for U.S. federal income tax purposes holds Securities, the tax treatment of a partner of the partnership generally will depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership acquiring the Securities, you are urged to consult your own tax advisor about the U.S. federal income tax consequences of acquiring, holding and disposing of the Securities.

You are a "U.S. person" for purposes of this discussion if you are a beneficial owner of a Security and you are for U.S. federal income tax purposes:

- an individual who is a U.S. citizen or U.S. resident alien;
- a corporation, or other entity taxable as a corporation for U.S. federal income tax purposes, that was created or organized in or under the laws of the United States, any state thereof or the District of Columbia;
- an estate whose income is subject to U.S. federal income taxation regardless of its source; or
- a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust, or that has a valid election in effect under applicable U.S. Treasury Regulations to be treated as a United States person.

Interest on the Securities

Stated interest on the Securities generally will be taxable to you as ordinary income at the time it is received or accrued in accordance with your regular method of accounting for U.S. federal income tax purposes.

Disposition of the Securities

You will generally recognize capital gain or loss on the sale, redemption, exchange, retirement or other taxable disposition of a Security. This gain or loss will equal the difference between the proceeds you receive (excluding any proceeds attributable to accrued but unpaid interest which will be recognized as ordinary interest income to the extent you have not previously included the accrued interest in income) and your adjusted tax basis in the Security. The proceeds you receive will include the amount of any cash and the fair market value of any other property received for the Security. Your adjusted tax basis in the Security will generally equal the amount you paid for the Security. The gain or loss will be long-term capital gain or loss if you held the Security for more than one year at the time of the sale, redemption, exchange, retirement or other disposition. Long-term capital gains of individuals, estates and trusts currently are subject to a reduced rate of U.S. federal income tax. The deductibility of capital losses is subject to limitation.

Information reporting and backup withholding

Information reporting generally will apply to payments of interest on, or the proceeds of the sale, redemption, exchange, retirement or other disposition of, Securities held by you unless you are an exempt recipient (such as a corporation). Backup withholding will apply to such payments unless you provide the appropriate intermediary with a taxpayer identification number, certified under penalties of perjury, as well as certain other information or otherwise establish an exemption from backup withholding. Any amount withheld under the backup withholding rules is allowable as a credit against your U.S. federal income tax liability and a refund may be obtained if the amounts withheld exceed your actual U.S. federal income tax liability and you timely provide the required information or appropriate claim form to the Internal Revenue Service.

Recently enacted legislation requires individual U.S. persons to report information to the Internal Revenue Service with respect to their investment in a Security unless certain requirements are met. Investors who are individuals and fail to report required information could become subject to substantial penalties. You are encouraged to consult with your own tax advisors regarding the possible implications of this new legislation on your investment in a Security.

To ensure compliance with requirements imposed by the Internal Revenue Service Circular 230 Notice, we inform you that: (i) any U.S. federal tax advice contained in this Offering Memorandum is not intended or written by us to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties under the Internal Revenue Code; (ii) such advice was written in connection with the promotion or marketing of the Securities; and (iii) taxpayers should seek advice based on their particular circumstances from an independent tax advisor.

U.K. Taxation

The comments below are of a general nature based on current United Kingdom tax law as applied in England and Wales and HM Revenue & Customs practice and are not intended to be exhaustive. They do not necessarily apply where the income is deemed for tax purposes to be the income of any other person. They relate only to the position of persons who are the absolute beneficial owners of their Securities and may not apply to certain classes of persons such as dealers, certain professional investors, or persons connected with the Issuer. Any holders who are in doubt as to their own tax position, or who may be subject to tax in a jurisdiction other than the United Kingdom, should consult their own professional advisors.

Interest

While the Securities continue to be listed on a "recognised stock exchange" within the meaning of Section 1005 Income Tax Act 2007, payments of interest by the Issuer may be made without withholding or deduction for or on account of United Kingdom income tax. The London Stock Exchange is a recognised stock exchange for these purposes. Securities will be treated as listed on the London Stock Exchange if they are included in the Official List by the United Kingdom Listing Authority and are admitted to trading on the London Stock Exchange.

If the Securities cease to be listed interest will generally be paid by the Issuer under deduction of income tax at the basic rate (currently 20%) unless:

(i) when that interest is paid the Issuer which makes the payment reasonably believes that the person beneficially entitled to the interest is:

(a) a company resident in the United Kingdom; or

(b) a company not resident in the United Kingdom which carries on a trade in the United Kingdom through a permanent establishment and which brings into account the interest in computing its United Kingdom taxable profits; or

(c) a partnership each member of which is a company referred to in (a) or (b) above or a combination of companies referred to in (a) or (b) above,

and HM Revenue & Customs has not given a direction that the interest should be paid under deduction of tax;

or

(ii) the Issuer has received a direction to the contrary from HM Revenue & Customs in respect of such relief as may be available pursuant to the provisions of any applicable double taxation treaty.

Persons in the United Kingdom paying interest to or receiving interest on behalf of another person who is an individual may be required to provide certain information to HM Revenue & Customs regarding the identity of the payee or person entitled to the interest and, in certain circumstances, such information may be exchanged with tax authorities in other countries.

The interest has a United Kingdom source and accordingly may be chargeable to United Kingdom tax by direct assessment. Where the interest is paid without withholding or deduction, the interest will not be assessed to United Kingdom tax in the hands of holders of the Securities who are not resident in the United Kingdom, except where the holder carries on a trade, profession or vocation through a branch or agency, or in the case of a corporate holder, carries on a trade through a permanent establishment in the United Kingdom, in connection with which the interest is received or to which the Securities are attributable, in which case (subject to exemptions for interest received by certain categories of agent) tax may be levied on the United Kingdom branch or agency, or permanent establishment.

If interest were paid under deduction of United Kingdom income tax (e.g. if the Securities lost their listing), holders who are not resident in the United Kingdom may be able to recover all or part of the tax deducted if there is an appropriate provision in an applicable double taxation treaty.

Holders should note that the provisions relating to additional amounts referred to in "Description of Securities — Additional Amounts" above would not apply if HM Revenue & Customs sought to assess directly the person entitled to the relevant interest to United Kingdom tax. However exemption from, or reduction of, such United Kingdom tax liability might be available under an applicable double taxation treaty.

Taxation of Disposal (including redemption) and Return

Corporate Bondholders

Holders within the charge to United Kingdom corporation tax (including non-resident holders whose Securities are used, held or acquired for the purposes of a trade carried on in the United Kingdom though a permanent establishment) will be subject to tax as income on all profits and gains from the Securities broadly in accordance with their statutory accounting treatment. Such holders will generally be charged in each accounting period by reference to interest and other amounts which, in accordance with generally accepted accounting practice, are recognised in determining the holder's profit or loss for that period. Fluctuations in value relating to foreign exchange gains and losses in respect of the Securities will be brought into account as income.

Other holders

A disposal of a Security by a holder resident or ordinarily resident for tax purposes in the United Kingdom or who carries on a trade, profession or vocation in the United Kingdom through a branch or agency to which the Security is attributable may give rise to a chargeable gain or allowable loss for the purposes of taxation of capital gains. In calculating any gain or loss on disposal of a Security, sterling values are compared at acquisition and transfer. Accordingly, a taxable profit can arise even where the foreign currency amount received on a disposal is less than or the same as the amount paid for the Security. Any accrued interest at the date of disposal will be taxed under the provisions of Chapter 2 of Part 12 of the Income Tax Act 2007 (Accrued Income Profits and Losses).

Accrued Income Scheme Language

A transfer of a Security by a holder resident or ordinarily resident for tax purposes in the United Kingdom or who carries on a trade, profession or vocation in the United Kingdom through a branch or agency to which the Security is attributable may give rise to a charge to tax on income in respect of an amount representing interest on the Security which has accrued since the preceding interest payment date.

United Kingdom Stamp Duty and Stamp Duty Reserve Tax

No United Kingdom Stamp Duty or Stamp Duty Reserve Tax is payable on the issue or transfer by delivery of a Security or on its redemption.

EU Directive on the Taxation of Savings Income

The EU has adopted a Directive regarding the taxation of savings income. The Directive requires Member States to provide to the tax authorities of other Member States details of payments of interest and other similar income paid by a person to (or for the benefit of) an individual or to certain other persons in another Member State, except that Austria and Luxembourg may instead impose a withholding system for a transitional period (subject to a procedure whereby, on meeting certain conditions, the beneficial owner of the interest or other income may request that no tax be withheld) unless during such period they elect otherwise. A number of non-EU countries and territories including Switzerland and certain dependent or associated territories of certain Member States have adopted or agreed to adopt similar measures (a withholding system in the case of Switzerland). In addition, the Member States have entered into reciprocal provision of information or transitional withholding arrangements with certain of those dependent or associated territories in relation to payments made by a person in a Member State to, or collected by such a person for, an individual resident in one of those territories. The European Commission has proposed certain amendments to the Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

CERTAIN ERISA CONSIDERATIONS

The Securities may generally be purchased and held by an employee benefit plan subject to Title I of the United States Employee Retirement Income Security Act of 1974, as amended ("*ERISA*"), or by an individual retirement account or employee benefit plan subject to Section 4975 of the Code. The Issuer and each Initial Purchaser may be considered a "party in interest" (within the meaning of ERISA) or a "disqualified person" (within the meaning of Section 4975 of the Code) with respect to employee benefit plans ("*Plans*") that are subject to ERISA and/or Section 4975 of the Code. The purchase of Securities by a Plan that is subject to the fiduciary responsibility provisions of ERISA or the prohibited transaction provisions of Section 4975 of the Code (including individual retirement arrangements and other plans described in Section 4975(e)(1) of the Code) and with respect to which the Issuer or any Initial Purchaser or any of their affiliates is a service provider (or otherwise is a party in interest or a disqualified person) may constitute or result in a prohibited transaction under ERISA or Section 4975 of the Code, unless such Securities are acquired pursuant to and in accordance with an applicable exemption. A fiduciary of an employee benefit plan subject to ERISA must determine that the purchase and holding of a Security is consistent with its fiduciary duties under ERISA. The fiduciary of an ERISA plan, as well as any other prospective investor subject to Section 4975 of the Code, must also determine that its purchase and holding of a Security does not result in a non-exempt prohibited transaction as defined in Section 406 of ERISA or Section 4975 of the Code. Each purchaser and transferee of a Security subject to ERISA and/or Section 4975 of the Code must make certain representations with respect to its acquisition, holding and disposition of the Security. See "*Transfer Restrictions.*"

PLAN OF DISTRIBUTION

Deutsche Bank Securities Inc., Goldman, Sachs & Co. and Morgan Stanley & Co. LLC are acting as representatives of the Initial Purchasers named below. Subject to the terms and conditions stated in the purchase agreement dated the date of this Offering Memorandum, each Initial Purchaser named below has agreed to severally purchase, and the Issuer has agreed to sell to that Initial Purchaser, the principal amount of the Securities set forth opposite the Initial Purchaser's name.

Initial Purchaser	Principal Amount of 2016 Notes	Principal Amount of 2021 Notes	Principal Amount of 2041 Notes
Deutsche Bank Securities Inc.	$ 99,167,000	$141,667,000	$113,333,000
Goldman, Sachs & Co.	99,166,000	141,666,000	113,333,000
Morgan Stanley & Co. LLC	99,167,000	141,667,000	113,334,000
Credit Suisse Securities (USA) LLC	26,250,000	37,500,000	30,000,000
J.P. Morgan Securities LLC	26,250,000	37,500,000	30,000,000
Total	$350,000,000	$500,000,000	$400,000,000

The purchase agreement provides that the obligations of the Initial Purchasers to purchase the Securities are subject to approval of legal matters by counsel and to other conditions. The offering of the Securities by the Initial Purchasers is subject to receipt and acceptance and subject to the Initial Purchasers' right to reject any order in whole or in part. The Initial Purchasers must purchase all the Securities if they purchase any of the Securities.

The Initial Purchasers propose to resell the Securities at the offering price set forth on the cover page of this Offering Memorandum within the United States to qualified institutional buyers (as defined in Rule 144A) in reliance on Rule 144A and, through their respective selling agents, outside the United States in reliance on Regulation S. See "*Transfer Restrictions*" and the representations of each Initial Purchaser set forth below. The price at which the Securities are offered may be changed at any time without notice.

The Securities have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons (as defined in Regulation S) except in transactions exempt from, or not subject to, the registration requirements of the Securities Act. See "*Transfer Restrictions*".

Accordingly, in connection with sales outside the United States, each Initial Purchaser has agreed that, except as permitted by the purchase agreement and set forth in "*Transfer Restrictions*", it will not offer or sell the Securities within the United States or to, or for the account or benefit of, U.S. persons (i) as part of its distribution at any time or (ii) otherwise until 40 days after the later of the commencement of the offering and the closing date, and it will have sent to each dealer to which it sells Securities during the 40-day restricted period a confirmation or other notice setting forth the restrictions on offers and sales of the Securities within the United States or to, or for the account or benefit of, U.S. persons.

In addition, until 40 days after the later of the commencement of the offering and the closing date, an offer or sale of Securities within the United States by a dealer that is not participating in this offering may violate the registration requirement of the Securities Act if that offer or sale is made otherwise than in accordance with Rule 144A.

The Securities will constitute a new class of securities with no established trading market. Application has been made for the Securities to be admitted to the Official List and to trading on the Market, but there can be no assurance that the Securities will be approved for listing or that such listing will be maintained. The Issuer cannot assure you that the prices at which the Securities will sell after this offering will not be lower than the initial offering price or that any trading market for the Securities will develop and continue after this offering. The Initial Purchasers currently intend to make a market in the Securities. However, they are not obligated to do so and they may discontinue any market-making activities with respect to the Securities at any time without notice. In addition, market-making activity will be subject to the limits imposed by the Securities Act and the Exchange

Act. Accordingly, the Issuer can neither assure investors that there will be a trading market for the Securities nor that there will be sufficient liquidity in any trading market.

In connection with the offering, Deutsche Bank Securities Inc., Goldman, Sachs & Co. and Morgan Stanley & Co. LLC (together, the "*Representatives*") may purchase and sell the Securities in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the Representatives of a greater number of Securities than they are required to purchase in the offering. Stabilizing transactions consist of certain bids or purchases made for the purpose of preventing or retarding a decline in the market price of the Securities while the offering is in progress.

The Representatives also may impose a penalty bid. This occurs when a particular Representative repays to the other Representatives a portion of the underwriting discount received by it because the other Representatives or their affiliates have repurchased Securities sold by or for the account of such Representative in stabilizing or short covering transactions.

These activities by the Representatives, as well as other purchases by the Representatives for their own accounts, may stabilize, maintain or otherwise affect the market price of the Securities. As a result, the price of the Securities may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued by the Representatives at any time. These transactions may be effected in the over-the-counter market or otherwise.

European Economic Area

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a "*Relevant Member State*"), each Initial Purchaser has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the "*Relevant Implementation Date*") it has not made and will not make an offer of Securities to the public in that Relevant Member State other than:

(a) to any legal entity which is a qualified investor as defined in the Prospectus Directive;

(b) to fewer than 100 or, if the Relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 150, natural or legal persons (other than qualified investors as defined in the Prospectus Directive), as permitted under the Prospectus Directive, subject to obtaining the prior consent of the relevant Initial Purchaser or Initial Purchasers nominated by the Issuer for any such offer; or

(c) in any other circumstances falling within Article 3(2) of the Prospectus Directive,

provided that no such offer of Securities shall require the Issuer or any Initial Purchaser to publish a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an "offer of Securities to the public" in relation to any Securities in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Securities to be offered so as to enable an investor to decide to purchase or subscribe for the Securities, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State, the expression "Prospectus Directive" means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive, to the extent implemented in the Relevant Member State), and includes any relevant implementing measure in each Relevant Member State, and the expression "2010 PD Amending Directive" means Directive 2010/73/EU.

United Kingdom

Each Initial Purchaser has represented and agreed that:

(a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of

Section 21 of the FSMA) received by it in connection with the issue or sale of the Securities in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer; and

(b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Securities in, from or otherwise involving the United Kingdom.

Other Relationships

The Initial Purchasers and their respective affiliates are full service financial institutions engaged in various activities, which may include securities trading, commercial and investment banking, financial advisory, investment management, investment research, principal investment, hedging, financing and brokerage activities. Certain of the Initial Purchasers and their respective affiliates have, from time to time, performed, and may in the future perform, various financial advisory and investment banking services for the Issuer and its affiliates, for which they received or will receive customary fees and expenses, and certain of the Initial Purchasers have provided and are providing general financing and banking services to the Issuer and its affiliates and may also act as lenders under the Issuer's credit facilities.

In the ordinary course of their various business activities, the Initial Purchasers and their respective affiliates have made or held, and may in the future make or hold, a broad array of investments including serving as counterparties to certain derivative and hedging arrangements, and may have actively traded, and, in the future may actively trade, debt and equity securities (or related derivative securities), and financial instruments (including bank loans) for their own account and for the accounts of their customers and may have in the past and at any time in the future hold long and short positions in such securities and instruments. Such investment and securities activities may have involved, and in the future may involve, securities and instruments of the Issuer and its subsidiaries.

The Issuer has agreed to indemnify the several Initial Purchasers against certain liabilities, including liability under the Securities Act, or to contribute to payments that the Initial Purchasers may be required to make because of any of those liabilities.

TRANSFER RESTRICTIONS

The Securities have not been registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons (as defined in Regulation S under the Securities Act ("*Regulation S*")) except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act. Accordingly, the Securities are being offered and sold only (i) to "qualified institutional buyers" (as defined in Rule 144A under the Securities Act ("*Rule 144A*")), commonly referred to as "QIBs", in reliance on the exemption from the registration requirements of the Securities Act provided by Rule 144A; and (ii) in offers and sales that occur outside the United States to purchasers who are not U.S. persons (as defined in Regulation S) in reliance on Regulation S.

Each Holder of a Security, or of any interest therein, will be deemed to acknowledge, represent, warrant and agree that, at the time of its acquisition and throughout the period of its holding and disposition of such Security or interest therein, either (a) it is not, and it will not become, an "employee benefit plan" (as defined in Section 3(3) of ERISA) that is subject to ERISA, a "plan" subject to Section 4975 of the Code, or an entity whose underlying assets include "plan assets" by reason of any such employee benefit plan's or plan's investment in the entity or otherwise, or a governmental plan, church plan, non-U.S. plan or other plan that is subject to any federal, state, local or non-U.S. law that is substantially similar to the provisions of Section 406 of ERISA or Section 4975 of the Code or (b) its purchase, holding and disposition of such Security or interest therein will not constitute or result in a non-exempt prohibited transaction under Section 406 of ERISA and/or Section 4975 of the Code (or, in the case of a governmental plan, church plan, non-U.S. plan or other plan, a violation of any substantially similar federal, state, local or non-U.S. law) by reason of an applicable statutory or administrative exemption.

Rule 144A

Each purchaser of the Securities (other than the Initial Purchasers) offered hereby in the United States will be deemed, by its acceptance or purchase thereof, to have represented to and agreed with the Issuer and each Initial Purchaser as follows:

1. It is not an "affiliate", as defined under Rule 144, of the Issuer or acting on behalf of such an affiliate and that it (A) is a QIB, (B) is acquiring the Securities for its own account or for the account of a QIB and (C) is aware that the sale of the Securities to it is being made in reliance on Rule 144A.

2. The purchase of the Securities is not part of a plan or scheme to evade the registration requirements of the Securities Act.

3. It acknowledges and understands that the Securities have not been registered under the Securities Act or any other applicable securities laws and that the Securities are being offered for resale in a transaction not requiring registration under the Securities Act or any other securities laws, and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons (as defined in Regulation S), except as set forth below.

4. It agrees that if in the future it decides to offer, resell, pledge or otherwise transfer any of the Securities, it shall not offer, resell, pledge or otherwise transfer any of the Securities except (A) (i) to the Issuer or any of its subsidiaries, (ii) for so long as the Securities are eligible for resale pursuant to Rule 144A, in the United States to a person whom the seller reasonably believes is a QIB in a transaction meeting the requirements of Rule 144A, (iii) outside the United States in an offshore transaction (as defined in Regulation S) in compliance with Rule 903 or Rule 904 of Regulation S, (iv) pursuant to the exemption from registration provided by Rule 144 under the Securities Act (if available), (v) pursuant to another available exemption from registration under the Securities Act or (vi) pursuant to an effective registration statement under the Securities Act and (B) in each case, in accordance with all applicable laws of any state of the United States or any other jurisdiction.

5. It understands and agrees that the Securities offered in the United States to QIBs will be represented by Rule 144A Global Securities and that Securities offered outside the United States in reliance on Regulation S will be represented by Regulation S Global Securities. Before any beneficial interest in a Rule 144A Global Security may be offered, sold, pledged or otherwise transferred to a purchaser outside the United States in compliance with Rule 903 or Rule 904 under the Securities Act, the transferor will be required to provide the Fiscal and Paying Agent with a written certificate (the form of which certification can be obtained from the Fiscal and Paying Agent) as to compliance with the transfer restrictions referred to above.

6. It agrees that it will deliver to each person to whom it transfers Securities notice of any restrictions on transfer of such Securities.

7. It understands that the Securities will bear a legend to the following effect unless otherwise agreed by the Issuer and the holder thereof:

   "THIS SECURITY HAS NOT BEEN REGISTERED UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE "*SECURITIES ACT*"), OR OTHER SECURITIES LAWS OF ANY STATE OR OTHER JURISDICTION. NEITHER THIS SECURITY NOR ANY INTEREST OR PARTICIPATION HEREIN MAY BE OFFERED, SOLD, ASSIGNED, TRANSFERRED, PLEDGED, ENCUMBERED OR OTHERWISE DISPOSED OF IN THE ABSENCE OF SUCH REGISTRATION UNLESS THE TRANSACTION IS EXEMPT FROM, OR NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT.

   THE HOLDER OF THIS SECURITY BY ITS ACCEPTANCE HEREOF (1) REPRESENTS THAT IT IS A "QUALIFIED INSTITUTIONAL BUYER" (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT ("*RULE 144A*")); (2) AGREES ON ITS OWN BEHALF AND ON BEHALF OF ANY ACCOUNT FOR WHICH IT HAS PURCHASED SECURITIES THAT IT WILL NOT OFFER, SELL OR OTHERWISE TRANSFER THIS SECURITY EXCEPT (A)(I) TO THE ISSUER OR ANY OF ITS SUBSIDIARIES, (II) FOR SO LONG AS THIS SECURITY IS ELIGIBLE FOR RESALE PURSUANT TO RULE 144A, IN THE UNITED STATES TO A PERSON WHOM THE SELLER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER IN A TRANSACTION MEETING THE REQUIREMENTS OF RULE 144A, (III) OUTSIDE THE UNITED STATES IN AN OFFSHORE TRANSACTION (AS DEFINED IN REGULATION S UNDER THE SECURITIES ACT ("*REGULATION S*")) IN COMPLIANCE WITH RULE 903 OR RULE 904 OF REGULATION S, (IV) PURSUANT TO THE EXEMPTION FROM REGISTRATION PROVIDED BY RULE 144 UNDER THE SECURITIES ACT (IF AVAILABLE), (V) PURSUANT TO ANOTHER AVAILABLE EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT, OR (VI) PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT, AND (B) IN EACH CASE, IN ACCORDANCE WITH ALL APPLICABLE LAWS OF ANY STATE OF THE UNITED STATES OR ANY OTHER JURISDICTION; AND (3) AGREES THAT IT WILL DELIVER TO EACH PERSON TO WHOM IT TRANSFERS SECURITIES A NOTICE SUBSTANTIALLY TO THE EFFECT OF THIS LEGEND. THE FISCAL AND PAYING AGENCY AGREEMENT CONTAINS A PROVISION REQUIRING THE FISCAL AND PAYING AGENT TO REFUSE TO REGISTER ANY TRANSFER OF THIS SECURITY IN VIOLATION OF THE FOREGOING RESTRICTIONS.

   EACH HOLDER OF THIS SECURITY, OR OF ANY INTEREST THEREIN, WILL BE DEEMED TO ACKNOWLEDGE, REPRESENT, WARRANT AND AGREE THAT, AT THE TIME OF ITS ACQUISITION AND THROUGHOUT THE PERIOD OF ITS HOLDING AND DISPOSITION OF SUCH SECURITY OR INTEREST THEREIN, EITHER (A) IT IS NOT, AND IT WILL NOT BECOME, AN "EMPLOYEE BENEFIT PLAN" (AS DEFINED IN SECTION 3(3) OF THE U.S. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, AS AMENDED ("*ERISA*")) THAT IS SUBJECT TO ERISA, A "PLAN" SUBJECT TO SECTION 4975 OF THE U.S. INTERNAL REVENUE CODE OF 1986, AS AMENDED (THE "*CODE*"), OR AN ENTITY WHOSE UNDERLYING ASSETS INCLUDE "PLAN ASSETS" BY REASON OF ANY SUCH EMPLOYEE BENEFIT PLAN'S OR PLAN'S INVESTMENT IN THE ENTITY OR OTHERWISE, OR A GOVERNMENTAL PLAN, CHURCH PLAN, NON-U.S. PLAN

OR OTHER PLAN THAT IS SUBJECT TO ANY FEDERAL, STATE, LOCAL OR NON-U.S. LAW THAT IS SUBSTANTIALLY SIMILAR TO THE PROVISIONS OF SECTION 406 OF ERISA OR SECTION 4975 OF THE CODE OR (B) ITS PURCHASE, HOLDING AND DISPOSITION OF SUCH SECURITY OR INTEREST THEREIN WILL NOT CONSTITUTE OR RESULT IN A NON-EXEMPT PROHIBITED TRANSACTION UNDER SECTION 406 OF ERISA AND/OR SECTION 4975 OF THE CODE (OR, IN THE CASE OF A GOVERNMENTAL PLAN, CHURCH PLAN, NON-U.S. PLAN OR OTHER PLAN, A VIOLATION OF ANY SUBSTANTIALLY SIMILAR FEDERAL, STATE, LOCAL OR NON-U.S. LAW) BY REASON OF AN APPLICABLE STATUTORY OR ADMINISTRATIVE EXEMPTION. THE FISCAL AND PAYING AGENCY AGREEMENT CONTAINS A PROVISION REQUIRING THE FISCAL AND PAYING AGENT TO REFUSE TO REGISTER ANY TRANSFER OF ANY SECURITY IN VIOLATION OF THE FOREGOING RESTRICTIONS."

8. It represents and agrees that (i) no other representation with respect to the offer or sale of the Securities has been made, other than the information contained in this Offering Memorandum; (ii) its investment decision is solely based on the information contained in this Offering Memorandum; (iii) the Initial Purchasers make no representation or warranty as to the accuracy or completeness of this Offering Memorandum; and (iv) it has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of its prospective investment and can afford the complete loss of such investment.

9. It represents and agrees that it has received a copy of this Offering Memorandum and acknowledges that it has had access to such financial and other information, and it has been afforded the opportunity to ask questions of the Issuer and receive answers thereto, as it deemed necessary in connection with its decision to purchase Securities.

10. It acknowledges that the Issuer, the Initial Purchasers and others will rely upon the truth and accuracy of the foregoing acknowledgments, representations, warranties and agreements and agrees that, if any of the acknowledgments, representations, warranties and agreements deemed to have been made by its purchase of the Securities is no longer accurate, it shall promptly notify the Issuer and the Initial Purchasers. If it is acquiring any Securities as a fiduciary or agent of one or more investor accounts, it represents that it has sole investment discretion with respect to each such investor account and that it has full power to make the foregoing acknowledgments, representations and agreements on behalf of each such investor account.

Regulation S

Each purchaser of the Securities (other than the Initial Purchasers) offered hereby outside the United States will be deemed, by its acceptance or purchase thereof, to have represented to and agreed with the Issuer and each Initial Purchaser as follows:

1. It is not an "affiliate", as defined under Rule 144, of the Issuer or acting on behalf of such an affiliate and that it (A) is not a U.S. person (as defined in Regulation S), (B) is not purchasing the Securities for the account or benefit of any U.S. person and (C) is purchasing the Securities in an offshore transaction (as defined in Regulation S) in accordance with Regulation S.

2. The purchase of the Securities is not part of a plan or scheme to evade the registration requirements of the Securities Act.

3. It acknowledges and understands that the Securities have not been registered under the Securities Act or any other applicable securities laws and that the Securities are being offered for resale in a transaction not requiring registration under the Securities Act or any other securities laws, and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons (as defined in Regulation S), except as set forth below.

4. It agrees that if in the future it decides to offer, resell, pledge or otherwise transfer any of the Securities, it shall not offer, resell, pledge or otherwise transfer any of the Securities except (A) (i) to the Issuer or any of its subsidiaries, (ii) for so long as the Securities are eligible for resale pursuant to Rule 144A, in the

United States to a person whom the seller reasonably believes is a QIB in a transaction meeting the requirements of Rule 144A, (iii) outside the United States in an offshore transaction (as defined in Regulation S) in compliance with Rule 903 or Rule 904 of Regulation S, (iv) pursuant to the exemption from registration provided by Rule 144 under the Securities Act (if available), (v) pursuant to another available exemption from registration under the Securities Act or (vi) pursuant to an effective registration statement under the Securities Act, and (B) in each case, in accordance with all applicable laws of any state of the United States or any other jurisdiction.

5. It understands and agrees that the Securities offered in the United States to QIBs will be represented by Rule 144A Global Securities and that Securities offered outside the United States in reliance on Regulation S will be represented by Regulation S Global Securities.

6. It agrees that it will deliver to each person to whom it transfers Securities notice of any restrictions on transfer of such Securities.

7. It understands that the Regulation S Global Securities will initially be restricted as described under "*Description of the Securities — Book Entry; Delivery and Form*" for a period ending 40 days after the later of the commencement of the offering and the closing date. Before any beneficial interest in a Regulation S Global Security may be offered, sold, pledged or otherwise transferred, the transferor will be required to provide the Fiscal and Paying Agent with a written certificate (the form of which certification can be obtained from the Fiscal and Paying Agent) as to compliance with the transfer restriction referred to above.

8. It understands that the Securities will bear a legend to the following effect unless otherwise agreed by the Issuer and the holder thereof:

   "THIS SECURITY HAS NOT BEEN REGISTERED UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE "*SECURITIES ACT*"), OR OTHER SECURITIES LAWS OF ANY STATE OR OTHER JURISDICTION. NEITHER THIS SECURITY NOR ANY INTEREST OR PARTICIPATION HEREIN MAY BE OFFERED, SOLD, ASSIGNED, TRANSFERRED, PLEDGED, ENCUMBERED OR OTHERWISE DISPOSED OF IN THE ABSENCE OF SUCH REGISTRATION UNLESS THE TRANSACTION IS EXEMPT FROM, OR NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT.

   THE HOLDER OF THIS SECURITY BY ITS ACCEPTANCE HEREOF (1) REPRESENTS THAT IT IS ACQUIRING THIS SECURITY IN AN "OFFSHORE TRANSACTION" (AS DEFINED IN REGULATION S UNDER THE SECURITIES ACT ("*REGULATION S*")) IN ACCORDANCE WITH RULE 903 OR RULE 904 OF REGULATION S AND, IF THE SECURITY HAS BEEN ACQUIRED ON OR PRIOR TO THE 40TH DAY AFTER THE LATER OF THE COMMENCEMENT OF THE OFFERING OF THE SECURITIES AND THE DATE OF INITIAL ISSUANCE OF THE SECURITIES (THE "*RESTRICTED PERIOD*"), IT IS NOT A U.S. PERSON (AS DEFINED IN REGULATION S) AND IT HAS NOT ACQUIRED THE SECURITY FOR THE ACCOUNT OR BENEFIT OF ANY U.S. PERSON; (2) AGREES ON ITS OWN BEHALF AND ON BEHALF OF ANY ACCOUNT FOR WHICH IT HAS PURCHASED SECURITIES THAT IT WILL NOT, ON OR PRIOR TO THE END OF THE RESTRICTED PERIOD, OFFER, SELL OR OTHERWISE TRANSFER THIS SECURITY EXCEPT (A) (I) TO THE ISSUER OR ANY OF ITS SUBSIDIARIES, (II) FOR SO LONG AS THIS SECURITY IS ELIGIBLE FOR RESALE PURSUANT TO RULE 144A, IN THE UNITED STATES TO A PERSON WHOM THE SELLER REASONABLY BELIEVES IS A QUALIFIED INSTITUTIONAL BUYER IN A TRANSACTION MEETING THE REQUIREMENTS OF RULE 144A UNDER THE SECURITIES ACT ("*RULE 144A*"), (III) TO A NON-U.S. PERSON OUTSIDE THE UNITED STATES IN AN OFFSHORE TRANSACTION (AS DEFINED IN REGULATION S) IN COMPLIANCE WITH RULE 903 OR RULE 904 OF REGULATION S, (IV) PURSUANT TO THE EXEMPTION FROM REGISTRATION PROVIDED BY RULE 144 UNDER THE SECURITIES ACT (IF AVAILABLE), (V) PURSUANT TO ANOTHER AVAILABLE EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT, OR (VI) PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES

ACT, AND (B) IN EACH CASE, IN ACCORDANCE WITH ANY APPLICABLE LAWS OF ANY STATE OF THE UNITED STATES OR ANY OTHER JURISDICTION; AND (3) AGREES THAT IT WILL DELIVER TO EACH PERSON TO WHOM IT TRANSFERS SECURITIES A NOTICE SUBSTANTIALLY TO THE EFFECT OF THIS LEGEND. THE FISCAL AND PAYING AGENCY AGREEMENT CONTAINS A PROVISION REQUIRING THE FISCAL AND PAYING AGENT TO REFUSE TO REGISTER ANY TRANSFER OF THIS SECURITY IN VIOLATION OF THE FOREGOING RESTRICTIONS. AFTER THE END OF THE RESTRICTED PERIOD, THIS SECURITY AND ANY INTEREST HEREIN MAY BE TRANSFERRED ONLY IN ACCORDANCE WITH THE SECURITIES ACT AND ALL APPLICABLE LAWS OF ANY OTHER JURISDICTION.

EACH HOLDER OF THIS SECURITY, OR OF ANY INTEREST THEREIN, WILL BE DEEMED TO ACKNOWLEDGE, REPRESENT, WARRANT AND AGREE THAT, AT THE TIME OF ITS ACQUISITION AND THROUGHOUT THE PERIOD OF ITS HOLDING AND DISPOSITION OF SUCH SECURITY OR INTEREST THEREIN, EITHER (A) IT IS NOT, AND IT WILL NOT BECOME, AN "EMPLOYEE BENEFIT PLAN" (AS DEFINED IN SECTION 3(3) OF THE U.S. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, AS AMENDED ("*ERISA*")) THAT IS SUBJECT TO ERISA, A "PLAN" SUBJECT TO SECTION 4975 OF THE U.S. INTERNAL REVENUE CODE OF 1986, AS AMENDED (THE "*CODE*"), OR AN ENTITY WHOSE UNDERLYING ASSETS INCLUDE "PLAN ASSETS" BY REASON OF ANY SUCH EMPLOYEE BENEFIT PLAN'S OR PLAN'S INVESTMENT IN THE ENTITY OR OTHERWISE, OR A GOVERNMENTAL PLAN, CHURCH PLAN, NON-U.S. PLAN OR OTHER PLAN THAT IS SUBJECT TO ANY FEDERAL, STATE, LOCAL OR NON-U.S. LAW THAT IS SUBSTANTIALLY SIMILAR TO THE PROVISIONS OF SECTION 406 OF ERISA OR SECTION 4975 OF THE CODE OR (B) ITS PURCHASE, HOLDING AND DISPOSITION OF SUCH SECURITY OR INTEREST THEREIN WILL NOT CONSTITUTE OR RESULT IN A NON-EXEMPT PROHIBITED TRANSACTION UNDER SECTION 406 OF ERISA AND/OR SECTION 4975 OF THE CODE (OR, IN THE CASE OF A GOVERNMENTAL PLAN, CHURCH PLAN, NON-U.S. PLAN OR OTHER PLAN, A VIOLATION OF ANY SUBSTANTIALLY SIMILAR FEDERAL, STATE, LOCAL OR NON-U.S. LAW) BY REASON OF AN APPLICABLE STATUTORY OR ADMINISTRATIVE EXEMPTION. THE FISCAL AND PAYING AGENCY AGREEMENT CONTAINS A PROVISION REQUIRING THE FISCAL AND PAYING AGENT TO REFUSE TO REGISTER ANY TRANSFER OF ANY SECURITY IN VIOLATION OF THE FOREGOING RESTRICTIONS."

9. It represents and agrees that (i) no other representation with respect to the offer or sale of the Securities has been made, other than the information contained in this Offering Memorandum; (ii) its investment decision is solely based on the information contained in this Offering Memorandum; (iii) the Initial Purchasers make no representation or warranty as to the accuracy or completeness of this Offering Memorandum; and (iv) it has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of its prospective investment and can afford the complete loss of such investment.

10. It represents and agrees that it has received a copy of this Offering Memorandum and acknowledges that it has had access to such financial and other information, and it has been afforded the opportunity to ask questions of the Issuer and receive answers thereto, as it deemed necessary in connection with its decision to purchase Securities.

11. It acknowledges that the Issuer, the Initial Purchasers and others will rely upon the truth and accuracy of the foregoing acknowledgments, representations, warranties and agreements and agrees that, if any of the acknowledgments, representations, warranties and agreements deemed to have been made by its purchase of the Securities is no longer accurate, it shall promptly notify the Issuer and the Initial Purchasers. If it is acquiring any Securities as a fiduciary or agent of one or more investor accounts, it represents that it has sole investment discretion with respect to each such investor account and that it has full power to make the foregoing acknowledgments, representations and agreements on behalf of each such investor account.

For further discussion of the requirements (including the presentation of transfer certificates) under the Fiscal and Paying Agency Agreement to effect exchanges or transfer of interests in Global Securities, see "*Description of Securities — Book Entry, Delivery and Form.*"

LEGAL MATTERS

The validity of the Securities offered by this Offering Memorandum and certain legal matters will be passed upon for the Issuer by Cravath, Swaine & Moore LLP, U.S. counsel for the Issuer. Certain U.K. legal matters will be passed upon for the Issuer by internal counsel for the Issuer. Cravath, Swaine & Moore LLP will rely, without independent investigation, upon internal counsel for the Issuer with respect to all matters of U.K. law. Certain U.S. legal matters in connection with the Securities will be passed upon for the Initial Purchasers by Milbank, Tweed, Hadley & McCloy LLP, U.S. counsel for the Initial Purchasers.

INDEPENDENT ACCOUNTANTS

BAE Systems Annual Financial Statements for the years ended December 31, 2009 and 2010 have been audited by KPMG Audit Plc, independent auditors. KPMG Audit Plc is regulated by the Institute of Chartered Accountants of England and Wales. Its business address is 15 Canada Square, London E14 5GL, United Kingdom.

In accordance with guidance issued by The Institute of Chartered Accountants in England and Wales, each of the independent auditor's reports dated February 16, 2011 and February 17, 2010 on the consolidated financial statements of BAE Systems plc states that: "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." The independent auditor's reports are included on pages F-3 and F-62 of this Offering Memorandum. The SEC would not permit such limiting language to be included in a registration statement or a prospectus used in connection with an offering of securities registered under the Securities Act, or in a report filed under the Exchange Act. If a U.S. court (or any other court) were to give effect to such limiting language, the recourse that investors in the Securities may have against the independent auditor based on its report or the consolidated financial statements to which it relates could be limited.

GENERAL INFORMATION

1) The listing of the Securities on the Official List will be expressed as a percentage of their nominal amount (exclusive of accrued interest). It is expected that listing of the Securities on the Official List and admission of the Securities to trading on the Market will be granted on or about October 11, 2011, subject only to the issue of the Global Securities. Prior to official listing and admission to trading, however, dealings will be permitted by the London Stock Exchange in accordance with its rules. Transactions will normally be effected for delivery on the third working day after the day of the transaction. The total expenses relating to the admission of the Securities to the Official List and to trading on the Market are estimated to amount to £11,675.

2) Clause 4 of BAE Systems' memorandum of association provides that the objects for which it is established include to invent, design, develop, manufacture, construct, assemble, test, repair, maintain, buy, sell, hire, let on hire, operate, import, export and deal in aeroplanes, airships, sea-planes, aircraft, hovercraft, space vehicles, communications satellites, navigational or guidance systems, guided missiles, rockets, propellers, and other machines or apparatus of any kind designed or capable of being used for or in connection with aerial transit conveyance or communication, arms and weapons, whether guided or otherwise, torpedoes, explosives and ammunition and armaments of all kinds, motor cars and vehicles generally, boats and all other conveyances, whether armoured or not, and means of locomotion of all descriptions, and any component or other parts thereof and accessories and fittings therefor, and all kinds of machinery and apparatus capable of being used in connection with such invention, design, development, manufacture, construction, assembly, testing, repair and maintenance and in connection with the operation and use of aeroplanes, airships, sea-planes, aircraft, hovercraft, space vehicles, communications satellites, guided missiles, rockets, propellors and such other machines or apparatus as aforesaid, airports and the like, and to carry on the business of flying and gliding instructors, and to establish, maintain and operate lines of aerial, land and sea conveyance and craft. In addition, its objects include a wide range of additional powers.

3) The Issuer has obtained all necessary consents, approvals and authorizations in the United Kingdom in connection with the issue of the Securities. The issue of the Securities was authorized by the Board of Directors of BAE SYSTEMS plc.

4) There has been (i) no significant change in the financial or trading position of BAE Systems since June 30, 2011 and (ii) no material adverse change in the prospects of BAE Systems since December 31, 2010, except as disclosed in "*Business — Home Markets — United States — Outlook*".

5) The Securities have been accepted for clearance through DTC's book-entry settlement system. The CUSIP and ISIN Numbers for the Securities are as follows:

   (a) 2016 Notes distributed pursuant to Rule 144A: CUSIP 05523R AA5; ISIN US05523RAA59;

   (b) 2016 Notes distributed pursuant to Regulation S: CUSIP G06940 AB9; ISIN USG06940AB90;

   (c) 2021 Notes distributed pursuant to Rule 144A: CUSIP 05523R AB3; ISIN US05523RAB33;

   (d) 2021 Notes distributed pursuant to Regulation S: CUSIP G06940 AC7; ISIN USG06940AC73.

   (e) 2041 Notes distributed pursuant to Rule 144A: CUSIP 05523R AC1; ISIN US05523RAC16; and

   (f) 2041 Notes distributed pursuant to Regulation S: CUSIP G06940 AD5; ISIN USG06940AD56.

   The address of DTC is The Depository Trust Company, 55 Water Street, New York, NY 10041-009, United States of America.

6) The yield on the 2016 Notes will be 3.577 per cent. per annum, the 2021 Notes will be 4.763 per cent. per annum and the 2041 Notes will be 5.837 per cent. per annum. Each such yield is calculated at the Issue Date on the basis of the relevant Issue Price. It is not an indication of future yield.

7) For the period of 12 months starting on the date on which this Offering Memorandum is made available to the public, copies of the following documents will be available, during usual business hours on any weekday (Saturdays and public holidays excepted), for inspection at the specified office of the Fiscal and Paying Agent:

   (a) the Memorandum and Articles of Association of the Issuer;

   (b) the audited consolidated financial statements of the Issuer for the financial years ended December 31, 2009 and 2010 and the unaudited consolidated financial statements of the Issuer for the six months ended June 30, 2011;

   (c) a copy of this Offering Memorandum together with any supplement to this Offering Memorandum or further Offering Memorandum; and

   (d) the purchase agreement referred to in "Plan of Distribution" and the Fiscal and Paying Agency Agreement.

This Offering Memorandum will be published on the website of the Regulatory News Service operated by the London Stock Exchange at www.londonstockexchange.com/en-gb/pricenews/marketnews.

INDEX TO FINANCIAL INFORMATION

* The information provided in this document has been extracted from the 2010 Annual Report of BAE Systems. As the information only represents extracts of the 2010 Annual Report, there are certain references made to pages of the 2010 Annual Report which have different pagination in this Offering Memorandum, or to other pages of the 2010 Annual Report that have not been included in this Offering Memorandum. Copies of the Annual Report for 2010 can be obtained through the website maintained by BAE Systems at http://www.baesystems.com. Information on BAE Systems' website is not incorporated by reference into this Offering Memorandum. Those parts of the 2010 Annual Report which are not included in this Offering Memorandum are not necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of BAE Systems and do not form part of this Offering Memorandum.

** The information provided in this document has been extracted from the 2009 Annual Report of BAE Systems. As the information only represents extracts of the 2009 Annual Report, there are certain references made to pages of the 2009 Annual Report which have different pagination in this Offering Memorandum, or to other pages of the 2009 Annual Report that have not been included in this Offering Memorandum. Copies of the Annual Report for 2009 can be obtained through the website maintained by BAE Systems at http://www.baesystems.com. Information on BAE Systems' website is not incorporated by reference into this Offering Memorandum. Those parts of the 2009 Annual Report which are not included in this Offering Memorandum are not necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of BAE Systems and do not form part of this Offering Memorandum.

*** The information provided in this document has been extracted from the Half-Yearly Report and Presentation 2011 of BAE Systems. As the information only represents extracts of the Half-Yearly Report, there are certain references made to pages of the Half-Yearly Report which have different pagination in this Offering Memorandum, or to other pages of the Half-Yearly Report that have not been included in this Offering Memorandum. Copies of the Half-Yearly Report and Presentation 2011 can be obtained through the website maintained by BAE Systems at http://www.baesystems.com. Information on BAE Systems' website is not incorporated by reference into this Offering Memorandum. Those parts of the Half-Yearly Report and Presentation 2011 which are not included in this Offering Memorandum are not necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of BAE Systems and do not form part of this Offering Memorandum.

2010 BAE SYSTEMS
ANNUAL FINANCIAL STATEMENTS

Independent auditor's report to the members of BAE Systems plc

We have audited the financial statements of BAE Systems plc for the year ended 31 December 2010 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Group and Parent Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity and related notes. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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 auditors
As explained more fully in the Directors' Responsibilities Statement set out on page 123, 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 (APB'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 APB's website at www.frc.org.uk/apb/scope/private.cfm

Opinion on financial statements
In our opinion:

– the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2010 and of the Group's profit for the year then ended;

– the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;

– the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and

– the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006
In our opinion:

– the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and

– the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

– adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or

– the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or

– certain disclosures of directors' remuneration specified by law are not made; or

– we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

– the directors' statement, set out on page 88, in relation to going concern;

– the part of the Corporate Governance Statement on pages 86 to 88 in the Directors' Report relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review; and

– certain elements of the report to shareholders by the Board on directors' remuneration.

A G Cates (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
London
E14 5GL

16 February 2011

Consolidated income statement
for the year ended 31 December

	Notes	2010 £m	2010 Total £m	Restated[1] 2009 £m	Restated[1] 2009 Total £m
Continuing operations					
Combined sales of Group and equity accounted investments	3		**22,392**		21,990
Less: share of sales of equity accounted investments	3		**(1,295)**		(1,616)
Revenue	3		**21,097**		20,374
Operating costs	4		**(19,761)**		(20,060)
Other income	5		**169**		465
Group operating profit excluding amortisation and impairment of intangible assets		**2,022**		2,038	
Amortisation	11	**(392)**		(286)	
Impairment	11	**(125)**		(973)	
Group operating profit			**1,505**		779
Share of results of equity accounted investments excluding finance costs and taxation expense		**177**		210	
Financial (expense)/income of equity accounted investments	6	**(2)**		2	
Taxation expense of equity accounted investments		**(44)**		(25)	
Share of results of equity accounted investments	14		**131**		187
EBITA[2] excluding non-recurring items		**2,214**		2,197	
Profit on disposal of businesses[3]	9	**1**		68	
Pension curtailment gains[3]		**2**		261	
Regulatory penalties[4]		**(18)**		(278)	
EBITA[2]		**2,199**		2,248	
Amortisation	11	**(392)**		(286)	
Impairment	11	**(125)**		(973)	
Financial (expense)/income of equity accounted investments	6	**(2)**		2	
Taxation expense of equity accounted investments		**(44)**		(25)	
Operating profit	3		**1,636**		966
Finance costs	6				
Financial income		**1,358**		1,573	
Financial expense		**(1,550)**		(2,273)	
			(192)		(700)
Profit before taxation			**1,444**		266
Taxation expense	8				
UK taxation		**(152)**		(105)	
Overseas taxation		**(265)**		(222)	
			(417)		(327)
Profit/(loss) for the year – continuing operations			**1,027**		(61)
Profit for the year – discontinued operations	9		**54**		16
Profit/(loss) for the year			**1,081**		(45)
Attributable to:					
BAE Systems shareholders			**1,052**		(67)
Non-controlling interests			**29**		22
			1,081		(45)
Earnings/(loss) per share	10				
Basic earnings/(loss) per share			**30.5p**		(1.9)p
Diluted earnings/(loss) per share			**30.3p**		(1.9)p
Earnings/(loss) per share – continuing operations					
Basic earnings/(loss) per share			**28.9p**		(2.3)p
Diluted earnings/(loss) per share			**28.7p**		(2.3)p

1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
3 Included in other income.
4 Included in operating costs.

Consolidated statement of comprehensive income

for the year ended 31 December

	Notes	2010 Other reserves[2] £m	2010 Retained earnings £m	2010 Total £m	Restated[1] 2009 Total £m
Profit/(loss) for the year		**–**	**1,081**	**1,081**	(45)
Other comprehensive income					
Currency translation on foreign currency net investments:					
Subsidiaries		**160**	**–**	**160**	(246)
Equity accounted investments	14	**(6)**	**–**	**(6)**	(56)
Amounts charged to hedging reserve		**(84)**	**–**	**(84)**	(393)
Gain on revaluation of step acquisition		**–**	**–**	**–**	14
Net actuarial gains/(losses) on defined benefit pension schemes[3]:					
Subsidiaries		**–**	**874**	**874**	(2,008)
Equity accounted investments		**–**	**40**	**40**	(54)
Fair value movements on available-for-sale investments	15	**–**	**14**	**14**	2
Recycling of cumulative currency translation reserve on disposal	9	**(17)**	**–**	**(17)**	–
Recycling of cumulative net hedging reserve on disposal	9	**(4)**	**–**	**(4)**	–
Current tax on items taken directly to equity	8	**(2)**	**70**	**68**	78
Deferred tax on items taken directly to equity:					
Subsidiaries	8	**24**	**(309)**	**(285)**	573
Tax rate adjustment[4]	8	**–**	**(23)**	**(23)**	–
Equity accounted investments		**–**	**(12)**	**(12)**	16
Total other comprehensive income for the year (net of tax)		**71**	**654**	**725**	(2,074)
Total comprehensive income for the year		**71**	**1,735**	**1,806**	(2,119)
Attributable to:					
Equity shareholders		**71**	**1,706**	**1,777**	(2,141)
Non-controlling interests		**–**	**29**	**29**	22
		71	**1,735**	**1,806**	(2,119)

Consolidated statement of changes in equity

for the year ended 31 December

	Attributable to equity holders of the parent						
	Issued share capital £m	Share premium £m	Other reserves[2] £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2010	90	1,243	5,399	(2,141)	4,591	72	4,663
Profit for the year	–	–	–	1,052	1,052	29	1,081
Total other comprehensive income for the year	–	–	71	654	725	–	725
Share-based payments	–	–	–	58	58	–	58
Share options:							
Proceeds from shares issued	–	6	–	–	6	–	6
Purchase of own shares	–	–	–	(23)	(23)	–	(23)
Purchase of treasury shares[5]	–	–	–	(503)	(503)	–	(503)
Other	–	–	–	–	–	2	2
Ordinary share dividends	–	–	–	(574)	(574)	(32)	(606)
At 31 December 2010	**90**	**1,249**	**5,470**	**(1,477)**	**5,332**	**71**	**5,403**
At 1 January 2009	90	1,238	5,974	(68)	7,234	55	7,289
(Loss)/profit for the year	–	–	–	(67)	(67)	22	(45)
Total other comprehensive income for the year	–	–	(575)	(1,499)	(2,074)	–	(2,074)
Share-based payments	–	–	–	52	52	–	52
Share options:							
Proceeds from shares issued	–	5	–	–	5	–	5
Purchase of own shares	–	–	–	(25)	(25)	–	(25)
Ordinary share dividends	–	–	–	(534)	(534)	(5)	(539)
At 31 December 2009 (restated[1])	90	1,243	5,399	(2,141)	4,591	72	4,663

1 Other reserves reduced by £64m following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
2 An analysis of other reserves is provided in note 24.
3 Includes a £348m benefit arising from the change from the Retail Prices Index to the Consumer Prices Index as the measure for determining minimum statutory pension increases (see note 21).
4 The UK current tax rate will be reduced from 28% to 27% with effect from 1 April 2011, which creates a tax rate adjustment (see note 8).
5 Includes transaction costs of £3m.

Consolidated balance sheet
as at 31 December

	Notes	2010 £m	Restated[1] 2009 £m
Non-current assets			
Intangible assets	11	**11,216**	11,306
Property, plant and equipment	12	**2,714**	2,552
Investment property	13	**134**	111
Equity accounted investments	14	**787**	846
Other investments	15	**11**	6
Other receivables	16	**282**	201
Other financial assets	17	**110**	133
Deferred tax assets	8	**1,160**	1,531
		16,414	16,686
Current assets			
Inventories	18	**644**	887
Trade and other receivables including amounts due from customers for contract work	16	**3,559**	3,764
Current tax		**51**	32
Other investments	15	**260**	211
Other financial assets	17	**289**	216
Cash and cash equivalents		**2,813**	3,693
		7,616	8,803
Total assets	3	**24,030**	25,489
Non-current liabilities			
Loans	19	**(2,133)**	(2,840)
Trade and other payables	20	**(694)**	(522)
Retirement benefit obligations	21	**(3,456)**	(4,679)
Other financial liabilities	17	**(255)**	(261)
Deferred tax liabilities	8	**(6)**	(8)
Provisions	22	**(425)**	(377)
		(6,969)	(8,687)
Current liabilities			
Loans and overdrafts	19	**(920)**	(453)
Trade and other payables	20	**(9,352)**	(10,381)
Other financial liabilities	17	**(109)**	(94)
Current tax		**(625)**	(659)
Provisions	22	**(652)**	(552)
		(11,658)	(12,139)
Total liabilities		**(18,627)**	(20,826)
Net assets		**5,403**	4,663
Capital and reserves			
Issued share capital	24	**90**	90
Share premium		**1,249**	1,243
Other reserves	24	**5,470**	5,399
Accumulated losses		**(1,477)**	(2,141)
Total equity attributable to equity holders of the parent		**5,332**	4,591
Non-controlling interests		**71**	72
Total equity		**5,403**	4,663

1 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).

Approved by the Board on 16 February 2011 and signed on its behalf by:

I G King
Chief Executive

G W Rose
Group Finance Director

Consolidated cash flow statement

for the year ended 31 December

	Notes	2010 £m	Restated[1] 2009 £m
Profit/(loss) for the year – continuing operations		**1,027**	(61)
Profit for the year – discontinued operations		**54**	16
Profit/(loss) for the year		**1,081**	(45)
Taxation expense		**417**	327
Share of results of equity accounted investments – continuing operations	14	**(131)**	(187)
Share of results of equity accounted investments – discontinued operations	9	**(2)**	(16)
Net finance costs		**192**	700
Depreciation, amortisation and impairment		**899**	1,600
Gain on disposal of property, plant and equipment	4, 5	**(13)**	(17)
Gain on disposal of businesses – continuing operations	5	**(1)**	(68)
Gain on disposal of businesses – discontinued operations	9	**(52)**	–
Cost of equity-settled employee share schemes		**58**	52
Movements in provisions		**101**	52
Decrease in liabilities for retirement benefit obligations		**(452)**	(657)
Decrease/(increase) in working capital:			
Inventories		**318**	6
Trade and other receivables		**183**	52
Trade and other payables		**(1,063)**	433
Cash inflow from operating activities		**1,535**	2,232
Interest paid		**(220)**	(250)
Interest element of finance lease rental payments		**(1)**	(2)
Taxation paid		**(352)**	(350)
Net cash inflow from operating activities		**962**	1,630
Dividends received from equity accounted investments – continuing operations	14	**67**	74
Dividends received from equity accounted investments – discontinued operations	14	**4**	3
Interest received		**48**	66
Purchases of property, plant and equipment		**(394)**	(483)
Purchases of investment property		**(14)**	–
Purchases of intangible assets		**(19)**	(42)
Proceeds from sale of property, plant and equipment		**68**	36
Proceeds from sale of investment property		**2**	–
Purchase of subsidiary undertakings	27	**(198)**	(357)
Cash and cash equivalents acquired with subsidiary undertakings	27	**19**	33
Purchase of equity accounted investments	27	**(2)**	(1)
Equity accounted investment funding	14	**(7)**	–
Proceeds from sale of subsidiary undertakings – continuing operations	9	**–**	2
Proceeds from sale of equity accounted investments – continuing operations	9	**1**	70
Proceeds from sale of equity accounted investments – discontinued operations	9	**92**	–
Purchase of other deposits/securities	15	**(40)**	(209)
Net cash outflow from investing activities		**(373)**	(808)
Capital element of finance lease rental payments		**(7)**	(13)
Proceeds from issue of share capital		**6**	5
Purchase of treasury shares		**(503)**	–
Purchase of own shares		**(23)**	(25)
Equity dividends paid	28	**(574)**	(534)
Dividends paid to non-controlling interests		**(32)**	(5)
Cash (outflow)/inflow from matured derivative financial instruments		**(123)**	36
Cash inflow/(outflow) from movement in cash collateral		**11**	(11)
Cash inflow from loans		**1,317**	920
Cash outflow from repayment of loans		**(1,576)**	(133)
Net cash (outflow)/inflow from financing activities		**(1,504)**	240
Net (decrease)/increase in cash and cash equivalents		**(915)**	1,062
Cash and cash equivalents at 1 January		**3,678**	2,605
Effect of foreign exchange rate changes on cash and cash equivalents		**39**	11
Cash and cash equivalents at 31 December		**2,802**	3,678
Comprising:			
Cash and cash equivalents		**2,813**	3,693
Overdrafts		**(11)**	(15)
Cash and cash equivalents at 31 December		**2,802**	3,678

1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).

1. Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

Basis of preparation
The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis as discussed in the Directors' report on page 88 and in accordance with EU-endorsed International Financial Reporting Standards (IFRS), International Financial Reporting Interpretations Committee interpretations (IFRICs) and the Companies Act 2006 applicable to companies reporting under IFRS.

The consolidated financial statements are presented in pounds sterling and, unless stated otherwise, rounded to the nearest million. They have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and other relevant financial assets and financial liabilities (including derivative instruments).

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates and judgements.

The directors consider the potential key areas of judgements required to be made in applying the Group's accounting policies. These relate to:

– the determination of the revenue recognition approach to apply to individual contracts;

– the classification of financial assets or liabilities;

– the classification of retirement benefit plans between defined benefit and defined contribution arrangements; and

– the classification of investments as subsidiaries, equity accounted investments or otherwise.

The directors do not consider that the practical application of the judgements is significantly uncertain or subjective in nature.

An analysis and explanation of the critical accounting estimates and judgements used in producing this set of financial statements is made in the Directors' report on page 44.

Basis of consolidation
The financial statements of the Group consolidate the results of the Company and its subsidiary entities, and include its share of its joint ventures' results accounted for under the equity method, all of which are prepared to 31 December.

Subsidiaries
A subsidiary is an entity controlled by the Group. Control is the power to govern the operating and financial policies of an entity so as to obtain benefits from its activities. Subsidiaries include the special purpose entities that the Group transacted through for the provision of guarantees in respect of residual values, and head lease and finance payments on certain regional aircraft sold. The results of subsidiaries are included in the consolidated income statement from the date of acquisition, up to the date of loss of control.

Business combinations on or after 1 January 2010 (IFRS 3, *Business Combinations*)
Business combinations are accounted for using the acquisition method as at the acquisition date, which is the date on which control is transferred to the Group. The Group measures goodwill as the acquisition-date fair value of the consideration transferred, including the amount of any non-controlling interest in the acquiree, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed, including contingent liabilities as required by IFRS 3.

Consideration transferred includes the fair values of assets transferred, liabilities incurred by the Group to the previous owners of the acquiree, equity interests issued by the Group, contingent consideration, and share-based payment awards of the acquiree that are replaced in the business combination. Any contingent consideration payable is recognised at fair value at the acquisition date. Subsequent changes to the fair value of contingent consideration that is not classified as equity are recognised in the consolidated income statement. If a business combination results in the termination of pre-existing relationships between the Group and the acquiree, then the lower of the termination amount, as contained in the agreement, and the value of the off-market element, is deducted from the consideration transferred and recognised in other expenses.

Transaction costs that the Group incurs in connection with a business combination, such as finder's fees, legal fees, due diligence fees, and other professional and consulting fees, are expensed as incurred.

Non-controlling interests are measured at either the non-controlling interest's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised or at fair value. The method used is determined on an acquisition-by-acquisition basis.

Business combinations between 1 January 2004 and 1 January 2010 (IFRS 3, *Business Combinations (2004)*)
The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired, and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. Previously held identifiable assets, liabilities and contingent liabilities of the acquired entity are revalued to their fair value at the date of acquisition, being the date at which the Group achieves control of the acquiree. The movement in fair value is taken to the asset revaluation reserve.

Upon initial acquisition of a non-controlling interest, the interest of minority shareholders is measured at the minority's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised.

Business combinations prior to 1 January 2004 (date of transition to IFRS)
On transition to IFRS, IFRS 3 (2004) was not retrospectively applied and, therefore, the goodwill arising on acquisition under UK Generally Accepted Accounting Practice (GAAP) is the difference between the consideration paid for an acquisition and the fair value of the net tangible assets acquired. Goodwill arising on acquisitions before the date of transition to IFRS has been retained at the previous UK GAAP amounts, as any amounts related to intangible assets that would have been recorded in the acquired entities if the Group had applied IAS 38, *Intangible Assets*, at the dates they were acquired were considered immaterial, after being tested for impairment at those dates. Goodwill written off to reserves under UK GAAP

1. Accounting policies *continued*

prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

Accounting for acquisition of non-controlling interests that do not result in a change in control
Acquisitions of non-controlling interests are accounted for as transactions with equity holders in their capacity as equity holders and, therefore, no goodwill or profit or loss in the consolidated income statement is recognised as a result of such transactions.

Prior to 1 January 2010, goodwill was recognised on the acquisition of non-controlling interests in a subsidiary, which represented the excess of the cost of the additional investment over the carrying amount of the interest in the net assets acquired at the date of the transaction.

Equity accounted investments
An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. Joint ventures are accounted for under the equity method where the Group's income statement includes its share of their profits and losses, and the Group's balance sheet includes its share of their net assets.

Intangible assets
Goodwill
Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

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

Group-funded expenditure on research activities is written off as incurred and charged to the income statement.

Group-funded expenditure on development activities applied to a plan or design for the production of new or substantially improved products and processes 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. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses.

Capitalised development expenditure is amortised over the expected life of the product.

Where the research and development activity is performed for customers, the revenue arising is recognised in accordance with the Group's revenue recognition policy.

Other intangible assets
Acquired computer software licences for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software.

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Capitalised software development expenditure is stated at cost less accumulated amortisation and impairment losses. Group-funded expenditure associated with enhancing or maintaining computer software programmes for sale is recognised as an expense as incurred.

Trademarks and licences have definite useful lives and are carried at cost less accumulated amortisation and impairment losses.

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing. The most significant intangible assets recognised by the Group on businesses acquired to date are in relation to programmes. 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.

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

The estimated useful lives are as follows:

Programme and customer related	
Programme and customer related	up to 15 years
Other	
Acquired computer software licences	2 to 5 years
Capitalised software development	2 to 5 years
Capitalised research and development expenditure	up to 10 years
Trademarks and licences	up to 20 years
Other intangibles	up to 10 years

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

Buildings	
Buildings	up to 50 years, or the lease term if shorter
Plant and machinery	
Computing equipment, motor vehicles and short-life works equipment	3 to 5 years
Research equipment	8 years
Other equipment	10 to 15 years, or the project life if shorter
Aircraft	
Aircraft	up to 15 years, or the lease term if shorter

For certain items of plant and equipment in the Group's US businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

No depreciation is provided on freehold land and assets in the course of construction.

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date. Where applicable, useful lives reflect the component accounting principle.

1. Accounting policies *continued*

Assets obtained under finance leases are included in property, plant and equipment and stated at an amount equal to the lower of the fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

Impairment
The carrying amounts of the Group's intangible assets, property, plant and equipment, and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, *Impairment of Assets*. If any such indication exists, the asset's recoverable amount is estimated. For goodwill and intangible assets that are not yet available for use, impairment testing is performed annually. All other assets are considered for impairment under the relevant standard.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

The carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill, and is assessed for impairment as a single asset.

The recoverable amount of assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at appropriate pre-tax discount rates.

The recoverable amount of other assets is the greater of their fair value less cost 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 inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss in respect of assets, other than goodwill, carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

An impairment loss in respect of goodwill is not reversed.

An impairment loss in respect of other assets is reversed 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.

Investment property
Land and buildings that are leased to non-Group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and accumulated impairment losses.

Depreciation is provided, on a straight-line basis, to write off the cost of investment property over its estimated useful life of up to 50 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Other investments
The Group determines the classification of its other investments at initial recognition taking account of, where relevant, the purpose for which the investments were acquired. The Group classifies its other investments as follows:

(a) loans and receivables: term deposits, principally comprising funds held with banks and other financial institutions, are carried at amortised cost using the effective interest method;

(b) at fair value through profit or loss: financial instruments held for trading or designated by management on initial recognition. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date;

(c) held to maturity: non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity;

(d) available-for-sale: investments other than interests in joint ventures and associates and term deposits and not classified as (b) or (c) above. They are held at fair value.

Purchases and sales of investments are recognised at the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss.

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership.

Realised and unrealised gains and losses arising from changes in the fair value of the investments classified as fair value through profit or loss are included in finance costs in the income statement in the period in which they arise. Unrealised gains or losses arising from changes in the fair value of investments classified as available-for-sale are recognised in equity. When investments classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities within finance costs.

The fair values of quoted investments are based on bid prices at the balance sheet date.

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 amortised cost less impairment losses. A provision for impairment is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

1. Accounting policies *continued*

An impairment loss 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 include long-term contract balances less attributable progress payments.

Long-term contract balances are stated at cost, plus attributable profit, less provision for any anticipated losses. Appropriate provisions for any losses are made in the year in which they are first foreseen.

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.

Cash received on customers' account is excluded from net cash/(debt) (as defined by the Group).

Derivative financial instruments and hedging activities
The global nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures as well as to manage anticipated economic cash flow exposures over the medium term. The Group also uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon. The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

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 directly in reserves. Amounts recognised in reserves are recycled from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement immediately.

Fair value hedges
Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

Cash and cash equivalents
Cash and cash equivalents includes cash in hand, call deposits and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

Loans and overdrafts
Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost or fair value in respect of the hedged risk where hedge accounting has been adopted, with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Trade and other payables
Trade and other payables are stated at their cost.

Provisions
A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

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 all possible outcomes against their associated probabilities.

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. Future operating costs are not provided for.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

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 work-in-progress for that portion of the work which has already been completed, and as liability provisions for the remainder. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Pension obligations
Group companies operate various pension plans. The Group has both defined benefit and defined contribution plans.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

For defined benefit retirement plans, 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. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of comprehensive income. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period

1. Accounting policies *continued*

until the benefits become vested. Curtailments due to the material reduction of the expected years of future services of current employees or the elimination of the accrual of defined benefits for some or all of the future services for a significant number of employees are recognised immediately as a gain or loss in the income statement.

The retirement benefit obligations recognised in the balance sheet represent the present value of the defined benefit obligations as adjusted for unrecognised past service cost and as reduced by the fair value of scheme assets.

Tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided in full, using the balance sheet liability method, on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes; the initial recognition of assets or liabilities that affect neither accounting nor taxable profit; and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

Share-based payment compensation

The Group issues equity-settled and cash-settled share options to employees. In accordance with the requirements of IFRS 2, *Share-based Payment*, the Group has applied IFRS 2 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005 and all cash-settled options outstanding at the balance sheet date.

As explained in note 25, equity-settled share options are measured at fair value at the date of grant using an option pricing model.

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

Cash-settled share options are measured at fair value at the balance sheet date using an option pricing model. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of the options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the consolidated income statement unless they qualify for net investment hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

For consolidation purposes, the assets and liabilities of overseas subsidiary entities, joint ventures and associates are translated at the exchange rate ruling at the balance sheet date. Income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences, including exchange differences arising from the translation of borrowings and other financial instruments designated as hedges of such investments, are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Revenue and profit recognition

Sales include the Group's net share of sales of equity accounted investments. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of equity accounted investments.

Long-term contracts

The majority of the Group's long-term contract arrangements are accounted for under IAS 11, *Construction Contracts*. Sales are recognised when the Group has obtained the right to consideration in exchange for its performance. This is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods sold and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

1. Accounting policies *continued*

Revenue from the sale of goods not under a long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

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

Lease income
Rental income from aircraft operating leases is recognised in revenue on a straight-line basis over the term of the relevant lease. Lease incentives granted are charged to the income statement over the term of the lease.

Leases
Assets obtained under finance leases are included in property, plant and equipment at cost and are depreciated over their useful lives, or the lease term, whichever is the shorter. Future instalments under such leases, net of financing costs, are included within loans. Rental payments are apportioned between the finance element, which is included in finance costs, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant charge on the outstanding obligation.

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

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and accumulated impairment losses. Rental income is recognised in revenue on a straight-line basis.

Assets leased out under finance leases cease to be recognised in the balance sheet after the inception of the lease. Instead, a finance lease receivable, representing the discounted future lease payments to be received from the lessee plus any discounted unguaranteed residual value, is recorded as a long-term financial asset. Interest income is recognised in the income statement as it accrues, taking into account the effective yield on the asset.

Underlying EBITA
Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. This definition is referred to as Underlying EBITA. Underlying EBITA is the measure of profit on which segmental performance is monitored by management. As such, it is disclosed in note 3 on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature. The non-recurring items for the current and prior years are presented on the face of the Group's consolidated income statement.

Finance costs
Financial income comprises interest income on funds invested, gains on the disposal of available-for-sale financial assets, changes in the fair value of financial assets at fair value through profit or loss, and gains on hedging instruments that are recognised in profit or loss.

Financial expense comprises interest expense on borrowings, unwinding of the discounts on provisions, changes in the fair value of financial assets at fair value through profit or loss, and losses on hedging instruments that are recognised in profit or loss.

Borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) are capitalised as part of the cost of that asset, until such time as the assets are ready for their intended use or sale.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

Dividends
Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

Discontinued operations
A discontinued operation is a component of the Group's business that represents a separate major line of business or geographical area of operations that has been disposed of or meets the criteria as held for sale. When an operation is classified as a discontinued operation, the comparative consolidated income statement is re-presented as if the operation had been discontinued from the start of the comparative period.

2. Changes in accounting policies

Standards, amendments and interpretations effective in 2010
With effect from 1 January 2010, the Group early adopted *Improvements to IFRSs 2010* which makes minor amendments to seven existing standards. These amendments impact disclosures and, therefore, have had no impact on the reported results or financial position of the Group. The amendment to IAS 1, *Presentation of Financial Statements*, allows the presentation either in the statement of changes in equity, or within the notes, of an analysis of the components of other comprehensive income by item.

With effect from 1 January 2010, the Group adopted the following amendments to existing standards:

- IFRS 3, *Business Combinations*, introduces changes in the accounting treatment of acquisitions, such as the accounting for acquisition-related costs, the initial recognition and subsequent measurement of contingent consideration, and business combinations achieved in stages. The change in accounting policy has been applied prospectively and has not had a material impact on reported results. The impact on future years will depend on the specific acquisitions undertaken; and
- Amendment to IAS 27, *Consolidated and Separate Financial Statements*, requires that acquisitions of non-controlling interests that do not result in a change of control are accounted for as transactions with equity holders and, therefore, no goodwill is recognised as a result. The change in accounting policy has been applied prospectively and has not had a material impact on reported results.

In addition, the Group has reviewed the effect of the following amendments and interpretations effective from 1 January 2010, and has concluded that they have no impact on the Group's accounts:

- Amendment to IAS 39, *Financial Instruments: Recognition and Measurement: Eligible Hedged Items*;
- Amendment to IFRS 2, *Share-based Payment: Group Cash-settled Share-based Payment Transactions*;
- *Improvements to IFRSs 2009*;
- International Financial Reporting Interpretations Committee (IFRIC) 17, *Distributions of Non-cash Assets to Owners*; and
- IFRIC 18, *Transfers of Assets from Customers*.

Amendments to existing standards and interpretations that are not yet effective and have not been early adopted by the Group
The Group has reviewed the effect of the following EU-endorsed amendments and interpretations, and does not expect that they will have an impact on the Group's accounts:

- Amendment to IAS 32, *Financial instruments: Presentation: Classification of Rights Issues*, effective on or after 1 February 2010;
- IFRIC 19, *Extinguishing Financial Liabilities with Equity Instruments*, effective on or after 1 July 2010;
- IAS 24, *Related Party Disclosures*, effective on or after 1 January 2011; and
- Amendment to IFRIC 14, *IAS 19*, *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*, effective on or after 1 January 2011.

3. Segmental analysis

The Group reports on five operating groups which are organised around a combination of the different products and services they provide, and the geographical areas in which they operate:

- **BAE Systems, Inc.:**
  - **Electronics, Intelligence & Support**, based primarily in the US, provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for US national security and federal markets, and ship repair and modernisation services. It comprises four businesses: Electronic Solutions, Intelligence & Security, Platform Solutions and Support Solutions;
  - **Land & Armaments**, based primarily in the US, designs, develops, produces, supports and upgrades armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products;
- **Programmes & Support** primarily comprises the Group's UK-based air, maritime and Cyber & Intelligence activities;
- **International** comprises the Group's businesses in Australia, India and Saudi Arabia, together with interests in the pan-European MBDA joint venture and Air Astana; and
- **HQ & Other Businesses** comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

The Group has not aggregated any segments in arriving at the analysis.

Management monitors the results of these operating groups to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on underlying EBITA[1]. This is reconciled below to the operating group result and the operating profit in the consolidated financial statements. Finance costs and taxation expense are managed on a Group basis.

Analysis by operating group – continuing operations

	Combined sales of Group and equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
	2010 £m	Restated[2] 2009 £m	**2010 £m**	Restated[2] 2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Electronics, Intelligence & Support	**5,653**	5,637	**(49)**	–	**49**	–	**5,653**	5,637
Land & Armaments	**5,930**	6,738	**(42)**	(6)	**–**	–	**5,888**	6,732
Programmes & Support	**6,680**	6,298	**(1,445)**	(1,779)	**1,339**	1,166	**6,574**	5,685
International	**4,534**	3,828	**(1,221)**	(1,088)	**–**	–	**3,313**	2,740
HQ & Other Businesses	**278**	254	**–**	–	**–**	–	**278**	254
	23,075	22,755	**(2,757)**	(2,873)	**1,388**	1,166	**21,706**	21,048
Intra-operating group sales/revenue	**(683)**	(765)	**21**	16	**53**	75	**(609)**	(674)
	22,392	21,990	**(2,736)**	(2,857)	**1,441**	1,241	**21,097**	20,374

	Intra-operating group revenue		Revenue from external customers	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Electronics, Intelligence & Support	**130**	138	**5,523**	5,499
Land & Armaments	**106**	45	**5,782**	6,687
Programmes & Support	**274**	431	**6,300**	5,254
International	**7**	12	**3,306**	2,728
HQ & Other Businesses	**92**	48	**186**	206
	609	674	**21,097**	20,374

	Capital expenditure[3]		Depreciation and amortisation[3]	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Electronics, Intelligence & Support	**116**	123	**134**	125
Land & Armaments	**99**	84	**348**	244
Programmes & Support	**119**	109	**140**	116
International	**61**	142	**61**	55
HQ & Other Businesses	**42**	64	**48**	64
	437	522	**731**	604

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).
2 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).
3 Includes intangible assets, property, plant and equipment, and investment property.

3. Segmental analysis *continued*

	Underlying EBITA[1]		Non-recurring items[3]		Amortisation of intangible assets		Impairment of intangible assets[4]		Operating group result[5]	
	2010 £m	Restated[2] 2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m	**2010 £m**	Restated[2] 2009 £m
Electronics, Intelligence & Support	**668**	575	**2**	202	**(27)**	(27)	**(8)**	(8)	**635**	742
Land & Armaments	**604**	604	**–**	59	**(281)**	(177)	**(25)**	(927)	**298**	(441)
Programmes & Support	**529**	670	**1**	68	**(58)**	(49)	**(85)**	(34)	**387**	655
International	**478**	419	**–**	–	**(25)**	(32)	**(7)**	(4)	**446**	383
HQ & Other Businesses	**(65)**	(71)	**(18)**	(278)	**(1)**	(1)	**–**	–	**(84)**	(350)
	2,214	2,197	**(15)**	51	**(392)**	(286)	**(125)**	(973)	**1,682**	989
Financial (expense)/income of equity accounted investments									**(2)**	2
Taxation expense of equity accounted investments									**(44)**	(25)
Operating profit									**1,636**	966
Finance costs									**(192)**	(700)
Profit before taxation									**1,444**	266
Taxation expense									**(417)**	(327)
Profit/(loss) for the year – continuing operations									**1,027**	(61)

Analysis of non-current assets by geographical location

	Carrying value of non-current assets	
Asset location	**2010 £m**	Restated[6] 2009 £m
United Kingdom	**2,582**	2,587
Rest of Europe	**1,105**	1,190
Saudi Arabia	**734**	729
United States	**10,022**	9,838
Asia and Pacific	**621**	589
Africa, Central and South America	**31**	47
Non-current operating group assets	**15,095**	14,980
Financial instruments	**354**	310
Inventories	**644**	887
Trade and other receivables	**3,559**	3,764
Total operating group assets	**19,652**	19,941
Tax	**1,211**	1,563
Retirement benefit obligations (note 21)	**49**	42
Cash (as defined by the Group) (note 27)	**3,118**	3,943
Consolidated total assets	**24,030**	25,489

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).
2 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).
3 Non-recurring items comprise profit on disposal of businesses of £1m (2009 £68m), pension curtailment gains of £2m (2009 £261m) and regulatory penalties of £18m (2009 £278m).
4 See note 11.
5 The analysis by operating group of the share of results of equity accounted investments is provided in note 14.
6 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).

3. Segmental analysis *continued*

Analysis of sales and revenue by geographical location – continuing operations

	Sales		Revenue	
		Restated[1]		
Customer location	**2010 £m**	2009 £m	**2010 £m**	2009 £m
United Kingdom	**4,306**	4,148	**4,161**	3,562
Rest of Europe	**2,793**	2,559	**2,036**	1,811
Saudi Arabia	**3,186**	2,779	**2,994**	2,607
Rest of Middle East	**217**	105	**162**	64
United States	**10,129**	10,921	**10,126**	10,902
Canada	**77**	119	**77**	119
Australia	**1,028**	675	**1,027**	672
Rest of Asia and Pacific	**339**	261	**257**	226
Africa, Central and South America	**317**	423	**257**	411
	22,392	21,990	**21,097**	20,374

1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).

Analysis of revenue by category – continuing operations

	2010 £m	2009 £m
Sale of goods	**5,793**	6,777
Construction contracts	**11,757**	10,274
Provision of services	**3,480**	3,239
Lease income	**60**	73
Royalty income	**7**	11
	21,097	20,374

Analysis of revenue by major customer – continuing operations
Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2010 £m	2009 £m
UK Ministry of Defence[1]	**5,060**	4,101
US Department of Defense	**7,696**	8,381
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**2,870**	2,602

1 Revenue from the UK Ministry of Defence includes £1.3bn (2009 £1.1bn) generated under the Typhoon workshare agreement with Eurofighter GmbH. This revenue is included within Rest of Europe in the analysis by geographical location above.

Revenue from the UK Ministry of Defence and the US Department of Defense was generated by all four principal operating groups. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was generated by the International operating group.

4. Operating costs

	2010 £m	2009 £m
Raw materials and other bought-in items	**8,471**	9,330
Change in inventories of finished goods and work-in-progress	**985**	(538)
Cost of inventories expensed	**9,456**	8,792
Staff costs (note 7)	**5,633**	5,605
Depreciation, amortisation and impairment	**899**	1,600
Loss on disposal of property, plant and equipment	**10**	–
Regulatory penalties[1]	**18**	278
Trinidad and Tobago charge	**100**	–
Other operating charges	**3,645**	3,785
	19,761	20,060
Included within the analysis of operating costs are the following expenses:		
Lease and sublease payments:		
Minimum lease payments	**177**	167
Research and development expense including amounts funded under contract	**1,298**	1,211[2]

1 The regulatory penalties of £278m in 2009 reflected the global settlement of the regulatory investigations by the US Department of Justice (DoJ) and the UK's Serious Fraud Office. The £18m charge in the current year reflects the US dollar exchange rate movement on payment of the penalty in respect of the DoJ.
2 Restated.

Costs of rationalisation programmes included in operating costs

	2010 £m	2009 £m
Electronics, Intelligence & Support	**14**	24
Land & Armaments	**26**	32
Programmes & Support	**90**	80
International	**13**	9
HQ & Other Businesses	**12**	6
	155	151

4. Operating costs *continued*

Fees payable to the Company's auditor and its associates included in operating costs

	2010			2009		
	UK £'000	**Overseas £'000**	**Total £'000**	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	**1,484**	**–**	**1,484**	1,486	–	1,486
Fees payable to the Company's auditor and its associates for other services						
The audit of the Company's subsidiaries pursuant to legislation*	**2,499**	**4,536**	**7,035**	2,497	4,217	6,714
Other services pursuant to legislation:						
Interim review	**579**	**–**	**579**	581	–	581
Other	**92**	**139**	**231**	57	–	57
Further assurance services						
Advice on accounting matters	**51**	**17**	**68**	–	22	22
Internal controls	**–**	**–**	**–**	–	2	2
Due diligence	**365**	**337**	**702**	437	45	482
Tax services						
Compliance	**637**	**2,026**	**2,663**	481	768	1,249
Advisory	**290**	**379**	**669**	272	542	814
Other services						
M&A	**58**	**638**	**696**	99	–	99
Other	**148**	**240**	**388**	76	2	78
Total fees payable to the Company's auditor and its associates	**6,203**	**8,312**	**14,515**	5,986	5,598	11,584
* Total fees payable to the Company's auditor and its associates for audit services			**8,519**			8,200

In addition to the amounts above, the auditors' fees for audit services in respect of the Group's pension schemes were £144,000 (2009 £143,000).

The increase in overseas fees for the audit of subsidiaries includes £317,000 relating to foreign exchange translation.

Tax services include tax compliance support and services in relation to the Group's expatriate employees based around the world.

5. Other income

	2010 £m	2009 £m
Rental income from operating leases (including from investment property)	**48**	50
Profit on disposal of property, plant and equipment	**23**	17
Profit on disposal of businesses (note 9)	**1**	68
Management recharges to equity accounted investments (note 31)	**14**	24
Pension curtailment gains (note 21)	**2**	261
US healthcare curtailment gains (note 21)	**5**	–
Other	**76**	45
	169	465

6. Finance costs

	2010 £m	2009 £m
Interest income	**40**	66
Net present value adjustments	**–**	5
Expected return on pension scheme assets (note 21)	**916**	777
Gain on remeasurement of financial instruments at fair value through profit or loss[1]	**176**	408
Foreign exchange gains	**226**	317
Financial income	**1,358**	1,573
Interest expense:		
On bank loans and overdrafts	**–**	(1)
On finance leases	**(1)**	(2)
On bonds and other financial instruments	**(203)**	(225)
	(204)	(228)
Facility fees	**(4)**	(4)
Net present value adjustments	**(28)**	(40)
Interest charge on pension scheme liabilities (note 21)	**(996)**	(900)
Loss on remeasurement of financial instruments at fair value through profit or loss	**(225)**	(467)
Foreign exchange losses	**(93)**	(634)
Financial expense	**(1,550)**	(2,273)
Net finance costs	**(192)**	(700)

1 Includes a £26m (translated at average exchange rates) fair value movement in 2010 in respect of the remaining 10.25% shareholding in Saab AB.

Additional analysis of finance costs

	2010 £m	Restated[2] 2009 £m
Net finance costs:		
Group	**(192)**	(700)
Share of equity accounted investments – continuing operations	**(2)**	2
	(194)	(698)
Analysed as:		
Net interest:		
Interest income	**40**	66
Interest expense	**(204)**	(228)
Facility fees	**(4)**	(4)
Net present value adjustments	**(28)**	(35)
Share of equity accounted investments – continuing operations	**5**	8
	(191)	(193)
Other finance costs:		
Group:		
Net financing charge on pensions	**(80)**	(123)
Market value and foreign exchange movements on financial instruments and investments[3]	**84**	(376)
Share of equity accounted investments – continuing operations	**(7)**	(6)
	(194)	(698)

2 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).
3 The loss in 2009 primarily reflected net foreign exchange movements on the unhedged portion of an intercompany loan from the UK to the US businesses.

Borrowing costs capitalised during the year were £nil (2009 £nil).

7. Employees and directors

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2010 Number '000	2009 Number '000	**2010 Number '000**	2009 Number '000
Electronics, Intelligence & Support	**31**	33	**31**	32
Land & Armaments	**18**	21	**16**	20
Programmes & Support	**33**	27	**32**	33
International	**11**	11	**11**	11
HQ & Other Businesses	**2**	2	**2**	2
	95	94	**92**	98

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

	2010 £m	2009 £m
Wages and salaries	**4,884**	4,897
Social security costs	**409**	400
Share options granted to directors and employees – equity-settled	**18**	13
Share options granted to directors and employees – cash-settled	**(2)**	(2)
Pension costs – defined contribution plans (note 21)	**110**	127
Pension costs – defined benefit plans (note 21)	**212**	167
US healthcare plans (note 21)	**2**	3
	5,633	5,605

The Group considers key management personnel as defined under IAS 24, *Related Party Disclosures*, to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 96 to 119. Total emoluments for directors and other key management personnel were:

	2010 £'000	2009 £'000
Short-term employee benefits	**15,131**	14,761
Post-employment benefits[1]	**1,300**	1,754
Share-based payments	**4,033**	4,773
	20,464	21,288

1 2009 includes special incentive awards.

8. Tax

Taxation expense

	2010 £m	Restated[1] 2009 £m
Current taxation expense		
UK corporation tax		
Current tax	**(121)**	(83)
Double tax relief	**3**	8
Adjustment in respect of prior years	**(29)**	(44)
	(147)	(119)
Overseas tax charges		
Current year	**(263)**	(300)
Adjustment in respect of prior years	**26**	46
	(237)	(254)
	(384)	(373)
Deferred taxation expense		
UK		
Origination and reversal of temporary differences	**(22)**	(2)
Adjustment in respect of prior years	**23**	16
Tax rate adjustment[2]	**(6)**	–
Overseas		
Origination and reversal of temporary differences	**(9)**	55
Adjustment in respect of prior years	**(19)**	(23)
	(33)	46
Taxation expense	**(417)**	(327)

Reconciliation of taxation expense – continuing operations

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

	2010 £m	Restated[3] 2009 £m
Profit before taxation	**1,444**	266
UK corporation tax rate	**28.0%**	28.0%
Expected income tax expense	**(404)**	(74)
Effect of tax rates in foreign jurisdictions	**(43)**	(37)
Expenses not tax effected	**(24)**	(43)
Income not subject to tax	**42**	32
Research and development tax credits	**32**	36
Goodwill impairment	**(24)**	(203)
Chargeable gains	**(2)**	(1)
Utilisation of previously unrecognised tax losses	**7**	6
Current year losses not tax effected	**–**	(7)
Adjustments in respect of prior years	**1**	(5)
Adjustments in respect of equity accounted investments	**37**	52
Regulatory penalties	**(5)**	(78)
Tax rate adjustment[2]	**(6)**	–
Other	**(28)**	(5)
Taxation expense	**(417)**	(327)

1 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
2 The UK current tax rate will be reduced from 28% to 27% with effect from 1 April 2011. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 28% to 27%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.
3 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).

8. Tax *continued*

Tax recognised in other comprehensive income

	2010			Restated[1] 2009		
	Before tax £m	**Tax benefit/ (expense) £m**	**Net of tax £m**	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
Currency translation on foreign currency net investments:						
Subsidiaries	**160**	**–**	**160**	(246)	–	(246)
Equity accounted investments	**(6)**	**–**	**(6)**	(56)	–	(56)
Amounts (charged)/credited to hedging reserve	**(84)**	**22**	**(62)**	(393)	110	(283)
Gain on revaluation of step acquisition	**–**	**–**	**–**	14	(4)	10
Net actuarial gains/(losses) on defined benefit pension schemes:						
Subsidiaries	**874**	**(234)**	**640**	(2,008)	541	(1,467)
Equity accounted investments	**40**	**(12)**	**28**	(54)	16	(38)
Fair value movements on available-for-sale investments	**14**	**–**	**14**	2	–	2
Recycling of cumulative currency translation reserve on disposal	**(17)**	**–**	**(17)**	–	–	–
Recycling of cumulative net hedging reserve on disposal	**(4)**	**–**	**(4)**	–	–	–
Share-based payments	**–**	**1**	**1**	–	(2)	(2)
Tax rate adjustment[2]	**–**	**(23)**	**(23)**	–	–	–
Other	**–**	**(6)**	**(6)**	–	6	6
	977	**(252)**	**725**	(2,741)	667	(2,074)

Current tax taken in equity

	2010 £m	Restated[1] 2009 £m
Relating to financial instruments	**(2)**	(3)
Relating to share-based payments	**2**	2
Relating to pensions	**69**	53
Relating to gain on revaluation of step acquisition	**–**	12
Other	**(1)**	14
	68	78

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2010 £m	Restated[1] 2009 £m	**2010 £m**	Restated[1] 2009 £m	**2010 £m**	Restated[1] 2009 £m
Property, plant and equipment	**14**	1	**(118)**	(47)	**(104)**	(46)
Intangible assets	**–**	–	**(207)**	(325)	**(207)**	(325)
Provisions and accruals	**394**	432	**–**	–	**394**	432
Goodwill	**–**	–	**(110)**	(69)	**(110)**	(69)
Pension/retirement plans:						
Deficits	**1,060**	1,430	**–**	–	**1,060**	1,430
Additional contributions	**18**	15	**–**	–	**18**	15
Share-based payments	**11**	22	**–**	–	**11**	22
Financial instruments	**20**	–	**(12)**	(4)	**8**	(4)
Other items	**58**	58	**(2)**	(6)	**56**	52
Rolled over capital gains	**–**	–	**(17)**	(18)	**(17)**	(18)
Capital losses carried forward	**17**	18	**–**	–	**17**	18
Trading losses carried forward	**28**	19	**–**	–	**28**	19
Unremitted overseas dividends	**–**	–	**–**	(3)	**–**	(3)
Deferred tax assets/(liabilities)	**1,620**	1,995	**(466)**	(472)	**1,154**	1,523
Set off of tax	**(460)**	(464)	**460**	464	**–**	–
Net deferred tax assets/(liabilities)	**1,160**	1,531	**(6)**	(8)	**1,154**	1,523

1 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
2 The UK current tax rate will be reduced from 28% to 27% with effect from 1 April 2011. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 28% to 27%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

8. Tax *continued*

Movement in temporary differences during the year

	At 1 January 2010[1] £m	Exchange movements £m	Acquisitions and disposals[2] £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2010 £m**
Property, plant and equipment	(46)	–	(46)	(12)	–	**(104)**
Intangible assets	(325)	(10)	(14)	138	4	**(207)**
Provisions and accruals	432	18	8	(64)	–	**394**
Goodwill	(69)	(2)	–	(39)	–	**(110)**
Pension/retirement plans:						
Deficits[3]	1,430	11	–	(47)	(334)	**1,060**
Additional contributions	15	–	–	–	3	**18**
Share-based payments	22	–	–	(11)	–	**11**
Financial instruments	(4)	–	–	(11)	23	**8**
Other items	52	2	1	5	(4)	**56**
Rolled over capital gains	(18)	–	–	1	–	**(17)**
Capital losses carried forward	18	–	–	(1)	–	**17**
Trading losses carried forward	19	3	1	5	–	**28**
Unremitted overseas dividends	(3)	–	–	3	–	**–**
	1,523	22	(50)	(33)	(308)	**1,154**

	At 1 January 2009 £m	Exchange movements £m	Acquisitions and disposals[4] £m	Recognised in income £m	Recognised in equity £m	At 31 December 2009 £m
Property, plant and equipment[1]	(69)	6	(2)	16	3	(46)
Intangible assets	(509)	33	(34)	214	(29)	(325)
Provisions and accruals[1]	457	(23)	20	(25)	3	432
Goodwill	(34)	5	–	(40)	–	(69)
Pension/retirement plans:						
Deficits[3]	1,115	(45)	–	(164)	524	1,430
Additional contributions	66	–	(3)	(12)	(36)	15
Share-based payments[1]	30	(1)	(1)	(1)	(5)	22
Financial instruments	(136)	–	–	19	113	(4)
Other items[1]	25	–	(3)	33	(3)	52
Rolled over capital gains	(18)	–	–	–	–	(18)
Capital losses carried forward	18	–	–	–	–	18
Trading losses carried forward[1]	1	1	5	9	3	19
Unremitted overseas dividends	–	–	–	(3)	–	(3)
	946	(24)	(18)	46	573	1,523

1 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
2 Acquisitions and disposals includes net deferred tax liabilities on the acquisitions of Atlantic Marine (£40m) and Tenix Defence (£10m).
3 Includes deferred tax assets on workers' deferred compensation plans in the US.
4 Acquisitions and disposals includes deferred tax assets on the acquisition of Tenix Defence (£7m) and Detica (£4m), less deferred tax liabilities arising on the acquisition of the remaining shareholding in BVT (£27m).

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2010 £m	2009 £m
Deductible temporary differences	**3**	10
Capital losses carried forward	**56**	58
Trading and other losses carried forward	**194**	158
	253	226

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be sufficiently accurately predicted at this time.

Due to changes in UK tax legislation during 2009, there are no unrecognised deferred tax liabilities arising on the aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures (2009 £nil). Any withholding tax due on the remittance of future earnings is expected to be insignificant.

8. Tax *continued*

Future changes in tax rates

The Emergency Budget on 22 June 2010 announced that the UK current tax rate will reduce from 28% to 24% over a period of four years from 2011. This will reduce future current tax charges accordingly. The first reduction from 28% to 27% was substantively enacted before 31 December 2010 and will be effective from 1 April 2011. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 28% to 27%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income. Accordingly, both recognised and unrecognised UK deferred tax balances as at 31 December 2010 have been calculated at 27%.

The reduction in the rate from 27% to 24% has not yet been substantively enacted. If these reductions had been substantively enacted by 31 December 2010, the effect would have been to reduce the net deferred tax asset as at 31 December 2010 from £1,154m to £1,065m. Of this reduction, it is estimated that £19m would have been charged to the consolidated income statement and £70m charged to the consolidated statement of comprehensive income. In addition, unrecognised deferred tax assets as at 31 December 2010 would have reduced from £253m to £235m.

9. Disposals

Discontinued operations for the year ended 31 December 2010

On 3 June 2010, the Group sold half of its 20.5% shareholding in Saab AB to Investor AB for a cash consideration of SEK1,041m (£92m). Following the loss of significant influence over the company, the Group has discontinued the use of the equity method and the remaining shareholding in Saab is shown within other financial assets as a financial asset at fair value through profit or loss at 31 December 2010 (see note 17). The Group's share of the results of Saab to the date of disposal is shown within discontinued operations for the current and prior periods.

The results from discontinued operations which have been included in the consolidated income statement are as follows:

	2010 £m	2009 £m
Share of results of equity accounted investments	**2**	16
Profit on disposal of discontinued operations	**52**	–
Profit for the year – discontinued operations	**54**	16

The profit on disposal of discontinued operations is calculated as follows:

	£m
Cash consideration	**92**
Fair value of retained 10.25% investment	**97**
Transaction costs	**(3)**
Carrying value of 20.5% shareholding (note 14)	**(155)**
Cumulative net hedging gain	**4**
Cumulative currency translation gain	**17**
Profit on disposal of discontinued operations	**52**

Following the classification of Saab as a discontinued operation, combined sales of Group and equity accounted investments in the comparatives for the year ended 31 December 2009 have been reduced by £425m.

Continuing operations for the year ended 31 December 2010

During 2010, the Group completed the disposal of its Sistemas y Desarrollos Funcionales Limitada (SISDEF) joint venture for total cash consideration of £1m. Profit on disposal is £1m.

Continuing operations for the year ended 31 December 2009

Profit on disposal of businesses of £68m comprised the finalisation of the accounting gain recognised in 2008 on the disposal of the Group's interests in the businesses contributed to the BVT joint venture following acquisition of VT Group's 45% interest in 2009 (£58m) and additional proceeds received in respect of the disposal in 2008 of the Group's interest in Flagship Training (£10m).

The Group received deferred consideration of £72m in the year ended 31 December 2009 in respect of the disposals of Flagship Training Limited in 2008 (£70m) and the Inertial Products business in 2007 (£2m).

10. Earnings per share

	2010			Restated[1] 2009		
	£m	**Basic pence per share**	**Diluted pence per share**	£m	Basic pence per share	Diluted pence per share
Profit/(loss) for the year attributable to equity shareholders	**1,052**	**30.5**	**30.3**	(67)	(1.9)	(1.9)
Represented by:						
Continuing operations	**998**	**28.9**	**28.7**	(83)	(2.3)	(2.3)
Discontinued operations	**54**	**1.6**	**1.6**	16	0.4	0.4
Add back/(deduct):						
Profit on disposal of businesses, post tax	**(1)**			(65)		
Pension curtailment gains, post tax	**(1)**			(188)		
Regulatory penalties	**18**			278		
Net financing charge on pensions, post tax	**59**			91		
Market value movements on derivatives, post tax	**(57)**			278		
Amortisation and impairment of intangible assets, post tax	**307**			384		
Impairment of goodwill	**84**			725		
Underlying earnings, post tax	**1,461**	**42.4**	**42.1**	1,436	40.7	40.6
Represented by:						
Continuing operations	**1,407**	**40.8**	**40.5**	1,415	40.1	40.0
Discontinued operations	**54**	**1.6**	**1.6**	21	0.6	0.6
	1,461	**42.4**	**42.1**	1,436	40.7	40.6

	Millions	**Millions**	Millions	Millions
Weighted average number of shares used in calculating basic earnings per share	**3,451**	**3,451**	3,532	3,532
Incremental shares in respect of employee share schemes		**20**		4
Weighted average number of shares used in calculating diluted earnings per share		**3,471**		3,536

1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).

Underlying earnings per share is presented in addition to that required by IAS 33, *Earnings per Share*, to align the adjusted earnings measure with the performance measure reviewed by the directors. The directors consider that this gives a more appropriate indication of underlying performance.

In the 12 months to 31 December 2009, outstanding share options were anti-dilutive and so were excluded from the diluted loss per share in accordance with IAS 33.

11. Intangible assets

	Goodwill £m	Programme and customer related[1] £m	Other[2] £m	Total £m
Cost or valuation				
At 1 January 2009	13,201	1,728	417	15,346
Additions:				
Acquired separately	–	–	28	28
Internally developed	–	–	14	14
Reclassification from equity accounted investments (note 14)[3]	253	–	–	253
Acquisition of subsidiaries (note 29) (restated[4])	420	225	–	645
Adjustment on finalisation of provisional goodwill[5]	5	11	–	16
Disposals	–	–	(7)	(7)
Transfer from property, plant and equipment	–	–	4	4
Exchange adjustments	(655)	(144)	(8)	(807)
At 31 December 2009 (restated[4])	13,224	1,820	448	15,492
Additions:				
Acquired separately	–	–	17	17
Internally developed	–	–	2	2
Acquisition of subsidiaries (note 29)	161	37	4	202
Adjustment to fair value of consideration[6]	(64)	–	–	(64)
Disposals	(12)	–	(6)	(18)
Asset reclassifications	–	27	(27)	–
Transfer from property, plant and equipment	–	–	3	3
Transfer from inventories	–	–	3	3
Exchange adjustments	279	60	21	360
At 31 December 2010	13,588	1,944	465	15,997
Amortisation and impairment				
At 1 January 2009	2,333	556	151	3,040
Disposals	–	–	(7)	(7)
Amortisation charge[7]	–	219	67	286
Impairment charge	725	240	8	973
Exchange adjustments	(55)	(48)	(3)	(106)
At 31 December 2009	3,003	967	216	4,186
Disposals	–	–	(6)	(6)
Amortisation charge[7]	–	327	65	392
Impairment charge	84	30	11	125
Asset reclassifications	–	15	(15)	–
Transfer from property, plant and equipment	–	–	1	1
Exchange adjustments	36	34	13	83
At 31 December 2010	3,123	1,373	285	4,781
Net book value				
At 31 December 2010	**10,465**	**571**	**180**	**11,216**
At 31 December 2009 (restated[4])	10,221	853	232	11,306
At 1 January 2009	10,868	1,172	266	12,306

1 Relates to intangible assets recognised on acquisition of subsidiary companies, mainly in respect of ongoing programme relationships and the acquired order book.
2 Other intangibles includes patents, trademarks, software and internally funded development costs.
3 Goodwill arising on the formation of the BVT joint venture in the year ended 31 December 2008 and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited was reclassified from equity accounted investments to intangible assets in accordance with IFRS 3 (2004) in 2009 upon acquisition of VT Group's 45% shareholding in the BVT joint venture (see note 14).
4 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
5 Adjustment on finalisation of provisional goodwill relating to the acquisition of MTC Technologies, Inc., Tenix Defence Holdings Pty Limited, Tenix Toll Defence Logistics Pty Limited, Detica Group Plc and IST Dynamics in 2008. The amounts were not considered material for the restatement of comparative information in 2009.
6 See note 29.
7 Amortisation is included in operating costs in the income statement. The 2010 charge for programme and customer related intangibles includes an acceleration of amortisation (£137m) reflecting the profile of vehicle deliveries under the Family of Medium Tactical Vehicles contract.

The Group has no indefinite life intangible assets other than goodwill. The Group's approach to goodwill impairment testing is set out in the accounting policies on page 132.

Impairment testing

In order to calculate the recoverable amount of the Group's goodwill, all goodwill balances have been considered with regard to value in use calculations. These calculations use risk-adjusted future cash flow projections based on the Group's five-year

11. Intangible assets *continued*

Integrated Business Plan (IBP) and include a terminal value based on the projections for the final year of that plan, with an inflationary growth rate assumption applied. The IBP process uses historic experience, available government spending data and the Group's order book. Pre-tax discount rates, derived from the Group's post-tax weighted average cost of capital of 7.28% (2009 7.72%) (adjusted for risks specific to the market in which the cash-generating unit (CGU) operates), have been used in discounting these projected risk-adjusted cash flows.

Significant CGUs

2010

The Group has two CGUs with allocated goodwill which is significant in comparison with the total carrying amount of goodwill, the Electronic Solutions business (£2.0bn) within Electronics, Intelligence & Support (EI&S), and the Land & Armaments business (£3.6bn).

The key assumptions underpinning the cash flow projections are, for Electronic Solutions, continuing demand from the US government for electronic warfare systems (where the business has a leadership position) and other technology-based solutions, and for Land & Armaments, the continued demand in the Group's home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support.

The pre-tax discount rates used to discount the risk-adjusted five-year cash flow projections were 9.1% and 9.0%, respectively.

The growth rate assumption applied to the final year of these projections was 3%.

2009

The Group had three CGUs with allocated goodwill which was significant in comparison with the total carrying amount of goodwill. These were the US-based electronic warfare, network and mission solutions business in the EI&S operating group (£2.6bn), and the US-based ex-United Defense Industries, Inc. (UDI) (£2.0bn) and ex-Armor Holdings, Inc. (Armor) (£1.7bn pre-impairment below) businesses in the Land & Armaments operating group.

The key assumptions underpinning the cash flow projections were, for the EI&S CGU, the continuing demand from the US government for electronic warfare systems, mission solutions and other technology-based solutions, and from non-military agencies for network solutions, and for the Land & Armaments CGUs, the continued demand in the Group's home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support.

The pre-tax discount rates used to discount the risk-adjusted five-year cash flow projections were 9.9%, 9.8% and 10.3%, respectively.

The growth rate assumption applied to the final year of these projections was 3% (2% for Armor).

Whilst there are no other CGUs with allocated goodwill balances exceeding 15% of the Group's total goodwill balance, the majority of the projected cash flows within the remaining CGUs are underpinned by expected levels of government spending on defence and security, and the Group's ability to capture a broadly consistent market share.

The directors have not identified any reasonably possible material changes relating either specifically to the global military vehicle market, or to the levels of defence and security spending in the Group's home markets, particularly in the US, that would cause the carrying value of goodwill to exceed its recoverable amount. The Group continues to monitor changes in US defence budgets on an annual basis.

Impairment – goodwill

2010

The total goodwill impairment charge of £84m mainly arose in Surface Ships (£70m) reflecting the underperformance of the ex-VT Group export ship contracts. The pre-tax discount rate was 10.4%.

2009

The total goodwill impairment charge of £725m mainly arose in three CGUs, Armor (£526m), Products Group (£156m) and Detica (£34m).

The Armor impairment charge reflected both the non-award of a follow-on contract for production of vehicles under the Family of Medium Tactical Vehicles (FMTV) programme and the subsequent impact on the growth prospects of the business.

The Products Group impairment charge reflected a weaker outlook for the business as spending from customer discretionary budgets had reduced in both domestic and export markets. The pre-tax discount rate used was 9.5%.

The Detica impairment charge related to the discontinued financial services element of the business. The pre-tax discount rate used was 10.0%.

Impairment – intangible assets

2010

The total intangible assets impairment charge of £41m comprises £30m relating to programme and customer related intangibles, and £11m relating to other intangibles. The charge impacted the EI&S (£8m), Land & Armaments (£25m) and Programmes & Support (£8m) operating groups.

2009

The total intangible assets impairment charge of £248m comprised £240m relating to programme and customer related intangibles, and £8m relating to other intangibles. The charge impacted the EI&S (£8m), Land & Armaments (£236m) and International (£4m) operating groups.

11. Intangible assets *continued*

The charge relating to Land & Armaments included £108m in respect of the Products Group business, £66m relating to the FMTV non-award and a number of individually small items each calculated on a programme-by-programme basis.

12. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Cost				
At 1 January 2009	1,972	2,529	826	5,327
Additions	245	187	48	480
Acquisition of subsidiaries (note 29)	85	53	–	138
Transfers from inventories	–	2	–	2
Transfer to investment properties	(2)	–	–	(2)
Transfer to other intangible assets	–	(4)	–	(4)
Reclassification between categories	28	(28)	–	–
Disposals	(23)	(78)	(43)	(144)
Exchange adjustments	(110)	(110)	(72)	(292)
At 31 December 2009	2,195	2,551	759	5,505
Additions	159	225	20	404
Acquisition of subsidiaries (note 29)	98	15	–	113
Transfers from inventories	–	1	–	1
Transfers to inventories	–	(5)	(5)	(10)
Transfer to investment properties	(15)	–	–	(15)
Transfer to other intangible assets	–	(3)	–	(3)
Reclassification between categories	17	(18)	1	–
Disposals	(41)	(136)	(95)	(272)
Exchange adjustments	64	51	21	136
At 31 December 2010	2,477	2,681	701	5,859
Depreciation and impairment				
At 1 January 2009	605	1,690	586	2,881
Depreciation charge for the year	80	184	51	315
Impairment charge for the year	11	2	10	23
Reclassification between categories	(5)	5	–	–
Disposals	(20)	(73)	(32)	(125)
Exchange adjustments	(27)	(63)	(51)	(141)
At 31 December 2009	644	1,745	564	2,953
Depreciation charge for the year	101	201	34	336
Impairment charge for the year	29	–	14	43
Transfers to inventories	–	(5)	(3)	(8)
Transfer to investment properties	(1)	–	–	(1)
Transfer to other intangible assets	–	(1)	–	(1)
Reclassification between categories	(12)	13	(1)	–
Disposals	(32)	(123)	(80)	(235)
Exchange adjustments	12	29	17	58
At 31 December 2010	741	1,859	545	3,145
Net book value:				
Freehold property	1,511	–	–	1,511
Long leasehold property	173	–	–	173
Short leasehold property	52	–	–	52
Plant and machinery	–	734	–	734
Fixtures, fittings and equipment	–	88	–	88
Aircraft	–	–	156	156
At 31 December 2010	**1,736**	**822**	**156**	**2,714**
At 31 December 2009	1,551	806	195	2,552
At 1 January 2009	1,367	839	240	2,446

12. Property, plant and equipment *continued*

Impairment

2010

The impairment charge of £43m in 2010 mainly comprises charges in respect of the carrying values of land and buildings in Saudi Arabia (£16m) and the US (£10m), and aircraft within the Regional Aircraft business (£14m). The impairment impacts the following segments: Electronics, Intelligence & Support (£10m); Land & Armaments (£3m); International (£16m); and HQ & Other Businesses (£14m).

2009

The impairment charge of £23m mainly comprised charges in respect of aircraft carrying values within the Regional Aircraft business (£8m) and a £13m charge following the reassessment of the carrying value of certain assets within the International operating group. The impairment impacted the International (£13m), HQ & Other Businesses (£8m) and Land & Armaments (£2m) segments.

Assets in the course of construction

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Assets in the course of construction (including investment property (note 13))				
At 31 December 2010	**67**	**77**	**–**	**144**
At 31 December 2009	133	76	–	209

Finance leases

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Net book value of assets held as capitalised finance leases				
At 31 December 2010	**–**	**–**	**–**	**–**
At 31 December 2009	–	–	5	5

At 31 December 2009, none of the assets held under finance leases were sublet under operating leases.

Operating leases

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

	2010 £m	2009 £m
Receipts due:		
Not later than one year	**68**	78
Later than one year and not later than five years	**173**	201
Later than five years	**185**	23
	426	302

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations. There is no lease income relating to assets held by the Group under capitalised finance leases within the above.

13. Investment property

	£m
Cost	
At 1 January 2009	153
Transfer from property, plant and equipment	2
At 31 December 2009	155
Additions	14
Transfer from property, plant and equipment	15
Disposals	(7)
At 31 December 2010	177
Depreciation and impairment	
At 1 January 2009	41
Depreciation charge for the year	3
At 31 December 2009	44
Depreciation charge for the year	3
Transfer from property, plant and equipment	1
Disposals	(5)
At 31 December 2010	43
Net book value of investment property	
At 31 December 2010	**134**
At 31 December 2009	111
At 1 January 2009	112

Fair value of investment property	
At 31 December 2010	**233**
At 31 December 2009	166

The fair values above are based on and reflect current market values as prepared by in-house professionals. The valuations were prepared by persons having the appropriate professional qualification, and with recent experience of valuing properties in the location and of the type being valued.

	2010 £m	2009 £m
Rental income from investment property	**22**	20

14. Equity accounted investments

Carrying value of equity accounted investments

	Share of net assets £m	Purchased goodwill £m	Carrying value £m
At 1 January 2009	374	660	1,034
Share of results after tax – continuing operations	187	–	187
Share of results after tax – discontinued operations (note 9)	16	–	16
Disposal	28	–	28
Reclassification to intangible assets (note 11)	–	(253)	(253)
Dividends – continuing operations	(74)	–	(74)
Dividends – discontinued operations	(3)	–	(3)
Market value adjustments in respect of derivative financial instruments, net of tax	5	–	5
Actuarial losses on defined benefit pension schemes, net of tax	(38)	–	(38)
Foreign exchange adjustment	(31)	(25)	(56)
At 31 December 2009	464	382	846
Share of results after tax – continuing operations	131	–	131
Share of results after tax – discontinued operations (note 9)	2	–	2
Acquisitions	2	–	2
Equity accounted investment funding	7	–	7
Disposal	(125)	(30)	(155)
Dividends – continuing operations	(67)	–	(67)
Dividends – discontinued operations	(4)	–	(4)
Market value adjustments in respect of derivative financial instruments, net of tax	3	–	3
Actuarial gains on defined benefit pension schemes, net of tax	28	–	28
Foreign exchange adjustment	4	(10)	(6)
At 31 December 2010	**445**	**342**	**787**

On 30 October 2009, the BVT Surface Fleet Limited (BVT) joint venture became a wholly-owned subsidiary of the Group after VT Group plc (VT) exercised its option to sell its 45% shareholding in BVT to BAE Systems (see note 29). As part of the transaction, the Group's shareholding in Fleet Support Limited also increased from 55% to 100%. On the date of the transaction, the Group gained full control of BVT, which was previously jointly controlled with VT.

Goodwill arising on the formation of the BVT joint venture in 2008 (£225m) and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited (£28m) was reclassified to intangible assets (see note 11) in 2009 in accordance with IFRS 3 (2004).

On 3 June 2010, the Group sold half of its 20.5% shareholding in Saab AB to Investor AB for a cash consideration of SEK1,041m (£92m) (see note 9). Following the loss of significant influence over the company, the Group has discontinued the use of the equity method and the remaining shareholding in Saab is shown within other financial assets as a financial asset at fair value through profit or loss at 31 December 2010 (see note 17). The Group's share of the results of Saab to the date of disposal is shown within discontinued operations for the current and prior periods.

Included within purchased goodwill is £59m (2009 £89m) relating to the goodwill arising on acquisitions made by the Group's equity accounted investments subsequent to their acquisition by the Group.

14. Equity accounted investments *continued*

Share of results of equity accounted investments by operating group – continuing operations

	2010 £m	Restated[1] 2009 £m
Share of results excluding finance costs and taxation expense:		
Electronics, Intelligence & Support	**1**	1
Land & Armaments	**8**	(3)
Programmes & Support	**24**	77
International	**143**	135
HQ & Other Businesses	**1**	–
	177	210
Financial (expense)/income	**(2)**	2
Taxation expense	**(44)**	(25)
	131	187

Share of the assets and liabilities of equity accounted investments

	2010 £m	2009 £m
Assets:		
Non-current assets	**803**	990
Current assets	**3,014**	3,313
	3,817	4,303
Liabilities:		
Non-current liabilities	**(466)**	(678)
Current liabilities	**(2,564)**	(2,779)
	(3,030)	(3,457)
Carrying value	**787**	846

1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation (see note 9).

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of equity accounted investments.

Principal equity accounted investments

Joint ventures	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
Eurofighter Jagdflugzeug GmbH *(Held by BAE Systems plc)*	Management and control of the Typhoon programme	33% ordinary	Germany	Germany
MBDA SAS *(Held via BAE Systems Electronics Limited and BAE Systems (Overseas Holdings) Limited)*	Development and manufacture of guided weapons	37.5% ordinary	Europe	France

The Group comprises a large number of equity accounted investments and it is not practical to include all of them in the above list. The list therefore only includes those equity accounted investments which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2010 will be annexed to the Company's next annual return filed with the Registrar of Companies.

15. Other investments

	2010 £m	2009 £m
Non-current		
Available-for-sale financial assets		
Equity securities	**11**	6
	11	6
Current		
Available-for-sale financial assets		
Government bonds[1]	**260**	211
	260	211

Reconciliation of movements

	2010 £m	2009 £m
Non-current		
At 1 January	**6**	6
Fair value movements	**5**	–
At 31 December	**11**	6
Current		
At 1 January	**211**	–
Additions	**40**	209
Fair value movements	**9**	2
At 31 December	**260**	211

1 The government bonds are held in a Trust in respect of the Group's UK pension schemes (see page 40).

16. Trade and other receivables

	2010 £m	2009 £m
Non-current		
Other receivables	**218**	156
Pension prepayment (note 21)	**49**	42
Prepayments and accrued income	**15**	3
	282	201
Current		
Long-term contract balances	**6,586**	7,034
Less: attributable progress payments	**(5,680)**	(5,941)
Amounts due from contract customers	**579**	482
Amounts due from customers for contract work[1]	**1,485**	1,575
Trade receivables	**1,252**	1,452
Amounts owed by equity accounted investments (note 31)	**307**	207
Other receivables	**200**	274
Prepayments and accrued income	**315**	256
	3,559	3,764

1 There are no retentions against long-term contracts (2009 £nil) and no amounts that are past due within amounts due from customers for contract work (2009 £nil).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2010 are estimated to be £31.9bn (2009 £36.9bn).

16. Trade and other receivables *continued*

The ageing of trade receivables is detailed below:

	2010			2009		
	Gross £m	**Provision £m**	**Net £m**	Gross £m	Provision £m	Net £m
Not past due and not impaired	**1,065**	**–**	**1,065**	1,194	–	1,194
Up to 180 days overdue and not impaired	**117**	**–**	**117**	233	–	233
Up to 180 days overdue and impaired	**1**	**(1)**	**–**	9	(2)	7
Past 180 days overdue and not impaired	**70**	**–**	**70**	18	–	18
Past 180 days overdue and impaired	**40**	**(40)**	**–**	45	(45)	–
	1,293	**(41)**	**1,252**	1,499	(47)	1,452

Trade receivables are disclosed net of a provision for impairment losses. Movement on the provision is as follows:

	2010 £m	2009 £m
At 1 January	**47**	50
Created	**23**	36
Released	**(22)**	(27)
Exchange adjustments	**1**	(2)
Acquisitions	**–**	2
Utilised	**(8)**	(12)
At 31 December	**41**	47

Other receivables do not contain assets which are considered to be impaired.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, the provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk.

17. Other financial assets and liabilities

	2010 Assets £m	**2010 Liabilities £m**	2009 Assets £m	2009 Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**57**	**(77)**	100	(95)
Other foreign exchange/interest rate contracts	**25**	**(178)**	6	(166)
Debt-related derivative financial instruments – assets[1]	**28**	**–**	27	–
	110	**(255)**	133	(261)
Current				
Cash flow hedges – foreign exchange contracts	**92**	**(68)**	158	(54)
Other foreign exchange/interest rate contracts	**53**	**(41)**	46	(40)
Fair value of 10.25% shareholding in Saab AB	**127**	**–**	–	–
Debt-related derivative financial instruments – assets[2]	**17**	**–**	12	–
	289	**(109)**	216	(94)

1 Includes fair value hedges of £9m (2009 £26m).
2 Includes fair value hedges of £17m (2009 £12m).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (see note 19).

The notional principal amounts of the outstanding contracts are detailed in note 30.

Cash flow hedges
The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts debited to the hedging reserve in respect of cash flow hedges were £84m (2009 £393m).

The amount reclassified from equity to the income statement was £3m (2009 £nil). The amount credited from equity and included in contract-related non-financial assets and liabilities was £1m (2009 debit £39m). The ineffective portion recognised in the income statement that arises from cash flow hedges amounts to £3m (2009 £nil).

Fair value hedges
The net loss arising in the income statement on fair value hedging instruments was £6m which comprises gains of £17m, less losses of £23m (2009 loss £20m). The net gain arising in the income statement on the fair value of the underlying hedged items was £6m which comprises gains of £23m, less losses of £17m (2009 gain £20m). The ineffective portion recognised in the income statement that arises from fair value hedges amounts to a gain of £6m (2009 £4m).

18. Inventories

	2010 £m	2009 £m
Short-term work-in-progress	**245**	451
Raw materials and consumables	**287**	312
Finished goods and goods for resale	**112**	124
	644	887

The Group recognised £10m (2009 £35m) as a write down of inventories to net realisable value.

19. Loans and overdrafts

	2010 £m	2009 £m
Non-current		
US$1bn 6.4% bond, repayable 2011	**–**	645
Class B and Class G certificates, final instalments 2013	**266**	379
Euro-Sterling £100m 10¾% bond, repayable 2014	**100**	100
US$500m 4.95% bond, repayable 2014	**318**	308
US$750m 5.2% bond, repayable 2015	**477**	463
Albertville Hangar Bond, repayable 2018	**6**	6
US$1bn 6.375% bond, repayable 2019	**645**	608
US$500m 7.5% bond, repayable 2027	**317**	307
Debt-related derivative financial instruments – liabilities	**4**	23
Obligations under finance leases	**–**	1
	2,133	2,840
Current		
Bank loans and overdrafts	**11**	15
US$500m 4.75% bond, repayable 2010	**–**	322
US$1bn 6.4% bond, repayable 2011	**656**	–
Class B and Class G certificates, final instalments 2011/2013	**108**	110
Debt-related derivative financial instruments – liabilities	**1**	–
US$ Commercial Paper	**144**	–
Obligations under finance leases	**–**	6
	920	453

The maturity of the Group's borrowings is as follows:

	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
At 31 December 2010				
Carrying amount[1]	920	1,171	962	3,053
Debt-related derivative financial instruments – assets	(17)	(9)	(19)	(45)
Carrying amount including debt-related derivative financial instruments – assets	**903**	**1,162**	**943**	**3,008**
Contractual cash flows, including future interest payments	**1,052**	**1,548**	**1,390**	**3,990**
At 31 December 2009				
Carrying amount[1]	453	1,453	1,387	3,293
Debt-related derivative financial instruments – assets	(12)	(26)	(1)	(39)
Carrying amount including debt-related derivative financial instruments – assets	441	1,427	1,386	3,254
Contractual cash flows, including future interest payments	583	1,849	1,890	4,322

1 The carrying amount of loans and overdrafts at 31 December 2010 excludes debt-related derivative financial assets of £45m (2009 £39m) presented as other financial assets.

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

19. Loans and overdrafts *continued*

The US$1bn 6.4% bond, repayable 2011, has been partially converted to a floating rate bond by utilising a series of interest rate swaps. US$500m has been swapped to a floating rate until maturity of the bond in 2011. This has been overlaid by US$300m of floating to fixed interest rate swaps that fix the interest payments at a lower rate than the original coupon. The effective interest rate during 2010 was 5.16% with an interest rate split on the bond at 31 December 2010 being US$800m fixed and US$200m floating.

The Class B and Class G certificates are repayable in 2011 and 2013, respectively, with fixed US$ coupon rates of 7.16% and 6.66%, giving a weighted average interest rate of 6.88%. At 31 December 2010, the gross outstanding principal due is US$571m. Of this balance, US$197m has been converted to a sterling floating rate bond by utilising a series of cross-currency swaps. Subsequently, £114m has been re-fixed utilising a sterling interest rate swap. The overall effective rate during 2010 is 2.86% on these elements.

The US$500m 4.95% bond, repayable 2014, was converted on issue to a floating rate bond utilising a series of interest rate swaps giving an effective rate during 2010 of 2.45%.

The Albertville Hangar Bond is a floating rate bond with an effective interest rate of 3.24%. This bond has been converted to a fixed rate using a floating to fixed rate swap, fixing the rate at 3.52%.

US$500m of the US$1bn 6.375% bond, repayable 2019, has been converted to a floating rate bond utilising a series of interest rate swaps that mature in December 2014 and give an effective rate during 2010 of 5.0%.

The US$500m 7.5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising a cross-currency swap and has an effective interest rate of 7.73%.

The US$500m 4.75% bond, repayable 2010, was converted on issue to a floating rate bond by utilising interest rate swaps giving an effective rate during 2010 of 3.67%. The bond was repaid in August 2010.

The debt-related derivative financial instruments represent the fair value of certain interest rate and cross-currency derivatives relating to the US$1bn 6.4% bond, repayable 2011, Class B and Class G certificates, final instalments 2011/2013, the US$1bn 6.375% bond, repayable 2019, and the US$500m 7.5% bond, repayable 2027. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

Finance lease obligations

	2010 £m	2009 £m
Finance lease liabilities – minimum lease payments due:		
Not later than one year	–	7
Later than one year and not later than five years	–	1
	–	8
Future finance charges on finance leases	–	(1)
Present value of finance lease liabilities	–	7
Present value of finance lease liabilities – payments due:		
Not later than one year	–	6
Later than one year and not later than five years	–	1
	–	7

The average interest rate on finance lease payables at 31 December 2009 was 5%.

20. Trade and other payables

	2010 £m	Restated[1] 2009 £m
Non-current		
Amounts due to long-term contract customers	**181**	142
Cash received on customers' account[2] for long-term contracts	**–**	5
Other payables	**339**	332
Accruals and deferred income[3]	**174**	43
	694	522
Current		
Amounts due to long-term contract customers	**5,036**	5,696
Amounts due to other customers	**193**	216
Cash received on customers' account[2]:		
Long-term contracts	**7**	14
Others	**9**	1
Trade payables	**1,114**	1,063
Amounts owed to equity accounted investments (note 31)	**1,232**	1,353
Other taxes and social security costs	**57**	51
Other payables[4]	**636**	851
Accruals and deferred income	**1,068**	1,136
	9,352	10,381

Included above:

	2010 £m	Restated[1] 2009 £m
Amounts due to long-term contract customers	**5,224**	5,857
Advances from long-term contract customers, including progress payments in respect of work not yet performed	**5,026**	5,416

1 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
2 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance.
3 Includes £125m at 31 December 2010 in respect of the three Offshore Patrol Vessels under the terminated Trinidad and Tobago contract.
4 Other payables at 31 December 2009 includes the regulatory penalties of £278m reflecting the global settlement of the regulatory investigations by the US Department of Justice (DoJ) and the UK's Serious Fraud Office (SFO). Other payables at 31 December 2010 includes £30m in respect of the global settlement with the UK's SFO following payment of the DoJ penalty during the year.

21. Retirement benefit obligations

Pension plans

BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans, and the assets are held in separate trustee administered funds. The plans in other countries are defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19, *Employee Benefits*, deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans 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 plans at 31 December each year. Plan assets are shown at the bid value.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2010. These plans were rolled forward to reflect the information at 31 December 2010. The method of accounting for these is similar to that used for defined benefit pension plans.

21. Retirement benefit obligations *continued*

The financial assumptions used to calculate liabilities for the principal plans are:

	UK			US		
	2010 %	2009 %	2008 %	**2010 %**	2009 %	2008 %
Discount rate	**5.5**	5.7	6.3	**5.5**	5.9	6.5
Inflation rate	**3.4**	3.5	2.9	**3.0**	3.0	3.0
Rate of increase in salaries	**4.4**	4.5	3.9	**4.5**	4.5	5.5
Rate of increase for pensions in payment	**2.3 – 3.6**	2.3 – 3.7	2.2 – 3.4	**–**	–	–
Rate of increase for deferred pensions[1]	**2.8 – 3.4**	3.5	2.9	**–**	–	–
Long-term healthcare cost increases	**–**	–	–	**5.3**	5.3	5.3

1 The assumption for the rate of deferred pension increases of 2.8% is in respect of those schemes which refer to the Consumer Prices Index as the relevant measure.

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid values of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present values of plan liabilities, which are derived from cash flow projections over long periods and therefore inherently uncertain, as at 31 December are shown in the tables below.

Discount rate assumptions are based on third-party AA corporate bond indices and yields that reflect the maturity profile of the expected benefit payments. The inflation rate 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. The inflation assumptions are used to derive the rate of increase for pensions in payment and the rate of increase in deferred pensions where there is such an increase.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2010, continued to use PA 00 medium cohort 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 plan members. In addition, this mortality has been subject to a minimum assumed rate of future annual mortality improvements of 1%. For its US pension arrangements, the mortality tables used are RP 2000 projected to 2018 for pensioners and projected to 2025 for non-pensioners. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 19 to 23 years for current male pensioners at age 65 and 21 to 26 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 8.0% in 2011 reducing to 5% by 2017 for pre-retirement and 8.5% in 2011 reducing to 5% by 2018 for post-retirement.

A summary of the movements in the retirement benefit obligations is shown below. The full disclosures, as required by IAS 19, are provided in the subsequent information.

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	**Total £m**
Total IAS 19 deficit at 1 January 2010	(5,006)	(610)	**(5,616)**
Actual return on assets above expected return	917	126	**1,043**
Decrease/(increase) in liabilities due to changes in assumptions	314	(259)	**55**
Additional contributions	301	–	**301**
Recurring contributions in excess of service cost	193	60	**253**
Past service cost	(39)	–	**(39)**
Curtailment gains	–	2	**2**
Net financing (charge)/credit	(118)	15	**(103)**
Exchange translation	–	(21)	**(21)**
Movement in US healthcare plans	–	22	**22**
Total IAS 19 deficit at 31 December 2010	(3,438)	(665)	**(4,103)**
Allocated to equity accounted investments and other participating employers	696	–	**696**
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers at 31 December 2010	(2,742)	(665)	**(3,407)**

The decrease in UK liabilities due to changes in assumptions includes a benefit of £348m arising from the change from the Retail Prices Index to the Consumer Prices Index as the measure of price inflation for the purposes of determining minimum statutory pension increases. With the exception of the BAE Systems 2000 Pension Plan (2000 Plan), this change has affected all of the Group's UK pension schemes for deferred pension increases, but has only affected two of the Group's smaller schemes for increases to pensions in payment.

21. Retirement benefit obligations *continued*

During the year, the Group contributed an additional £25m into Trust for the benefit of the Group's main pension scheme (2009 £225m). The cumulative contributions totalling £250m are reported within other investments (£260m after cumulative fair value gains of £11m) and cash and cash equivalents (£1m) at 31 December 2010, and the use of these assets is restricted under the terms of the Trust. The Group considers these contributions to be equivalent to the other lump sum contributions it makes into the Group's pension schemes and, accordingly, presents below a definition of the pension deficit including them.

	2010 £m	2009 £m
Group's share of IAS 19 deficit, net	**(3,407)**	(4,637)
Assets held in Trust	**261**	227
Pension deficit (as defined by the Group)	**(3,146)**	(4,410)

Amounts recognised on the balance sheet

	2010				2009			
	UK defined benefit pension plans £m	**US and other pension plans £m**	**US healthcare plans £m**	**Total £m**	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Present value of unfunded obligations	**(28)**	**(138)**	**(11)**	**(177)**	(10)	(115)	(11)	(136)
Present value of funded obligations	**(17,990)**	**(3,002)**	**(137)**	**(21,129)**	(17,776)	(2,587)	(140)	(20,503)
Fair value of plan assets	**14,580**	**2,496**	**127**	**17,203**	12,780	2,135	108	15,023
Total IAS 19 deficit, net	**(3,438)**	**(644)**	**(21)**	**(4,103)**	(5,006)	(567)	(43)	(5,616)
Allocated to equity accounted investments and other participating employers	**696**	**–**	**–**	**696**	979	–	–	979
Group's share of IAS 19 deficit, net	**(2,742)**	**(644)**	**(21)**	**(3,407)**	(4,027)	(567)	(43)	(4,637)
Represented by:								
Pension prepayments (within trade and other receivables)	**–**	**49**	**–**	**49**	–	42	–	42
Retirement benefit obligations	**(2,742)**	**(693)**	**(21)**	**(3,456)**	(4,027)	(609)	(43)	(4,679)
	(2,742)	**(644)**	**(21)**	**(3,407)**	(4,027)	(567)	(43)	(4,637)
Group's share of IAS 19 deficit of equity accounted investments	**(88)**	**–**	**–**	**(88)**	(128)	–	–	(128)

Amounts for the current and previous four years are as follows:

Defined benefit pension plans	**2010 £m**	2009 £m	2008 £m	2007 £m	2006 £m
Defined benefit obligations	**(21,158)**	(20,488)	(17,133)	(17,109)	(17,456)
Plan assets at bid value	**17,076**	14,915	12,978	15,110	14,289
Total deficit before tax and allocation to equity accounted investments and other participating employers	**(4,082)**	(5,573)	(4,155)	(1,999)	(3,167)
Actuarial gain/(loss) on plan liabilities	**55**	(3,342)	1,433	952	473
Actuarial gain/(loss) on plan assets at bid value	**1,043**	1,258	(3,724)	(156)	521

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £2.5bn (2009 £3.4bn).

Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments. In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote.

21. Retirement benefit obligations *continued*

Assets of defined benefit pension plans

	2010							
	UK			**US**			**Total**	
	£m	**%**	**Expected return %**	**£m**	**%**	**Expected return %**	**£m**	**%**
Equities	**8,544**	**59**	**8.25**	**1,690**	**68**	**9.0**	**10,234**	**60**
Bonds	**4,765**	**33**	**4.7**	**613**	**25**	**6.0**	**5,378**	**31**
Property[1]	**1,084**	**7**	**6.0**	**108**	**4**	**7.0**	**1,192**	**7**
Other	**187**	**1**	**1.0**	**85**	**3**	**4.0**	**272**	**2**
Total	**14,580**	**100**	**6.8**	**2,496**	**100**	**8.0**	**17,076**	**100**

	2009							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,195	64	8.25	1,384	65	9.25	9,579	64
Bonds	3,411	27	4.8	551	26	6.0	3,962	27
Property[1]	960	7	6.0	101	5	7.0	1,061	7
Other	214	2	1.0	99	4	4.0	313	2
Total	12,780	100	7.0	2,135	100	8.1	14,915	100

1 Includes £181m (2009 £168m) of properties occupied by Group companies.

When setting the overall expected rate of return on plan assets, historical markets are studied, and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

Changes in the fair value of plan assets are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Value of plan assets at 1 January 2009	11,159	1,819	92	13,070
Expected return on assets	765	141	6	912
Actuarial gain	994	264	13	1,271
Actual return on assets	1,759	405	19	2,183
Contributions by employer	421	216	13	650
Contributions by employer in respect of employee salary sacrifice arrangements	107	–	–	107
Total contributions by employer	528	216	13	757
Members' contributions (including Department for Work and Pensions rebates)	36	18	–	54
Currency loss	–	(198)	(10)	(208)
Benefits paid	(702)	(125)	(6)	(833)
Value of plan assets at 31 December 2009	12,780	2,135	108	15,023
Expected return on assets	883	180	8	1,071
Actuarial gain	917	126	8	1,051
Actual return on assets	1,800	306	16	2,122
Contributions by employer	653	113	8	774
Contributions by employer in respect of employee salary sacrifice arrangements	108	–	–	108
Total contributions by employer	761	113	8	882
Members' contributions (including Department for Work and Pensions rebates)	37	16	–	53
Currency gain	–	65	3	68
Benefits paid	(798)	(139)	(8)	(945)
Value of plan assets at 31 December 2010	**14,580**	**2,496**	**127**	**17,203**

21. Retirement benefit obligations *continued*

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Defined benefit obligations at 1 January 2009	(14,231)	(2,902)	(153)	(17,286)
Current service cost	(92)	(70)	(3)	(165)
Contributions by employer in respect of employee salary sacrifice arrangements	(107)	–	–	(107)
Total current service cost	(199)	(70)	(3)	(272)
Members' contributions (including Department for Work and Pensions rebates)	(36)	(18)	–	(54)
Past service cost	(18)	(3)	–	(21)
Actuarial loss on liabilities	(3,120)	(222)	(8)	(3,350)
Curtailment gains	–	261	–	261
Interest expense	(884)	(167)	(9)	(1,060)
Currency gain	–	294	16	310
Benefits paid	702	125	6	833
Defined benefit obligations at 31 December 2009	(17,786)	(2,702)	(151)	(20,639)
Current service cost	(159)	(53)	(2)	(214)
Contributions by employer in respect of employee salary sacrifice arrangements	(108)	–	–	(108)
Total current service cost	(267)	(53)	(2)	(322)
Members' contributions (including Department for Work and Pensions rebates)	(37)	(16)	–	(53)
Past service cost	(39)	–	–	(39)
Actuarial gain/(loss) on liabilities	314	(259)	6	61
Curtailment gains	–	2	5	7
Interest expense	(1,001)	(165)	(8)	(1,174)
Currency loss	–	(86)	(6)	(92)
Benefits paid	798	139	8	945
Defined benefit obligations at 31 December 2010	**(18,018)**	**(3,140)**	**(148)**	**(21,306)**

Contributions

The Group contributions made to the defined benefit plans in the year ended 31 December 2010 were £695m (2009 £546m) excluding those amounts allocated to equity accounted investments and participating employers (£71m). This includes contributions of £157m into the UK schemes relating to the £500m share buyback programme completed in July 2010 and £51m into the 2000 Plan following the triennial actuarial valuation of that scheme. In 2011, the Group expects to make regular contributions at a similar level to those made in 2010.

The Group incurred a charge in respect of the cash contributions of £110m (2009 £127m) paid to defined contribution plans for employees. It expects to make contributions of £108m to these plans in 2011.

21. Retirement benefit obligations *continued*

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2010				2009			
	UK defined benefit pension plans £m	**US and other pension plans £m**	**US healthcare plans £m**	**Total £m**	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Included in operating costs:								
Current service cost	**(130)**	**(53)**	**(2)**	**(185)**	(80)	(70)	(3)	(153)
Past service cost	**(29)**	**–**	**–**	**(29)**	(14)	(3)	–	(17)
	(159)	**(53)**	**(2)**	**(214)**	(94)	(73)	(3)	(170)
Included in other income:								
Pension curtailment gains	**–**	**2**	**–**	**2**	–	261	–	261
US healthcare curtailment gains	**–**	**–**	**5**	**5**	–	–	–	–
	–	**2**	**5**	**7**	–	261	–	261
Included in finance costs:								
Expected return on plan assets	**728**	**180**	**8**	**916**	630	141	6	777
Interest on obligations	**(823)**	**(165)**	**(8)**	**(996)**	(724)	(167)	(9)	(900)
	(95)	**15**	**–**	**(80)**	(94)	(26)	(3)	(123)
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	**(8)**	**–**	**–**	**(8)**	(9)	–	–	(9)
Group's share of equity accounted investments' finance costs	**(3)**	**–**	**–**	**(3)**	(3)	–	–	(3)

A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	One percentage point increase £m	One percentage point decrease £m
(Increase)/decrease in the aggregate of service cost and interest cost	(0.2)	0.1
(Increase)/decrease in defined benefit obligations	(2.4)	1.7

A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect:

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Decrease/(increase) in defined benefit obligations	1.7	(1.7)

22. Provisions

	Aircraft financing £m	Warranties and after-sales service £m	Reorganisations – continuing operations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	20	99	21	169	68	377
Current	18	64	126	263	81	552
At 1 January 2010	38	163	147	432	149	929
Created	5	69	204	164	21	463
Released	(5)	(24)	(16)	(55)	(33)	(133)
Utilised	(20)	(34)	(104)	(47)	(31)	(236)
Provisions and fair values arising on acquisitions (note 29)	–	–	–	4	12	16
Discounting	2	–	–	16	3	21
Exchange adjustments	–	7	–	7	3	17
At 31 December 2010	**20**	**181**	**231**	**521**	**124**	**1,077**
Represented by:						
Non-current	–	107	7	242	69	425
Current	20	74	224	279	55	652
	20	**181**	**231**	**521**	**124**	**1,077**

22. Provisions *continued*

Aircraft financing
The provision includes probable exposures under residual value guarantees issued by the Group on previous sales transactions. The Group has provided residual value guarantees in respect of certain commercial aircraft sold. At 31 December 2010, the Group's gross exposure to make future payments in respect of these arrangements was £33m (2009 £48m). The Group's net exposure to these guarantees is covered by the provisions held of £18m (2009 £32m) and the residual values of the related aircraft of £18m (2009 £12m).

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. Such costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum but not the timing of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels.

Reorganisations – continuing operations
The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Such costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

The reorganisation provisions totalling £204m created in 2010 include £60m for which the Group is contractually entitled to reimbursement from the customer. This amount is included in prepayments and accrued income at 31 December 2010 (see note 16).

Legal, contractual and environmental provisions
The Group holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period.

These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

There are no individually significant amounts included in the legal, contractual and environmental provisions created in 2010 totalling £164m.

Other provisions
There are no individually significant provisions included within other provisions.

23. Contingent liabilities and commitments

Guarantees and performance bonds
The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business. Provision is made for any amounts that the directors consider may become payable under such arrangements.

Operating lease commitments – where the Group is the lessee
The Group leases various offices, factories, shipyards and aircraft under non-cancellable operating lease agreements. The leases have varying terms including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2010 £m	2009 £m
Payments due:		
Not later than one year	**222**	180
Later than one year and not later than five years	**608**	571
Later than five years	**670**	704
	1,500	1,455
Total of future minimum sublease income under non-cancellable subleases	**254**	286

Capital commitments
Capital expenditure contracted for but not provided for in the accounts is as follows:

	2010 £m	2009 £m
Property, plant and equipment	**103**	126
Intangible assets	**4**	7
	107	133

24. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2009	3,582	90	1	1	90
Exercise of options	3	–	–	–	–
At 1 January 2010	3,585	90	1	1	90
Exercise of options	2	–	–	–	–
At 31 December 2010	**3,587**	**90**	**1**	**1**	**90**

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Treasury shares

During the year, 143,951,447 ordinary shares of 2.5p each were repurchased under the buyback programme completed in July 2010.

As at 31 December 2010, 178,377,628 (2009 43,952,360) ordinary shares of 2.5p each with an aggregate nominal value of £4,459,441 (2009 £1,098,809) were held in treasury. During 2010, 9,526,179 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Share Matching Plan (2009 11,086,593 to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme).

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and November 2010.

At 31 December 2010, the ESOP held 2,202,800 (2009 3,644,598) ordinary shares of 2.5p each with a market value of £7m (2009 £13m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2010 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and November 2010 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

Capital

The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2010, the Group's capital was £5,356m (2009 £4,550m), which comprises total equity of £5,403m (2009 £4,663m), less amounts accumulated in equity relating to cash flow hedges of £47m (2009 £113m). Net debt (as defined by the Group) was £242m (2009 net cash £403m).

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. The Group's policy is to maintain an investment grade credit rating. The Group's dividend policy is to grow the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

24. Share capital and other reserves *continued*

Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Total £m
At 1 January 2010 (restated[1])	4,589	202	10	485	113	5,399
Currency translation on foreign currency net investments:						
Subsidiaries	–	–	–	160	–	160
Equity accounted investments	–	–	–	(6)	–	(6)
Amounts charged to hedging reserve	–	–	–	–	(84)	(84)
Recycling of cumulative currency translation reserve on disposal	–	–	–	(17)	–	(17)
Recycling of cumulative net hedging reserve on disposal	–	–	–	–	(4)	(4)
Current tax on items taken directly to equity	–	–	–	–	(2)	(2)
Deferred tax on items taken directly to equity	–	–	–	–	24	24
At 31 December 2010	**4,589**	**202**	**10**	**622**	**47**	**5,470**

1 Revaluation reserve reduced by £64m following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).

Merger reserve

The merger reserve arose on the acquisition of the Marconi Electronic Systems (MES) business by British Aerospace in 1999 to form BAE Systems, and represents the amount by which the fair value of the shares issued by British Aerospace as consideration exceeded their nominal value.

Statutory reserve

Under Section 4 of the British Aerospace Act 1980 the statutory reserve may only be applied in paying up unissued shares of the Group to be allotted to members of the Group as fully paid bonus shares.

Revaluation reserve

The revaluation reserve relates to the revaluation at fair value of the net assets previously held as an equity accounted investment relating to the BVT joint venture on the acquisition of the remaining 45% interest in 2009.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

25. Share-based payments

Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 96 to 119.

Executive Share Option Scheme (ExSOS)
Equity-settled options

	2010		2009	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**18,230**	**3.48**	23,731	3.49
Exercised during the year	**(3,242)**	**2.26**	(1,931)	2.40
Expired during the year	**(2,381)**	**4.13**	(3,570)	4.14
Outstanding at the end of the year	**12,607**	**3.67**	18,230	3.48
Exercisable at the end of the year	**12,607**	**3.67**	13,506	3.09

Cash-settled share appreciation rights

	2010		2009	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**10,088**	**2.62**	12,667	2.65
Exercised during the year	**(1,531)**	**2.25**	(1,420)	2.15
Expired during the year	**(2,700)**	**3.74**	(1,159)	3.54
Outstanding at the end of the year	**5,857**	**2.20**	10,088	2.62
Exercisable at the end of the year	**5,857**	**2.20**	10,088	2.62

	2010		2009	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	**1.72 – 4.79**	**1.72 –3.56**	1.72 – 4.79	1.72 – 3.98
Weighted average remaining contracted life (years)	**5**	**3**	6	3
Expense/(credit) recognised for the year (£m)	**2**	**(2)**	2	(2)

Performance Share Plan (PSP)
Equity-settled options

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	**26,195**	20,880
Granted during the year	**11,167**	12,701
Exercised during the year	**(3,123)**	(4,445)
Expired during the year	**(5,962)**	(2,941)
Outstanding at the end of the year	**28,277**	26,195
Exercisable at the end of the year	**1,029**	2,212

Cash-settled share appreciation rights

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	**817**	3,143
Exercised during the year	**(780)**	(2,291)
Expired during the year	**(12)**	(35)
Outstanding at the end of the year	**25**	817
Exercisable at the end of the year	**25**	–

	2010		2009	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Weighted average remaining contracted life (years)	**5**	**1**	5	2
Weighted average fair value of options granted (£)	**3.00**	**–**	2.81	–
Expense recognised for the year (£m)	**14**	**–**	8	1

The exercise price for the PSP is £nil (2009 £nil).

25. Share-based payments *continued*

Restricted Share Plan (RSP)
All awards are equity-settled.

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	**–**	216
Exercised during the year	**–**	(216)
Outstanding at the end of the year	**–**	–

	2010	2009
Expense recognised for the year (£m)	**–**	–

The exercise price for the RSP is £nil (2009 £nil).

Share Matching Plan (SMP)
All awards are equity-settled.

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	**8,680**	1,811
Granted during the year	**5,881**	7,661
Exercised during the year	**(307)**	(94)
Expired during the year	**(1,229)**	(698)
Outstanding at the end of the year	**13,025**	8,680
Exercisable at the end of the year	**–**	–

	2010	2009
Weighted average remaining contracted life (years)	**2**	2
Weighted average fair value of options granted (£)	**3.80**	3.43
Expense recognised for the year (£m)	**2**	3

The exercise price for the SMP is £nil (2009 £nil).

Save-As-You-Earn (SAYE)
Equity-settled options

	2010		2009	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**4**	**1.56**	4,636	1.56
Exercised during the year	**(4)**	**1.56**	(4,550)	1.56
Expired during the year	**–**	**–**	(82)	1.54
Outstanding at the end of the year	**–**	**–**	4	1.56
Exercisable at the end of the year	**–**	**–**	4	1.56

25. Share-based payments *continued*

Cash-settled share appreciation rights

	2010		2009	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**–**	**–**	2,895	3.56
Exercised during the year	**–**	**–**	(349)	3.56
Expired during the year	**–**	**–**	(2,546)	3.56
Outstanding at the end of the year	**–**	**–**	–	–

	2010		2009	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	**–**	**–**	1.56	–
Credit recognised for the year (£m)	**–**	**–**	–	(1)

Details of options granted in the year

The fair value of both equity-settled awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

PSP – Monte Carlo
SMP – Dividend valuation model

	2010	2009
Range of share price at date of grant (£)	**3.23 – 3.80**	3.23 – 3.43
Exercise price (£)	**–**	–
Expected option life (years)	**3 – 4**	3 – 4
Volatility	**33 – 34%**	34%
Spot dividend yield	**–**	4.2 – 4.6%
Risk free interest rate	**1.0 – 1.8%**	1.7 – 1.8%

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £3.42 (2009 £3.44).

The liability in respect of the cash-settled elements of the schemes shown above and reported within liability provisions at 31 December 2010 is £5m (2009 £12m).

The intrinsic value of cash-settled options that have vested at 31 December 2010 is £6m (2009 £10m).

Share Incentive Plan

The Group also incurred a charge of £29m (2009 £31m) in respect of the all-employee free shares element of the Share Incentive Plan.

26. Reconciliation of operating business cash flow

	2010 £m	2009 £m
Cash inflow from operating activities	**1,535**	2,232
Assets contributed to Trust	**(25)**	(225)
Purchases of property, plant and equipment, and investment property	**(408)**	(483)
Purchases of intangible assets	**(19)**	(42)
Proceeds from sale of property, plant and equipment	**68**	36
Proceeds from sale of investment property	**2**	–
Equity accounted investment funding	**(7)**	–
Dividends received from equity accounted investments	**71**	77
Cash held for charitable contribution to Tanzania	**(30)**	–
Operating business cash flow	**1,187**	1,595
Electronics, Intelligence & Support	**568**	380
Land & Armaments	**858**	480
Programmes & Support	**227**	285
International	**195**	813
HQ & Other Businesses	**(665)**	(366)
Discontinued operations	**4**	3
Operating business cash flow	**1,187**	1,595

27. Net (debt)/cash (as defined by the Group)

	2010 £m	2009 £m
Debt-related derivative financial instrument assets – current	**17**	12
Debt-related derivative financial instrument assets – non-current	**28**	27
Other investments – current	**260**	211
Cash and cash equivalents	**2,813**	3,693
	3,118	3,943
Loans – non-current	**(2,133)**	(2,840)
Loans – current	**(909)**	(438)
Overdrafts – current	**(11)**	(15)
Loans and overdrafts – current	**(920)**	(453)
Less: Cash received on customers' account[1]	**(16)**	(20)
Less: Assets held in Trust	**(261)**	(227)
Less: Cash held for charitable contribution to Tanzania	**(30)**	–
	(3,360)	(3,540)
Net (debt)/cash (as defined by the Group)	**(242)**	403

Movement in net (debt)/cash (as defined by the Group)

	2010 £m	2009 £m
Operating business cash flow	**1,187**	1,595
Interest	**(173)**	(186)
Taxation	**(352)**	(350)
Free cash inflow	**662**	1,059
Acquisitions and disposals	**(88)**	(253)
Debt acquired on acquisition of subsidiary undertakings	**–**	(1)
Proceeds from issue of share capital	**6**	5
Equity dividends paid	**(574)**	(534)
Dividends paid to non-controlling interests	**(32)**	(5)
Purchase of own shares, including treasury shares	**(526)**	(25)
Cash (outflow)/inflow from matured derivative financial instruments	**(123)**	36
Cash inflow/(outflow) from movement in cash collateral	**11**	(11)
Movement in cash received on customers' account[1]	**7**	(12)
Foreign exchange translation	**(20)**	262
Other non-cash movements	**32**	(157)
Movement in net (debt)/cash (as defined by the Group)	**(645)**	364
Opening net cash (as defined by the Group)	**403**	39
Closing net (debt)/cash (as defined by the Group)	**(242)**	403

1 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance. It is included within trade and other payables.

27. Net (debt)/cash (as defined by the Group) *continued*

Cash flows in relation to acquisitions and disposals

	Cash (consideration)/ proceeds £m	Cash and cash equivalents acquired £m	Total £m
Subsidiaries			
Atlantic Marine	(245)	18	(227)
Tenix Defence	65	–	65
OASYS	(15)	1	(14)
Other	(3)	–	(3)
Purchase of subsidiary undertakings	**(198)**	**19**	**(179)**
Equity accounted investments			
Other	(2)	–	(2)
Purchase of equity accounted investments	**(2)**	**–**	**(2)**
Other	1	–	1
Proceeds from sale of equity accounted investments – continuing operations	**1**	**–**	**1**
Saab	92	–	92
Proceeds from sale of equity accounted investments – discontinued operations	**92**	**–**	**92**
Total cash flows in relation to acquisitions and disposals	**(107)**	**19**	**(88)**

28. Dividends

Equity dividends	**2010 £m**	2009 £m
Prior year final 9.6p dividend per ordinary share paid in the year (2009 8.7p)	**335**	307
Interim 7.0p dividend per ordinary share paid in the year (2009 6.4p)	**239**	227
	574	534

After the balance sheet date, the directors proposed a final dividend of 10.5p (2009 9.6p). The dividend, which is subject to shareholder approval, will be paid on 1 June 2011 to shareholders registered on 26 April 2011. The ex-dividend date is 20 April 2011.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 10 May 2011.

29. Acquisition of subsidiaries

Acquisition of subsidiaries for the year ended 31 December 2010

In 2010, the Group acquired Atlantic Marine Holding Company (Atlantic Marine) and OASYS Technology, LLC (OASYS). If the acquisitions had occurred on 1 January 2010, combined sales of Group and equity accounted investments would have been £22.5bn, revenue £21.2bn and profit £1,022m from continuing operations for the year ended 31 December 2010.

For all acquisitions made in the year, fair values remain provisional, but will be finalised within 12 months of acquisition.

					Consolidated results for the period from acquisition to 31 December 2010	
Acquisition	Acquisition date	Percentage share	Total consideration £m	Goodwill £m	Revenue £m	Profit after tax £m
Atlantic Marine	13 July 2010	100%	245	133	74	3
OASYS	19 October 2010	100%	33	28	7	1
			278	161	81	4

29. Acquisition of subsidiaries *continued*

Atlantic Marine
On 13 July 2010, the Group completed the acquisition of Atlantic Marine, a naval services and marine fabrication business, for $372m (headline price of $352m, plus purchase price adjustments of $20m) (£245m). The business employs approximately 1,500 people at Mayport and Jacksonville, Florida, Moss Point, Mississippi, and Mobile, Alabama.

The acquisition complements BAE Systems' existing ship repair and upgrade capabilities serving the US Navy. The Group anticipates continued strong demand for naval support capabilities in the US and the acquisition is consistent with BAE Systems' strategy to address anticipated growth in Services activity in its home markets. Atlantic Marine operates two facilities in Jacksonville and Mobile, both of which are situated in deep water ports along some of the busiest trade routes in the US. Additionally, Atlantic Marine operates a facility located on the Mayport Naval Station near Jacksonville, the second largest homeport of US Navy surface combatants on the East and Gulf Coasts, and proposed as the new homeport for an aircraft carrier in the 2010 Quadrennial Defense Review. These opportunities do not translate into separately identifiable intangible assets, but represent much of the assessed value within Atlantic Marine supporting the recognised goodwill.

The goodwill is not expected to be deductible for tax purposes.

The Atlantic Marine acquisition had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	1	–	36	37
Property, plant and equipment	94	(1)	20	113
Inventories	–	1	–	1
Receivables	15	(1)	–	14
Deferred tax assets	1	–	–	1
Payables	(13)	(1)	(1)	(15)
Deferred tax liabilities	(23)	–	(18)	(41)
Provisions	(14)	–	(2)	(16)
Cash and cash equivalents	18	–	–	18
Net assets/(liabilities) acquired	**79**	**(2)**	**35**	**112**
Goodwill				**133**
Consideration – cash				**245**

The Group incurred acquisition-related costs of £5m related to external legal fees and due diligence costs. These costs have been included in operating costs.

The intangible assets acquired as part of the acquisition of Atlantic Marine of £37m primarily relate to customer relationships.

Receivables include trade receivables with a fair value and gross contractual value of £13m, which are expected to be fully recoverable.

OASYS
On 19 October 2010, the Group completed the acquisition of OASYS, a US manufacturer of electro-optical systems and sub-assemblies based in Manchester, New Hampshire, for cash consideration of $24m (£15m) and a potential earn-out of up to $29m (£18m). The fair value of the contingent consideration at the acquisition date is $29m (£18m). Payment of the contingent consideration is dependent on the business achieving certain revenue targets for 2010 and 2011.

The net assets and goodwill included in the consolidated balance sheet as a result of this acquisition are £5m and £28m, respectively.

The acquisition of OASYS complements the existing Electronic Solutions business in the US and enhances the Group's product offerings in growing electro-optical markets. These opportunities do not translate to separately identifiable intangible assets, but represent much of the assessed value within OASYS supporting the recognised goodwill.

Adjustments to goodwill in respect of prior year acquisitions
Tenix Defence Holdings Pty Limited (Tenix Defence)
Outstanding issues concerning the acquisition of the Tenix Defence business in 2008, including the completion accounting process, have been resolved successfully with agreement of contingent payments totalling A$127.5m (£74m, net of legal fees) from the former owners of the business. In September 2010, the Group received a payment of A$112.5m (£65m, net of legal fees) with the remainder due in 2011. These payments reduce purchase consideration and, therefore, the amount of goodwill arising on consolidation is reduced by £64m (£74m, less £10m deferred tax) from £323m to £259m.

29. Acquisition of subsidiaries *continued*

Acquisition of subsidiaries for the year ended 31 December 2009

The most significant acquisition made by the Group during the year ended 31 December 2009 was of the 45% shareholding in BVT Surface Fleet Limited (BVT) held by VT Group plc (VT). If the acquisition had occurred on 1 January 2009, combined sales of Group and equity accounted investments, revenue and loss for the year ended 31 December 2009 from continuing operations would have been £22.4bn, £21.3bn and £74m, respectively.

BVT (now BAE Systems Surface Ships)

On 30 October 2009, the BVT joint venture became a wholly-owned subsidiary of the Group after VT Group plc exercised its option to sell its 45% shareholding in BVT to BAE Systems. Consideration paid including transaction costs for the remaining 45% interest was £348m. The now wholly-owned company has been renamed BAE Systems Surface Ships Limited (Surface Ships). The Group previously held a 55% interest in BVT, and accounted for its share of the results and net assets of BVT in accordance with IAS 31, *Interests in Joint Ventures*.

Total goodwill arising amounted to £584m, which comprised £225m on the initial formation of the BVT joint venture in the year ended 31 December 2008 and £359m arising on the acquisition of the 45% interest.

A final update of the fair values arising on acquisition has been undertaken, with the main adjustment being for additional losses identified on the export ship contracts amounting to £163m. The losses have arisen due to circumstances in existence prior to 1 July 2008, but those losses have only been identified in the current year. Goodwill has increased by £53m to £637m primarily reflecting 45% of the post-tax losses. In accordance with IFRS 3 (2004), the portion of these losses relating to the Group's original 55% interest in the joint venture has been reflected in the revaluation reserve (£64m), leaving a cumulative credit on that reserve of £10m. Comparatives for the year ended 31 December 2009 have been restated accordingly.

In the period from acquisition to 31 December 2009, Surface Ships contributed revenue and profit after tax of £338m and £34m, respectively, to the Group's consolidated results as a wholly-owned subsidiary.

The acquisition of BVT has had the following effect on the Group's assets and liabilities. The figures in the table below represent a 100% interest in BVT.

			Restated	
	Book value (30 October 2009) £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	–	–	225	225
Property, plant and equipment	136	–	–	136
Inventories	61	–	–	61
Receivables	225	–	–	225
Deferred tax assets	2	–	22	24
Payables	(433)	–	(327)	(760)
Current tax (liabilities)/assets	(16)	–	27	11
Deferred tax liabilities	(6)	–	(63)	(69)
Provisions	(12)	–	–	(12)
Cash and cash equivalents	33	–	–	33
Net liabilities acquired	**(10)**	**–**	**(116)**	**(126)**
Goodwill				**637**
Fair value of net liabilities acquired and goodwill arising				**511**

Components of cost of acquisitions:	
Fair value of consideration for initial 55% shareholding in 2008	189
Fair value of consideration for remaining 45% shareholding in 2009	348
Total cost of acquisition	**537**
Losses under equity method of initial 55% shareholding	(36)
Gain on revaluation of step acquisition	10
Fair value of net liabilities acquired and goodwill arising	**511**

Consideration satisfied by:	
Cash paid on acquisition of remaining 45% shareholding in 2009	346
Directly attributable costs:	
Paid	2
Cash consideration	348
Fair value of net assets contributed to BVT joint venture for initial 55% shareholding in 2008	178
Directly attributable costs:	
Paid	11
Total cost of acquisition	**537**

29. Acquisition of subsidiaries *continued*

The intangible assets acquired as part of the acquisition of BVT of £225m represented order backlog.

Advanced Ceramics Research
The Group acquired Advanced Ceramics Research, Inc. in the US on 8 June 2009 for a consideration of $14m (£9m). The net assets and goodwill included in the Group's consolidated balance sheet as a result of this acquisition were £1m and £8m, respectively.

30. Financial risk management

A discussion of the Group's treasury objectives and policies, and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net (debt)/cash (note 27) together with other financial assets and other financial liabilities (note 17), and other instruments deemed to be financial instruments under IAS 32, *Financial Instruments: Presentation*, including non-current receivables, non-current payables and non-current provisions.

Hedging instruments
The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

	31 December 2010				31 December 2009			
Foreign exchange contracts	**Not exceeding one year £m**	**Between one year and five years £m**	**More than five years £m**	**Total £m**	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Net forward (sales)/purchase contracts								
US dollar	**(887)**	**5**	**15**	**(867)**	(614)	202	53	(359)
Euro	**1,851**	**495**	**8**	**2,354**	1,882	392	17	2,291
Other	**249**	**65**	**–**	**314**	44	71	–	115
	1,213	**565**	**23**	**1,801**	1,312	665	70	2,047

	31 December 2010				31 December 2009			
Interest rate contracts	**Not exceeding one year £m**	**Between one year and five years £m**	**More than five years £m**	**Total £m**	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Interest rate swap contracts								
US dollar	**512**	**639**	**–**	**1,151**	310	1,115	–	1,425
Sterling	**31**	**84**	**–**	**115**	31	115	–	146
	543	**723**	**–**	**1,266**	341	1,230	–	1,571

	31 December 2010				31 December 2009			
Cross-currency swap contracts	**Not exceeding one year £m**	**Between one year and five years £m**	**More than five years £m**	**Total £m**	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Net forward purchase contracts								
US dollar	**51**	**945**	**320**	**1,316**	51	965	310	1,326
	51	**945**	**320**	**1,316**	51	965	310	1,326

Fair value of financial instruments
The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

– the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;

– the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates; and

– the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

30. Financial risk management *continued*

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date[1].

	Net carrying amount 2010 £m	**Estimated fair value 2010 £m**	Net carrying amount 2009 £m	Estimated fair value 2009 £m
Assets				
Non-current				
Other receivables[2]	**233**	**233**	159	159
Other financial assets	**110**	**110**	133	133
Current				
Available-for-sale investments	**260**	**260**	211	211
Other financial assets	**289**	**289**	216	216
Cash and cash equivalents	**2,813**	**2,813**	3,693	3,693
Liabilities				
Non-current				
Loans	**(2,133)**	**(2,598)**	(2,840)	(3,266)
Other financial liabilities	**(255)**	**(255)**	(261)	(261)
Current				
Loans and overdrafts	**(920)**	**(940)**	(453)	(454)
Other financial liabilities	**(109)**	**(109)**	(94)	(94)

1 The estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date.
2 Net carrying amount approximates to estimated fair value as there is no active market.

Fair value hierarchy

The fair value measurement hierarchy is as follows:

– Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;

– Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

– Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

The following table presents the Group's assets and liabilities that are measured at fair value.

	2010				2009			
	Level 1 £m	**Level 2 £m**	**Level 3 £m**	**Total £m**	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets								
Available-for-sale investments	**260**	**–**	**–**	**260**	211	–	–	211
Derivatives used for hedging	**126**	**23**	**–**	**149**	197	61	–	258
Financial assets at fair value through profit or loss	**183**	**22**	**–**	**205**	46	6	–	52
Debt-related derivative financial instruments	**–**	**45**	**–**	**45**	–	39	–	39
Total assets	**569**	**90**	**–**	**659**	454	106	–	560
Liabilities								
Loans	**–**	**(801)**	**–**	**(801)**	–	(1,118)	–	(1,118)
Derivatives used for hedging	**(112)**	**(33)**	**–**	**(145)**	(68)	(81)	–	(149)
Financial liabilities at fair value through profit or loss	**(42)**	**(177)**	**–**	**(219)**	(43)	(163)	–	(206)
Debt-related derivative financial instruments	**–**	**(5)**	**–**	**(5)**	–	(23)	–	(23)
Total liabilities	**(154)**	**(1,016)**	**–**	**(1,170)**	(111)	(1,385)	–	(1,496)

Level 1 includes foreign exchange hedges valued at unadjusted quoted prices at less than two years' maturity. Level 2 includes all other fair value items and foreign exchange hedges greater than two years' maturity.

Net financial liabilities of £8m measured at their 2010 balance sheet carrying value were transferred from Level 2 to Level 1 as a result of changes in maturity profile.

30. Financial risk management *continued*

Interest rate risk
Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	2011 £m	2012 £m	2013 £m	2014 £m	Beyond 2014 £m
Assets					
Current					
Cash and cash equivalents	2,813	–	–	–	–
Liabilities					
Non-current					
Loans	(737)	(737)	(711)	(639)	–
Current					
Loans and overdrafts	(311)	–	–	–	–

Collateral
As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2010 totalled £nil (2009 £11m).

Interest rate risk
The Group's objective is to mitigate its exposure to interest rate fluctuations on borrowings and deposits through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps.

The Group's current interest rate management policy is that a minimum of 50% (2009 50%) and a maximum of 75% (2009 75%) of gross debt is maintained at fixed interest rates. At 31 December 2010, the Group had 65% (2009 62%) of fixed rate debt and 35% (2009 38%) of floating rate debt based on a gross debt of £3.0bn, including debt-related derivative financial assets (2009 £3.3bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2010, the Group had a total of $1.5bn (2009 $1.9bn) of this type of swap outstanding with a weighted average duration of 4.6 years (2009 4.2 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 5.7 years (2009 6.4 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 3.3% (2009 3.4%), 2.7% on US dollars and 1.8% on sterling (2009 3.0% on US dollars and 2.3% on sterling). The cost of the fixed rate debt was 6.5% (2009 6.3%).

A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £12m (2009 £12m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £16m (2009 £17m).

Liquidity risk
Cash flow forecasting is performed by each line of business as part of the annual Integrated Business Planning process and as part of the monthly reporting cycle. The Group monitors a rolling forecast of liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities.

Surplus cash held by the operating groups over and above balances required for working capital management is loaned to the Group's centralised treasury department. Surplus cash is invested in interest bearing current accounts, term deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient headroom as determined by the line of business cash forecasts.

At 31 December 2010, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2009 £1.455bn). The RCF is contracted until 2015, and was undrawn throughout the year.

30. Financial risk management *continued*

Credit risk

The Group is exposed to credit risk on its cash and cash equivalents to the extent of non-performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. The Group has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2010 of £2,813m (2009 £3,693m) was invested with 24 (2009 26) financial institutions. The system assigns a maximum exposure based on the counterparty's size, a composite credit rating and credit default swap price. These limits are regularly monitored and updated.

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has reduced its exposure to credit risk through this process.

The Group has material receivables due from the UK and US governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 5% of the balance (2009 5%).

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

The Group's objective is to reduce its exposure to volatility in earnings and cash flows as a result of movements in foreign currency exchange rates. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.

The Group is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. To mitigate this risk, the Group's policy is to hedge all material firm transactional exposures, unless otherwise approved as an exception by the Treasury Review Management Committee, as well as to manage anticipated economic cash flows over the medium term. The Group aims, where possible, to apply hedge accounting treatment for all derivatives that hedge material transactional foreign currency exposures.

The Group is also exposed to movements in foreign currency exchange rates in respect of the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of overseas subsidiaries and equity accounted investments it regards as long-term investments. Hedges are, however, undertaken in respect of investments that are not considered long term or core to the Group.

31. Related party transactions

The Group has a related party relationship with its directors and key management (as disclosed in the Remuneration report on pages 96 to 119 and in note 7), its equity accounted investments (note 14) and the pension plans (note 21).

Transactions occur with the equity accounted investments in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party		Lease income/ (expense) with related party		Management recharges	
Related party	**2010 £m**	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Advanced Electronics Company Limited	**–**	–	**149**	–	**1**	–	**–**	–	**–**	–	**–**	–
BVT Surface Fleet Limited[1]	**–**	64	**–**	4	**–**	–	**–**	–	**–**	–	**–**	6
Eurofighter Jagdflugzeug GmbH	**1,313**	1,073	**–**	–	**283**	132	**143[3]**	159	**–**	–	**–**	–
FADEC International LLC	**49**	–	**–**	–	**–**	–	**–**	–	**–**	–	**–**	–
Gripen International KB	**1**	1	**1**	–	**11**	59	**67[3]**	98	**–**	–	**–**	–
MBDA SAS	**36**	46	**162**	302	**10**	4	**1,010[3]**	1,080	**–**	2	**14[3]**	18
Panavia Aircraft GmbH	**40**	52	**92**	103	**1**	9	**12**	15	**–**	–	**–**	–
Saab AB[2]	**3**	5	**20**	17	**–**	–	**–**	1	**–**	–	**–**	–
CTA International SAS	**–**	–	**–**	–	**–**	3	**–**	–	**–**	–	**–**	–
Other	**2**	–	**–**	–	**1**	–	**–**	–	**–**	–	**–**	–
	1,444	1,241	**424**	426	**307**	207	**1,232**	1,353	**–**	2	**14**	24

1 To date of acquisition (30 October 2009).
2 To date of sale of half of the Group's 20.5% shareholding (3 June 2010).
3 Also relates to disclosures under Financial Reporting Standard 8, *Related Party Disclosures*, for the parent company, BAE Systems plc.

32. Group entities

Principal subsidiary undertakings	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
BAE Systems (Operations) Limited *(Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)*	Defence and commercial aerospace activities	100% Ordinary	UK	England and Wales
BAE Systems Information and Electronic Systems Integration Inc. *(Held via BAE Systems, Inc.)*	Designs, develops and manufactures electronic systems and subsystems	100% Common	US	US
BAE Systems Land & Armaments LP *1300 North 17th Street, Suite 1400, Arlington VA 22209, USA* *(Partners: BAE Systems Land & Armaments Inc. and BAE Systems Land & Armaments Holdings Inc.)*	Manufactures and supports military vehicles	100%	US	US
BAE Systems Tactical Vehicle Systems LP *5000 Interstate 10 West, Sealy, TX 77474, USA* *(Partners: BAE Systems TVS Holdings LLC and BAE Systems TVS Inc.)*	Mobility and protection systems	100%	US	US

The Group comprises a large number of subsidiary undertakings and it is not practical to include all of them in the above list. The list therefore only includes those subsidiary undertakings which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2010 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group consolidation.

33. Events after the balance sheet date

In January 2011, the Group entered into an agreement to acquire the 91.3% outstanding equity of Fairchild Imaging, Inc. for a cash consideration of $86m (£55m). The California-based business provides solid-state electronic imaging components, cameras, and systems for aerospace, industrial, medical and scientific imaging applications. The acquisition complements the Group's electro-optics and night vision capabilities. The acquisition is conditional, among other things, upon receiving regulatory approval.

In January 2011, the Group announced a recommended €217m (£186m) cash offer for Norkom Group plc, a provider of innovative counter-fraud and anti-money laundering solutions to the global financial services industry.

On 15 February 2011, the Group acquired 100% of L-1 Identity Solutions, Inc.'s Intelligence Services Group, a leading provider of security and counter threat capabilities to the US government, for a cash consideration of approximately $297m (£190m). The acquisition accounting exercise is yet to be undertaken.

Five-year summary

Income statement[1,2,3]	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Continuing operations					
Sales including Group's share of equity accounted investments					
Electronics, Intelligence & Support	**5,653**	5,637	4,459	3,916	4,007
Land & Armaments	**5,930**	6,738	6,407	3,538	2,115
Programmes & Support	**6,680**	6,298	4,638	5,327	4,615
International	**4,534**	3,828	2,926	3,009	3,102
HQ & Other Businesses	**278**	254	235	243	295
Intra-operating group sales	**(683)**	(765)	(529)	(673)	(695)
	22,392	21,990	18,136	15,360	13,439
Underlying EBITA[4]					
Electronics, Intelligence & Support	**668**	575	506	437	429
Land & Armaments	**604**	604	566	324	168
Programmes & Support	**529**	670	491	456	331
International	**478**	419	417	403	387
HQ & Other Businesses	**(65)**	(71)	(101)	(203)	(146)
	2,214	2,197	1,879	1,417	1,169
Profit on disposal of businesses	**1**	68	238	40	13
Pension curtailment gains	**2**	261	–	–	–
Regulatory penalties	**(18)**	(278)	–	–	–
Uplift on acquired inventories	**–**	–	–	(12)	–
EBITA[5]	**2,199**	2,248	2,117	1,445	1,182
Amortisation and impairment of intangible assets	**(517)**	(1,259)	(303)	(297)	(139)
Finance costs including share of equity accounted investments	**(194)**	(698)	701	93	(174)
Profit before taxation	**1,488**	291	2,515	1,241	869
Taxation expense including share of equity accounted investments	**(461)**	(352)	(636)	(366)	(243)
Profit/(loss) for the year – continuing operations	**1,027**	(61)	1,879	875	626
Profit/(loss) for the year – discontinued operations	**54**	16	(111)	47	1,013
Profit/(loss) for the year	**1,081**	(45)	1,768	922	1,639

Balance sheet	2010 £m	2009[6] £m	2008 £m	2007 £m	2006 £m
Intangible assets	**11,216**	11,306	12,306	9,559	7,595
Property, plant and equipment, and investment property	**2,848**	2,663	2,558	1,887	1,869
Non-current investments	**798**	852	1,040	787	678
Inventories	**644**	887	926	701	395
Assets held in Trust	**261**	227	–	–	–
Payables (excluding cash on customers' account) less receivables	**(6,159)**	(6,918)	(5,866)	(5,373)	(4,298)
Other financial assets and liabilities	**(10)**	(45)	240	52	6
Retirement benefit obligations	**(3,456)**	(4,679)	(3,365)	(1,629)	(2,499)
Provisions	**(1,077)**	(929)	(845)	(809)	(695)
Net tax	**580**	896	256	63	648
Net (debt)/cash (as defined by the Group)	**(242)**	403	39	700	435
Disposal groups held for sale	**–**	–	–	64	–
Non-controlling interests	**(71)**	(72)	(55)	(36)	(17)
Total equity attributable to equity holders of the parent	**5,332**	4,591	7,234	5,966	4,117

Movement in net (debt)/cash (as defined by the Group)	**2010 £m**	2009 £m	2008 £m	2007 £m	2006 £m
Cash inflow from operating activities	**1,535**	2,232	2,009	2,162	778
Net capital expenditure[7]	**(364)**	(489)	(503)	(262)	(141)
Dividends received from equity accounted investments	**71**	77	89	78	145
Assets contributed to Trust	**(25)**	(225)	–	–	–
Cash held for charitable contribution to Tanzania	**(30)**	–	–	–	–
Operating business cash flow	**1,187**	1,595	1,595	1,978	782
Acquisitions and disposals	**(88)**	(254)	(1,038)	(2,112)	1,330
Interest	**(173)**	(186)	(98)	(65)	(207)
Tax and dividends	**(958)**	(889)	(750)	(509)	(431)
(Purchase)/issue of equity shares	**(520)**	(20)	(27)	603	(71)
Preference share conversion	**–**	–	–	245	6
Exchange movements	**(20)**	262	(374)	36	323
Other movements[8]	**(80)**	(132)	5	57	(11)
Net (decrease)/increase in net funds	**(652)**	376	(687)	233	1,721
Movement in cash on customers' account	**7**	(12)	26	32	(9)
Movement in net (debt)/cash (as defined by the Group)	**(645)**	364	(661)	265	1,712
Opening net cash/(debt) (as defined by the Group)	**403**	39	700	435	(1,277)
Closing net (debt)/cash (as defined by the Group)	**(242)**	403	39	700	435

Other information	**2010**	2009	2008	2007	2006
Continuing operations					
Basic earnings/(loss) per share – total (pence)	**28.9**	(2.3)	52.7	25.2	19.3
Basic earnings per share – underlying[9] (pence)	**40.8**	40.1	36.8	29.4	22.9
Order book including the Group's share of equity accounted investments (£bn)	**39.7**	46.3	45.7	37.9	30.9
Including discontinued operations					
Dividend per ordinary share (pence)	**17.5**	16.0	14.5	12.8	11.3
Number of employees, excluding share of employees of equity accounted investments, at year end	**92,000**	98,000	94,000	88,000	79,000
Capital expenditure including leased assets (£m)	**437**	522	552	341	538

1 For the year ended 31 December 2006, Airbus SAS is presented as a discontinued operation.
2 For the year ended 31 December 2006, the operating group information has been restated to reflect changes made to the Group's organisational structure.
3 For the years ended 31 December 2006 to 2010, Saab AB is presented as a discontinued operation.
4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. From 2006 to 2008, non-recurring items are profit on disposal of businesses and uplift on acquired inventories. In 2009 and 2010, non-recurring items are profit on disposal of businesses, pension curtailment gains and regulatory penalties.
5 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
6 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).
7 Includes expenditure on property, plant and equipment, investment property, intangible assets and other investments, and equity accounted investment funding.
8 Other movements include cash flows from matured derivative financial instruments, cash collateral and other non-cash movements (see page 172).
9 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items. From 2006 to 2008, non-recurring items are profit on disposal of businesses and uplift on acquired inventories. In 2009 and 2010, non-recurring items are profit on disposal of businesses, pension curtailment gains and regulatory penalties.

2009 BAE SYSTEMS
ANNUAL FINANCIAL STATEMENTS

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF BAE SYSTEMS PLC

We have audited the financial statements of BAE Systems plc for the year ended 31 December 2009 which comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Group and Parent Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity and related notes. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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 auditors' 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 auditors
As explained more fully in the Directors' Responsibilities Statement set out on page 115, 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 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 (APB'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 APB's web-site at www.frc.org.uk/apb/scope/UKP

Opinion on financial statements
In our opinion:

– the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2009 and of the Group's loss for the year then ended;

– the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;

– the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and

– the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006
In our opinion:

– the part of the Directors' Remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and

– the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

– adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or

– the parent company financial statements and the part of the Directors' Remuneration report to be audited are not in agreement with the accounting records and returns; or

– certain disclosures of directors' remuneration specified by law are not made; or

– we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

– the directors' statement, set out on page 84, in relation to going concern; and

– the part of the Corporate Governance Statement on pages 83 to 84 in the Directors' report relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review.

A G Cates (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
London

17 February 2010

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Notes	2009 £m	Total 2009 £m	2008 £m	Total 2008 £m
Continuing operations					
Combined sales of Group and equity accounted investments	3		**22,415**		18,543
Less: share of sales of equity accounted investments	3		**(2,041)**		(1,872)
Revenue	3		**20,374**		16,671
Operating costs	4		**(20,060)**		(15,386)
Other income	5		**465**		415
Group operating profit excluding amortisation and impairment of intangible assets		**2,038**		2,003	
Amortisation	11	**(286)**		(247)	
Impairment	11	**(973)**		(56)	
Group operating profit			**779**		1,700
Share of results of equity accounted investments excluding finance costs and taxation expense		**233**		132	
Financial (expense)/income of equity accounted investments	6	**(7)**		44	
Taxation expense of equity accounted investments		**(23)**		(37)	
Share of results of equity accounted investments	14	**203**		139	
Goodwill impairment in respect of equity accounted investments	14	**–**		(121)	
Contribution from equity accounted investments			**203**		18
EBITA[1] excluding non-recurring items		**2,220**		1,897	
Profit on disposal of businesses[2]	9	**68**		238	
Pension curtailment gains[2]		**261**		–	
Regulatory penalties[3]		**(278)**		–	
EBITA[1]		**2,271**		2,135	
Amortisation		**(286)**		(247)	
Impairments		**(973)**		(177)	
Financial (expense)/income of equity accounted investments	6	**(7)**		44	
Taxation expense of equity accounted investments		**(23)**		(37)	
Operating profit	3		**982**		1,718
Finance costs	6				
Financial income		**1,573**		3,380	
Financial expense		**(2,273)**		(2,727)	
			(700)		653
Profit before taxation			**282**		2,371
Taxation expense	8				
UK taxation		**(105)**		(351)	
Overseas taxation		**(222)**		(252)	
			(327)		(603)
(Loss)/profit for the year			**(45)**		1,768
Attributable to:					
BAE Systems shareholders			**(67)**		1,745
Minority interests			**22**		23
			(45)		1,768
(Loss)/earnings per share	10				
Basic (loss)/earnings per share			**(1.9)p**		49.6p
Diluted (loss)/earnings per share			**(1.9)p**		49.5p

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
2 Included in other income.
3 Included in operating costs.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December

	Notes	**2009 £m**	2008 £m
(Loss)/profit for the year		**(45)**	1,768
Other comprehensive income			
Currency translation on foreign currency net investments:			
Subsidiaries		**(246)**	807
Equity accounted investments	14	**(56)**	197
Amounts (charged)/credited to hedging reserve		**(393)**	469
Gain on revaluation of step acquisition		**103**	–
Net actuarial losses on defined benefit pension schemes:			
Subsidiaries		**(2,008)**	(1,937)
Equity accounted investments		**(54)**	(60)
Fair value movements on available-for-sale investments		**2**	–
Recycling of cumulative currency translation on disposal		**–**	1
Current tax on items taken directly to equity	8	**64**	58
Deferred tax on items taken directly to equity:			
Subsidiaries	8	**562**	425
Equity accounted investments		**16**	17
Total other comprehensive income for the year (net of tax)		**(2,010)**	(23)
Total comprehensive income for the year		**(2,055)**	1,745
Attributable to:			
Equity shareholders		**(2,077)**	1,722
Minority interests		**22**	23
		(2,055)	1,745

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December

	Attributable to equity holders of the parent						
	Issued share capital £m	Share premium £m	Other reserves[1] £m	Retained earnings £m	Total £m	Minority interests £m	Total equity £m
At 1 January 2009	90	1,238	5,974	(68)	7,234	55	7,289
Total comprehensive income for the year	–	–	(511)	(1,566)	(2,077)	22	(2,055)
Share-based payments	–	–	–	52	52	–	52
Share options:							
Proceeds from shares issued	–	5	–	–	5	–	5
Purchase of own shares	–	–	–	(25)	(25)	–	(25)
Ordinary share dividends	–	–	–	(534)	(534)	(5)	(539)
At 31 December 2009	**90**	**1,243**	**5,463**	**(2,141)**	**4,655**	**72**	**4,727**
At 1 January 2008	90	1,222	4,631	23	5,966	36	6,002
Total comprehensive income for the year	–	–	1,343	379	1,722	23	1,745
Share-based payments	–	–	–	51	51	–	51
Share options:							
Proceeds from shares issued	–	16	–	–	16	–	16
Purchase of own shares	–	–	–	(43)	(43)	–	(43)
Other	–	–	–	–	–	7	7
Ordinary share dividends	–	–	–	(478)	(478)	(11)	(489)
At 31 December 2008	90	1,238	5,974	(68)	7,234	55	7,289

1 An analysis of other reserves is provided in note 24.

CONSOLIDATED BALANCE SHEET

as at 31 December

	Notes	2009 £m	2008 £m
Non-current assets			
Intangible assets	11	**11,253**	12,306
Property, plant and equipment	12	**2,552**	2,446
Investment property	13	**111**	112
Equity accounted investments	14	**846**	1,034
Other investments	15	**6**	6
Other receivables	16	**201**	162
Other financial assets	17	**133**	514
Deferred tax assets	8	**1,517**	1,026
		16,619	17,606
Current assets			
Inventories	18	**887**	926
Trade and other receivables including amounts due from customers for contract work	16	**3,764**	3,831
Current tax		**17**	14
Other investments	15	**211**	–
Other financial assets	17	**216**	674
Cash and cash equivalents		**3,693**	2,624
		8,788	8,069
Total assets	3	**25,407**	25,675
Non-current liabilities			
Loans	19	**(2,840)**	(2,608)
Trade and other payables	20	**(522)**	(701)
Retirement benefit obligations	21	**(4,679)**	(3,365)
Other financial liabilities	17	**(261)**	(383)
Deferred tax liabilities	8	**(8)**	(80)
Provisions	22	**(377)**	(459)
		(8,687)	(7,596)
Current liabilities			
Loans and overdrafts	19	**(453)**	(173)
Trade and other payables	20	**(10,218)**	(9,165)
Other financial liabilities	17	**(94)**	(362)
Current tax		**(676)**	(704)
Provisions	22	**(552)**	(386)
		(11,993)	(10,790)
Total liabilities	3	**(20,680)**	(18,386)
Net assets		**4,727**	7,289
Capital and reserves			
Issued share capital	24	**90**	90
Share premium		**1,243**	1,238
Other reserves	24	**5,463**	5,974
Accumulated losses		**(2,141)**	(68)
Total equity attributable to equity holders of the parent		**4,655**	7,234
Minority interests		**72**	55
Total equity		**4,727**	7,289

Approved by the Board on 17 February 2010 and signed on its behalf by:

I G King
Chief Executive

G W Rose
Group Finance Director

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December

	Notes	2009 £m	2008 £m
(Loss)/profit for the year		**(45)**	1,768
Taxation expense		**327**	603
Share of results of equity accounted investments	14	**(203)**	(139)
Net finance costs		**700**	(653)
Depreciation, amortisation and impairment		**1,600**	755
Gain on disposal of property, plant and equipment	4, 5	**(17)**	(33)
Gain on disposal of investment property	5	**–**	(5)
Gain on disposal of businesses	5	**(68)**	(238)
Cost of equity-settled employee share schemes		**52**	51
Movements in provisions		**52**	(115)
Decrease in liabilities for retirement benefit obligations		**(657)**	(272)
Decrease/(increase) in working capital:			
Inventories		**6**	46
Trade and other receivables		**52**	(5)
Trade and other payables		**433**	246
Cash inflow from operating activities		**2,232**	2,009
Interest paid		**(250)**	(249)
Interest element of finance lease rental payments		**(2)**	(5)
Taxation paid		**(350)**	(261)
Net cash inflow from operating activities		**1,630**	1,494
Dividends received from equity accounted investments	14	**77**	89
Interest received		**66**	156
Purchases of property, plant and equipment		**(483)**	(520)
Purchases of intangible assets		**(42)**	(32)
Proceeds from sale of property, plant and equipment		**36**	44
Proceeds from sale of investment property		**–**	5
Purchase of subsidiary undertakings	27, 29	**(357)**	(1,078)
Cash and cash equivalents acquired with subsidiary undertakings	27	**33**	2
Purchase of equity accounted investments	27	**(1)**	(12)
Proceeds from sale of subsidiary undertakings	9	**2**	131
Cash and cash equivalents disposed of with subsidiary undertakings		**–**	(60)
Proceeds from sale of equity accounted investments	9	**70**	16
Net proceeds from (purchase)/sale of other deposits/securities		**(209)**	164
Net cash outflow from investing activities		**(808)**	(1,095)
Capital element of finance lease rental payments		**(13)**	(18)
Proceeds from issue of share capital		**5**	16
Purchase of own shares		**(25)**	(43)
Equity dividends paid	28	**(534)**	(478)
Dividends paid to minority interests		**(5)**	(11)
Cash inflow/(outflow) from matured derivative financial instruments		**36**	(440)
Cash (outflow)/inflow from movement in cash collateral		**(11)**	106
Cash inflow from loans		**920**	–
Cash outflow from repayment of loans		**(133)**	(306)
Net cash inflow/(outflow) from financing activities		**240**	(1,174)
Net increase/(decrease) in cash and cash equivalents		**1,062**	(775)
Cash and cash equivalents at 1 January		**2,605**	3,046
Effect of foreign exchange rate changes on cash and cash equivalents		**11**	334
Cash and cash equivalents at 31 December		**3,678**	2,605
Comprising:			
Cash and cash equivalents		**3,693**	2,624
Overdrafts		**(15)**	(19)
Cash and cash equivalents at 31 December		**3,678**	2,605

NOTES TO THE GROUP ACCOUNTS

1. Accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

Basis of preparation
The consolidated financial statements of BAE Systems plc have been prepared on a going concern basis as discussed in the Directors' report on page 84 and in accordance with EU endorsed International Financial Reporting Standards (IFRS), International Financial Reporting Interpretations Committee interpretations (IFRICs) and the Companies Act 2006 applicable to companies reporting under IFRS.

The consolidated financial statements are presented in pounds sterling and, unless stated otherwise, rounded to the nearest million. They have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and other relevant financial assets and financial liabilities (including derivative instruments).

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates and judgements.

The directors consider the potential key areas of judgements required to be made in applying the Group's accounting policies. These relate to:

– the determination of the revenue recognition approach to apply to individual contracts;

– the classification of financial assets or liabilities;

– the classification of retirement benefit plans between defined benefit and defined contribution arrangements; and

– the classification of investments as subsidiaries, equity accounted investments or otherwise.

The directors do not consider that the practical application of the judgements is significantly uncertain or subjective in nature.

An analysis and explanation of the critical accounting estimates and judgements used in producing this set of financial statements is made in the Directors' report on page 37.

Basis of consolidation
The financial statements of the Group consolidate the results of the Company and its subsidiary entities, and include its share of its joint ventures' results accounted for under the equity method, all of which are prepared to 31 December.

Subsidiaries
A subsidiary is an entity controlled by the Group. Control is the power to govern the operating and financial policies of the entity so as to obtain benefits from its activities. Subsidiaries include the special purpose entities that the Group transacted through for the provision of guarantees in respect of residual values, and head lease and finance payments on certain regional aircraft sold. The results of such subsidiaries are included in the consolidated income statement from the date of acquisition, up to the date of disposal.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired, and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. Previously held identifiable assets, liabilities and contingent liabilities of the acquired entity are revalued to their fair value at the date of acquisition, being the date at which the Group achieves control of the acquiree. The movement in fair value is taken to the asset revaluation reserve.

Minority interests
Upon initial acquisition of a minority interest, the interest of minority shareholders is measured at the minority's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised.

Equity accounted investments
An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. Joint ventures are accounted for under the equity method where the Group's income statement includes its share of their profits and losses, and the Group's balance sheet includes its share of their net assets.

Intangible assets
Goodwill
Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill arising on acquisitions before the date of transition to IFRS (1 January 2004) has been retained at the previous UK GAAP amounts, as any amounts related to intangible assets that would have been recorded in the acquired entity if it had applied IAS 38, *Intangible Assets*, at the date it was acquired by the Group were considered immaterial, after being tested for impairment at that date. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

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

Group-funded expenditure on research activities is written off as incurred and charged to the income statement.

Group-funded expenditure on development activities applied to a plan or design for the production of new or substantially improved products and processes 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. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses. Capitalised development expenditure is amortised over the expected life of the product.

Where the research and development activity is performed for customers, the revenue arising is recognised in accordance with the Group's revenue recognition policy.

Other intangible assets
Acquired computer software licences for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software.

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Capitalised software development expenditure is stated at cost less accumulated amortisation and impairment losses. Group-funded expenditure associated with enhancing or maintaining computer software programmes for sale is recognised as an expense as incurred.

1. Accounting policies *continued*

Trademarks and licences have definite useful lives and are carried at cost less accumulated amortisation and impairment losses.

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing. The most significant intangible assets recognised by the Group on businesses acquired to date are in relation to programmes. 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.

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

The estimated useful lives are as follows:

Acquired computer software licences	2 to 5 years
Capitalised software development	2 to 5 years
Trademarks and licences	up to 20 years
Capitalised research and development expenditure	up to 10 years
Programme and customer related	up to 15 years
Other intangibles	up to 10 years

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

Buildings	up to 50 years, or the lease term if shorter
Research equipment	8 years
Computing equipment, motor vehicles and short-life works equipment	3 to 5 years
Aircraft	up to 15 years, or the lease term if shorter
Other equipment	10 to 15 years, or the project life if shorter

For certain items of plant and equipment in the Group's US businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

No depreciation is provided on freehold land and assets in the course of construction.

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date. Where applicable, useful lives reflect the component accounting principle.

Assets obtained under finance leases are included in property, plant and equipment and stated at an amount equal to the lower of the fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

Impairment
The carrying amounts of the Group's intangible assets, property, plant and equipment, and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, *Impairment of Assets*. If any such indication exists, the asset's recoverable amount is estimated. For goodwill and intangible assets that are not yet available for use, impairment testing is performed annually. All other assets are considered for impairment under the relevant standard.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

The carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill and is assessed for impairment as a single asset.

The recoverable amount of assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at appropriate pre-tax discount rates.

The recoverable amount of other assets is the greater of their fair value less cost 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 inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss in respect of assets, other than goodwill, carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

An impairment loss in respect of goodwill is not reversed.

An impairment loss in respect of other assets is reversed 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.

Investment property
Land and buildings that are leased to non-Group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and accumulated impairment losses.

Depreciation is provided, on a straight-line basis, to write off the cost of investment property over its estimated useful life of up to 50 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Other investments
The Group determines the classification of its other investments at initial recognition taking account of, where relevant, the purpose for which the investments were acquired. The Group classifies its other investments as follows:

(a) loans and receivables: term deposits, principally comprising funds held with banks and other financial institutions, are carried at amortised cost using the effective interest method;

(b) at fair value through profit or loss: financial instruments held for trading or designated by management on initial recognition. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date;

(c) held to maturity: non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity;

(d) available-for-sale: investments other than interests in joint ventures and associates and term deposits and not classified as (b) or (c) above. They are held at fair value.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

1. Accounting policies *continued*

Purchases and sales of investments are recognised at the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss.

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership.

Realised and unrealised gains and losses arising from changes in the fair value of the investments classified as at fair value through profit or loss are included in finance costs in the income statement in the period in which they arise. Unrealised gains or losses arising from changes in the fair value of investments classified as available-for-sale are recognised in equity. When investments classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities within finance costs.

The fair values of quoted investments are based on bid prices at the balance sheet date.

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 amortised cost less impairment losses. A provision for impairment is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

An impairment loss 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 include long-term contract balances less attributable progress payments.

Long-term contract balances are stated at cost, plus attributable profit, less provision for any anticipated losses. Appropriate provisions for any losses are made in the year in which they are first foreseen.

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.

Cash received on customers' account is excluded from net cash/(debt) as defined by the Group.

Derivative financial instruments and hedging activities
The global nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures as well as to manage anticipated economic cash flow exposures over the medium term. The Group also uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon. The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

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 directly in reserves. Amounts recognised in reserves are recycled from reserves into the cost of the underlying transaction and recognised in the income statement when the underlying transaction affects profit or loss. The ineffective portion of any change in the fair value of the instrument is recognised in the income statement immediately.

Fair value hedges
Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

Cash and cash equivalents
Cash and cash equivalents includes cash in hand, call deposits and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

Loans and overdrafts
Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost or fair value in respect of the hedged risk where hedge accounting has been adopted, with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Trade and other payables
Trade and other payables are stated at their cost.

Provisions
A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

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 all possible outcomes against their associated probabilities.

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. Future operating costs are not provided for.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

1. Accounting policies *continued*

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 work-in-progress for that portion of the work which has already been completed, and as liability provisions for the remainder. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Pension obligations
Group companies operate various pension plans. The Group has both defined benefit and defined contribution plans.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

For defined benefit retirement plans, 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. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of comprehensive income. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period until the benefits become vested. Curtailments due to the material reduction of the expected years of future services of current employees or the elimination of the accrual of defined benefits for some or all of the future services for a significant number of employees are recognised immediately as a gain or loss in the income statement.

The retirement benefit obligations recognised in the balance sheet represent the present value of the defined benefit obligations as adjusted for unrecognised past service cost and as reduced by the fair value of scheme assets.

Tax
Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided in full, using the balance sheet liability method, on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

Share-based payment compensation
The Group issues equity-settled and cash-settled share options to employees. In accordance with the requirements of IFRS 2, *Share-based Payment*, the Group has applied IFRS 2 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005 and all cash-settled options outstanding at the balance sheet date.

As explained in note 25, equity-settled share options are measured at fair value at the date of grant using an option pricing model. The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of the number of shares that will actually vest.

Cash-settled share options are measured at fair value at the balance sheet date using an option pricing model. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of the options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

Foreign currencies
Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the consolidated income statement unless they qualify for net investment hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

For consolidation purposes, the assets and liabilities of overseas subsidiary entities, joint ventures and associates are translated at the exchange rate ruling at the balance sheet date. Income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences, including exchange differences arising from the translation of borrowings and other financial instruments designated as hedges of such investments, are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Revenue and profit recognition
Sales include the Group's net share of sales of equity accounted investments. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of equity accounted investments.

Long-term contracts
The majority of the Group's long-term contract arrangements are accounted for under IAS 11, *Construction Contracts*. Sales are recognised when the Group has obtained the right to consideration in exchange for its performance. This is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

1. Accounting policies *continued*

Goods sold and services rendered
Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

Revenue from the sale of goods not under a long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

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

Lease income
Rental income from aircraft operating leases is recognised in revenue on a straight-line basis over the term of the relevant lease. Lease incentives granted are charged to the income statement over the term of the lease.

Leases
Assets obtained under finance leases are included in property, plant and equipment at cost and are depreciated over their useful lives, or the lease term, whichever is the shorter. Future instalments under such leases, net of financing costs, are included within loans. Rental payments are apportioned between the finance element, which is included in finance costs, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant charge on the outstanding obligation.

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

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and accumulated impairment losses. Rental income is recognised in revenue on a straight-line basis.

Assets leased out under finance leases cease to be recognised in the balance sheet after the inception of the lease. Instead, a finance lease receivable, representing the discounted future lease payments to be received from the lessee plus any discounted unguaranteed residual value, is recorded as a long-term financial asset. Interest income is recognised in the income statement as it accrues, taking into account the effective yield on the asset.

Underlying EBITA
Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. This definition is referred to as Underlying EBITA. In order to ensure that it continues to provide a measure of profitability that is comparable over time, it has been amended to exclude all non-recurring items. Underlying EBITA continues to be the measure of profit on which segmental performance is monitored by management. As such, it is disclosed in note 3 on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality, nature and function. The non-recurring items for the current and prior years are presented on the face of the Group's consolidated income statement.

Finance costs
Financial income comprises interest income on funds invested, gains on the disposal of available-for-sale financial assets, changes in the fair value of financial assets at fair value through profit or loss, and gains on hedging instruments that are recognised in profit or loss.

Financial costs comprise interest expense on borrowings, unwinding of the discounts on provisions, changes in the fair value of financial assets at fair value through profit or loss, and losses on hedging instruments that are recognised in profit or loss.

Borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) are capitalised as part of the cost of that asset, until such time as the assets are ready for their intended use or sale.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

No borrowing costs were capitalised in the year ended 31 December 2009.

Dividends
Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

2. Changes in accounting policies

With effect from 1 January 2008, the Group early adopted IFRS 8, *Operating segments*. The standard is concerned with disclosure only.

Standards, amendments and interpretations effective in 2009
With effect from 1 January 2009, the Group has adopted the following amendments to existing standards and interpretations:

- IAS 1 (revised 2007), *Presentation of Financial Statements,* requires that the Group presents a 'statement of comprehensive income' and a 'consolidated statement of changes in equity' as primary statements. The standard is concerned with disclosure only and has no impact on the reported results or financial position of the Group;
- IAS 23 (revised 2007), *Borrowing Costs,* requires borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) to be capitalised as part of the cost of that asset. There is no longer an option to immediately expense those borrowing costs. Whilst this represents a change in the Group's accounting policy, application of the revised standard is prospective i.e. applies to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. This has not had an impact on the reported results or financial position of the Group;
- Amendment to IFRS 7, *Financial Instruments: Disclosures,* requires enhanced disclosures about fair value measurement and liquidity risk. The amendment requires disclosure of fair value measurements by reference to a fair value measurement hierarchy. The amendment is concerned with disclosure only and has no impact on the reported results or financial position of the Group;
- Amendment to IFRS 2, *Share-based Payment: Vesting Conditions and Cancellations,* provides clarification on the vesting conditions which should be included in the grant date fair value for transactions with employees and others providing similar services. This has had no impact on the reported results or financial position of the Group; and
- *Improvements to IFRSs 2008*, the first standard issued under the International Accounting Standards Board's annual improvement process. It amends 20 existing standards, basis of conclusions and guidance. The improvements include changes in presentation, recognition and measurement requirements and have had no significant impact on the reported results or financial position of the Group.

In addition, the Group has reviewed the effect of the following amendments and interpretations endorsed during 2009 and effective for accounting periods beginning on or after 1 January 2009, and has concluded that they have no impact on the Group's accounts:

- Amendments to IAS 32, *Financial Instruments: Presentation,* and IAS 1, *Presentation of Financial Statements: Puttable Financial Instruments and Obligations Arising on Liquidation*;
- Amendments to IAS 39, *Financial Instruments: Recognition and Measurement,* and IFRS 7, *Financial Instruments: Disclosures: Reclassification of Financial Assets*;
- Amendments to IFRS 1, *First-time Adoption of IFRS*, and IAS 27, *Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*;
- Amendments to International Financial Reporting Interpretations Committee (IFRIC) 9, *Reassessment of Embedded Derivatives, and IAS 39, Financial Instruments: Recognition and Measurement: Embedded Derivatives*;
- IFRIC 12, *Service Concession Arrangements*;
- IFRIC 13, *Customer Loyalty Programmes*;
- IFRIC 14, IAS 19, *Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*;
- IFRIC 15, *Agreements for the Construction of Real Estate*; and
- IFRIC 16, *Hedges of a Net Investment in a Foreign Operation*.

Amendments to existing standards and interpretations that are not yet effective and have not been early adopted by the Group
The following EU endorsed amendments and interpretations to published standards are effective for accounting periods beginning on or after 1 July 2009, and have not been early adopted by the Group:

- IFRS 3 (revised 2008), *Business Combinations,* introduces some significant changes in the accounting treatment for acquisitions. The most significant change for the Group will be the requirement to expense all acquisition-related costs. The impact on the Group's reported results will be dependent on the specific transaction; and
- Amendments to IAS 27, *Consolidated and Separate Financial Statements: Changes in non-controlling interest with no change in control.* The amendment requires that acquisitions of minority interests that do not result in a change of control are accounted for as transactions with equity holders and therefore no goodwill is recognised as a result of such transactions. The potential impact on the Group's accounts will be dependent on the specific transaction.

The Group has reviewed the effect of the following amendments and interpretations effective for accounting periods beginning on or after 1 July 2009 and does not expect them to have an impact on the Group's accounts:

- Amendment to IAS 39*, Financial Instruments: Recognition and Measurement on Eligible Hedged Items;*
- IFRIC 17, *Distributions of Non-cash Assets to Owners*; and
- IFRIC 18, *Transfers of Assets from Customers*.

The following EU endorsed amendments to published standards are effective for accounting periods beginning on or after 1 January 2010, but have not been early adopted by the Group:

- Amendment to IAS 32, *Financial Instruments: Presentation: Classification of Rights Issues*.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

3. Segmental analysis

The Group has five reportable segments which are organised around a combination of the different products and services they provide and the geographical areas in which they operate:

- **Electronics, Intelligence & Support,** based primarily in the US, designs, develops, produces and services systems and subsystems for a wide range of military and commercial applications. It comprises four lines of business: Electronic Solutions, Information Solutions, Platform Solutions and Support Solutions;
- **Land & Armaments,** based primarily in the US, designs, develops, produces, supports and upgrades armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products;
- **Programmes & Support** primarily comprises the Group's UK-based air, naval and security activities;
- **International** comprises the Group's businesses in Saudi Arabia and Australia, and its interests in the pan-European MBDA joint venture, Saab of Sweden and Air Astana; and
- **HQ & Other Businesses** comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

The Group has not aggregated any segments in arriving at the analysis.

Management monitors the results of these operating groups to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on underlying EBITA[1]. This is reconciled below to the operating group result and the operating profit in the consolidated financial statements. Finance costs and taxation expense are managed on a Group basis.

Analysis by operating group

	Combined sales of Group and equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Electronics, Intelligence & Support	**5,637**	4,459	**–**	–	**–**	–	**5,637**	4,459
Land & Armaments	**6,738**	6,407	**(6)**	(1)	**–**	1	**6,732**	6,407
Programmes & Support	**6,298**	4,638	**(1,779)**	(1,531)	**1,166**	983	**5,685**	4,090
International	**4,253**	3,333	**(1,513)**	(1,446)	**–**	–	**2,740**	1,887
HQ & Other Businesses	**254**	235	**–**	–	**–**	–	**254**	235
	23,180	19,072	**(3,298)**	(2,978)	**1,166**	984	**21,048**	17,078
Intra-operating group sales/revenue	**(765)**	(529)	**16**	25	**75**	97	**(674)**	(407)
	22,415	18,543	**(3,282)**	(2,953)	**1,241**	1,081	**20,374**	16,671

	Intra-operating group revenue		Revenue from external customers	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Electronics, Intelligence & Support	**138**	94	**5,499**	4,365
Land & Armaments	**45**	30	**6,687**	6,377
Programmes & Support	**431**	248	**5,254**	3,842
International	**12**	11	**2,728**	1,876
HQ & Other Businesses	**48**	24	**206**	211
	674	407	**20,374**	16,671

	Capital expenditure[2]		Depreciation and amortisation[2]	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Electronics, Intelligence & Support	**123**	105	**125**	104
Land & Armaments	**84**	98	**244**	227
Programmes & Support	**109**	85	**116**	92
International	**142**	212	**55**	46
HQ & Other Businesses	**64**	52	**64**	69
	522	552	**604**	538

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see the Financial review on page 30).
2 Includes intangible assets, property, plant and equipment, and investment property.

3. Segmental analysis *continued*

	Underlying EBITA[1]		Non-recurring items[2]		Amortisation of intangible assets		Impairment of intangible assets[3]		Operating group result[4]	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Electronics, Intelligence & Support	**575**	506	**202**	61	**(27)**	(24)	**(8)**	–	**742**	543
Land & Armaments	**604**	566	**59**	–	**(177)**	(168)	**(927)**	(40)	**(441)**	358
Programmes & Support	**670**	491	**68**	177	**(49)**	(24)	**(34)**	(5)	**655**	639
International	**442**	435	**–**	–	**(32)**	(30)	**(4)**	(120)	**406**	285
HQ & Other Businesses	**(71)**	(101)	**(278)**	–	**(1)**	(1)	**–**	(12)	**(350)**	(114)
	2,220	1,897	**51**	238	**(286)**	(247)	**(973)**	(177)	**1,012**	1,711
Financial (expense)/income of equity accounted investments									**(7)**	44
Taxation expense of equity accounted investments									**(23)**	(37)
Operating profit									**982**	1,718
Finance costs									**(700)**	653
Profit before taxation									**282**	2,371
Taxation expense									**(327)**	(603)
(Loss)/profit for the year									**(45)**	1,768

	Assets excluding intangible assets and equity accounted investments		Intangible assets		Equity accounted investments		Total assets		Total liabilities	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Electronics, Intelligence & Support	**1,827**	1,954	**5,082**	5,272	**5**	4	**6,914**	7,230	**(1,366)**	(1,470)
Land & Armaments	**2,030**	2,019	**4,082**	5,712	**(4)**	–	**6,108**	7,731	**(1,482)**	(1,505)
Programmes & Support	**1,485**	866	**1,616**	875	**47**	217	**3,148**	1,958	**(4,611)**	(3,506)
International	**1,622**	1,899	**457**	429	**798**	813	**2,877**	3,141	**(1,921)**	(1,933)
HQ & Other Businesses	**825**	1,690	**16**	18	**–**	–	**841**	1,708	**(2,624)**	(3,035)
	7,789	8,428	**11,253**	12,306	**846**	1,034	**19,888**	21,768	**(12,004)**	(11,449)
Tax							**1,534**	1,040	**(684)**	(784)
Retirement benefit obligations as defined by the Group (note 21)							**42**	40	**(4,452)**	(3,365)
Cash/(debt) as defined by the Group (note 27)							**3,943**	2,827	**(3,540)**	(2,788)
Consolidated total assets/(liabilities)							**25,407**	25,675	**(20,680)**	(18,386)

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see the Financial review on page 30).
2 Non-recurring items comprise profit on disposal of businesses of £68m (2008 £238m), pension curtailment gains of £261m (2008 £nil) and regulatory penalties of £278m (2008 £nil).
3 See note 11.
4 The analysis by operating group of the share of results of equity accounted investments is provided in note 14.

Analysis of non-current assets by geographical location

	Carrying value of non-current assets	
Asset location	**2009 £m**	2008 £m
United Kingdom	**2,534**	1,774
Rest of Europe	**1,190**	1,272
Saudi Arabia	**729**	704
United States	**9,838**	11,703
Asia and Pacific	**589**	554
Africa, Central and South America	**47**	22
Non-current operating group assets	**14,927**	16,029
Financial instruments	**310**	985
Inventories	**887**	926
Trade and other receivables	**3,764**	3,828
Total operating group assets	**19,888**	21,768

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

3. Segmental analysis *continued*

Analysis of sales and revenue by geographical location

	Sales		Revenue	
Customer location	**2009 £m**	2008 £m	**2009 £m**	2008 £m
United Kingdom	**4,181**	3,398	**3,562**	2,908
Rest of Europe	**2,765**	2,647	**1,811**	1,633
Saudi Arabia	**2,780**	1,626	**2,607**	1,538
Rest of Middle East	**138**	130	**64**	87
United States	**10,941**	9,417	**10,902**	9,401
Canada	**127**	129	**119**	125
Asia and Pacific	**1,000**	808	**898**	692
Africa, Central and South America	**483**	388	**411**	287
	22,415	18,543	**20,374**	16,671

Analysis of revenue by category

	2009 £m	2008 £m
Sale of goods	**6,777**	6,042
Construction contracts	**10,274**	8,176
Services	**3,239**	2,376
Lease income	**73**	68
Royalty income	**11**	9
	20,374	16,671

Analysis of revenue by major customer

Revenue from the Group's three principal customers is as follows:

	2009 £m	2008 £m
UK Ministry of Defence	**4,101**	3,669
US Department of Defense	**8,381**	7,094
Kingdom of Saudi Arabia Ministry of Defence and Aviation	**2,602**	1,531

Revenue from the UK Ministry of Defence amounted to £4,101m (2008 £3,669m). Revenue from the US Department of Defense was £8,381m (2008 £7,094m) and is also from all four principal operating groups. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was £2,602m (2008 £1,531m) from sales by the Electronics, Intelligence & Support and International operating groups.

4. Operating costs

	2009 £m	2008 £m
Raw materials and other bought-in items	**9,330**	7,809
Change in inventories of finished goods and work-in-progress	**(538)**	(1,395)
Cost of inventories expensed	**8,792**	6,414
Staff costs (note 7)	**5,605**	4,618
Depreciation, amortisation and impairment	**1,600**	634
Loss on disposal of property, plant and equipment	**–**	1
Regulatory penalties[1]	**278**	–
Other operating charges	**3,785**	3,719
	20,060	15,386
Included within the analysis of operating costs are the following expenses:		
Lease and sublease payments:		
Minimum lease payments	**167**	151
Research and development expense including amounts funded under contract	**1,153**	1,044

1 The regulatory penalties of £278m in 2009 reflect the global settlement of the regulatory investigations by the US Department of Justice and the UK's Serious Fraud Office referred to in the Chairman's letter on page 3.

Costs of rationalisation programmes included in operating costs

	2009 £m	2008 £m
Electronics, Intelligence & Support	**24**	7
Land & Armaments	**32**	19
Programmes & Support	**80**	52
International	**9**	4
HQ & Other Businesses	**6**	5
	151	87

Fees payable to the Company's auditor and its associates included in operating costs

	2009			2008		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	**1,486**	**–**	**1,486**	1,333	–	1,333
Fees payable to the Company's auditor and its associates for other services						
The audit of the Company's subsidiaries pursuant to legislation*	**2,497**	**4,217**	**6,714**	2,178	3,576	5,754
Other services pursuant to legislation:						
Interim review	**581**	**–**	**581**	543	–	543
Other	**57**	**–**	**57**	81	–	81
Further assurance services						
Advice on accounting matters	**–**	**22**	**22**	19	3	22
Internal controls	**–**	**2**	**2**	39	–	39
Due diligence	**437**	**45**	**482**	795	–	795
Tax services						
Compliance	**481**	**768**	**1,249**	392	1,112	1,504
Advisory	**272**	**542**	**814**	490	547	1,037
Other services	**175**	**2**	**177**	–	–	–
Total fees payable to the Company's auditor and its associates	**5,986**	**5,598**	**11,584**	5,870	5,238	11,108
* Total fees payable to the Company's auditor and its associates for audit services			**8,200**			7,087

The increase in audit fees relating to overseas subsidiaries primarily reflects exchange translation.

Tax services include tax compliance support and services in relation to the Group's expatriate employees based around the world. The majority of services provided outside the UK were provided in the US.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

5. Other income

	2009 £m	2008 £m
Rental income from operating leases (including from investment property)	**50**	47
Profit on disposal of investment property	**–**	5
Profit on disposal of property, plant and equipment	**17**	34
Profit on disposal of businesses (note 9)	**68**	238
Management recharges to equity accounted investments (note 31)	**24**	17
Pension curtailment gains (note 21)	**261**	–
Other	**45**	74
	465	415

6. Finance costs

	2009 £m	2008 £m
Interest income	**66**	147
Net present value adjustments	**5**	3
Expected return on pension scheme assets (note 21)	**777**	846
Net gain on remeasurement of financial instruments	**408**	681
Foreign exchange gains	**317**	1,703
Financial income	**1,573**	3,380
Interest expense:		
On bank loans and overdrafts	**(1)**	(2)
On finance leases	**(2)**	(5)
On bonds and other financial instruments	**(225)**	(253)
	(228)	(260)
Facility fees	**(4)**	(4)
Net present value adjustments	**(40)**	(30)
Interest charge on pension scheme liabilities (note 21)	**(900)**	(795)
Net loss on remeasurement of financial instruments at fair value through profit or loss	**(467)**	(917)
Foreign exchange losses	**(634)**	(721)
Financial expense	**(2,273)**	(2,727)
Net finance costs	**(700)**	653

Additional analysis of finance costs

	2009 £m	2008 £m
Net finance costs – Group	**(700)**	653
Net finance costs – share of equity accounted investments	**(7)**	44
	(707)	697
Analysed as:		
Net interest:		
Interest income	**66**	147
Interest expense	**(228)**	(260)
Facility fees	**(4)**	(4)
Net present value adjustments	**(35)**	(27)
Share of equity accounted investments	**6**	42
	(195)	(102)
Other finance costs:		
Group:		
Net financing (charge)/credit on pensions	**(123)**	51
Market value and foreign exchange movements on financial instruments and investments[1]	**(376)**	746
Share of equity accounted investments	**(13)**	2
	(707)	697

1 The loss in 2009 (2008 gain) primarily reflects net foreign exchange movements on the unhedged portion of an intercompany loan from the UK to the US businesses.

7. Employees and directors

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2009 Number '000	2008 Number '000	**2009 Number '000**	2008 Number '000
Electronics, Intelligence & Support	**33**	32	**32**	34
Land & Armaments	**21**	21	**20**	21
Programmes & Support	**27**	26	**33**	26
International	**11**	9	**11**	11
HQ & Other Businesses	**2**	2	**2**	2
	94	90	**98**	94

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

	2009 £m	2008 £m
Wages and salaries[1]	**4,897**	4,053
Social security costs	**400**	324
Share options granted to directors and employees – equity-settled	**13**	18
Share options granted to directors and employees – cash-settled	**(2)**	(23)
Pension costs – defined contribution plans (note 21)	**127**	84
Pension costs – defined benefit plans (note 21)[2]	**167**	160
US healthcare plans (note 21)	**3**	2
	5,605	4,618

1 On a like-for-like basis, after excluding the impact of exchange translation, and acquisitions and disposals, wages and salaries increased by 3% per employee on 2008.
2 Excluded £21m of past service credit included within other income in 2008 (note 5).

The Group considers key management personnel as defined under IAS 24, *Related Party Disclosures*, to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 90 to 111. Total emoluments for directors and other key management personnel were:

	2009 £'000	2008 £'000
Short-term employee benefits	**14,761**	14,954
Post-employment benefits[3]	**1,754**	1,339
Termination benefits	**–**	237
Share-based payment	**4,773**	5,142
	21,288	21,672

3 2009 includes special incentive awards (see page 110).

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

8. Tax

Taxation expense

	2009 £m	2008 £m
Current taxation expense		
UK corporation tax		
Current tax	**(88)**	(357)
Double tax relief	**8**	7
Adjustment in respect of prior years	**(44)**	19
	(124)	(331)
Overseas tax charges		
Current year	**(300)**	(241)
Adjustment in respect of prior years	**46**	23
	(254)	(218)
	(378)	(549)
Deferred taxation expense		
UK		
Origination and reversal of temporary differences	**3**	(58)
Adjustment in respect of prior years	**16**	38
Overseas		
Origination and reversal of temporary differences	**55**	(47)
Adjustment in respect of prior years	**(23)**	13
	51	(54)
Taxation expense	**(327)**	(603)

Reconciliation of taxation expense

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

	2009 £m	2008 £m
Profit before taxation	**282**	2,371
UK corporation tax rate	**28.0%**	28.5%
Expected income tax expense	**(79)**	(676)
Effect of tax rates in foreign jurisdictions	**(37)**	(45)
Expenses not tax effected	**(43)**	(40)
Income not subject to tax	**32**	55
Research and development tax credits	**36**	5
Goodwill impairment	**(203)**	(15)
Chargeable gains	**(1)**	(5)
Utilisation of previously unrecognised tax losses	**6**	74
Current year losses not tax effected	**(7)**	(9)
Adjustments in respect of prior years	**(5)**	93
Adjustments in respect of equity accounted investments	**57**	6
Regulatory penalties	**(78)**	–
Other	**(5)**	(46)
Taxation expense	**(327)**	(603)

8. Tax *continued*

Tax recognised in other comprehensive income

	2009 Before tax £m	2009 Tax benefit/ (expense) £m	2009 Net of tax £m	2008 Before tax £m	2008 Tax benefit/ (expense) £m	2008 Net of tax £m
Currency translation on foreign currency net investments:						
Subsidiaries	**(246)**	**–**	**(246)**	807	–	807
Equity accounted investments	**(56)**	**–**	**(56)**	197	–	197
Amounts (charged)/credited to hedging reserve	**(393)**	**110**	**(283)**	469	(130)	339
Gain on revaluation of step acquisition	**103**	**(29)**	**74**	–	–	–
Net actuarial losses on defined benefit pension schemes:						
Subsidiaries	**(2,008)**	**541**	**(1,467)**	(1,937)	634	(1,303)
Equity accounted investments	**(54)**	**16**	**(38)**	(60)	17	(43)
Recycling of cumulative currency translation on disposal	**–**	**–**	**–**	1	–	1
Share-based payments	**–**	**(2)**	**(2)**	–	(24)	(24)
Fair value movements on available-for-sale investments	**2**	**–**	**2**	–	–	–
Other	**–**	**6**	**6**	–	3	3
	(2,652)	**642**	**(2,010)**	(523)	500	(23)

Current tax taken in equity

	2009 £m	2008 £m
Relating to financial instruments	**(3)**	2
Relating to share-based payments	**2**	2
Relating to pensions	**53**	54
Other	**12**	–
	64	58

Deferred tax assets/(liabilities)

	Deferred tax assets 2009 £m	Deferred tax assets 2008 £m	Deferred tax liabilities 2009 £m	Deferred tax liabilities 2008 £m	Net balance at 31 December 2009 £m	Net balance at 31 December 2008 £m
Property, plant and equipment	**1**	1	**(52)**	(70)	**(51)**	(69)
Intangible assets	**–**	–	**(325)**	(509)	**(325)**	(509)
Provisions and accruals	**431**	459	**–**	(2)	**431**	457
Goodwill	**–**	–	**(69)**	(34)	**(69)**	(34)
Pension/retirement plans:						
Deficits	**1,430**	1,115	**–**	–	**1,430**	1,115
Additional contributions	**15**	66	**–**	–	**15**	66
Share-based payments	**24**	30	**–**	–	**24**	30
Financial instruments	**–**	–	**(4)**	(136)	**(4)**	(136)
Other items	**53**	42	**(6)**	(17)	**47**	25
Rolled over capital gains	**–**	–	**(18)**	(18)	**(18)**	(18)
Capital losses carried forward	**18**	18	**–**	–	**18**	18
Trading losses carried forward	**14**	1	**–**	–	**14**	1
Unremitted overseas dividends	**–**	–	**(3)**	–	**(3)**	–
Deferred tax assets/(liabilities)	**1,986**	1,732	**(477)**	(786)	**1,509**	946
Set off of tax	**(469)**	(706)	**469**	706	**–**	–
Net deferred tax assets/(liabilities)	**1,517**	1,026	**(8)**	(80)	**1,509**	946

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

8. Tax *continued*

Movement in temporary differences during the year

	At 1 January 2009 £m	Exchange movements £m	Acquisitions and disposals[1] £m	Other movements £m	Recognised in income £m	Recognised in equity £m	**At 31 December 2009 £m**
Property, plant and equipment	(69)	6	(4)	–	16	–	**(51)**
Intangible assets	(509)	33	(34)	–	214	(29)	**(325)**
Provisions and accruals	457	(23)	17	–	(20)	–	**431**
Goodwill	(34)	5	–	–	(40)	–	**(69)**
Pension/retirement plans:							
Deficits	1,115	(45)	–	–	(164)	524	**1,430**
Additional contributions	66	–	(3)	–	(12)	(36)	**15**
Share-based payments	30	(1)	–	–	(1)	(4)	**24**
Financial instruments	(136)	–	–	–	19	113	**(4)**
Other items	25	–	(5)	–	33	(6)	**47**
Rolled over capital gains	(18)	–	–	–	–	–	**(18)**
Capital losses carried forward	18	–	–	–	–	–	**18**
Trading losses carried forward	1	1	3	–	9	–	**14**
Unremitted overseas dividends	–	–	–	–	(3)	–	**(3)**
	946	(24)	(26)	–	51	562	**1,509**

1 Acquisitions and disposals includes deferred tax assets on the acquisition of Tenix Defence (£7m) and Detica (£4m), less deferred tax liabilities arising on the acquisition of the remaining shareholding in BVT (£35m).

	At 1 January 2008 £m	Exchange movements £m	Acquisitions and disposals[2] £m	Other movements £m	Recognised in income £m	Recognised in equity £m	At 31 December 2008 £m
Property, plant and equipment	(70)	(17)	(2)	–	20	–	(69)
Intangible assets	(372)	(116)	(67)	–	46	–	(509)
Provisions and accruals	269	92	45	1	50	–	457
Goodwill	(25)	(9)	28	–	(28)	–	(34)
Pension/retirement plans:							
Deficits	522	115	(35)	1	(98)	610	1,115
Additional contributions	106	–	4	–	(14)	(30)	66
Share-based payments	75	4	–	–	(23)	(26)	30
Financial instruments	6	–	–	–	(10)	(132)	(136)
Other items	9	(2)	3	1	11	3	25
Rolled over capital gains	(18)	–	–	–	–	–	(18)
Capital losses carried forward	18	–	–	–	–	–	18
Trading losses carried forward	7	–	2	–	(8)	–	1
	527	67	(22)	3	(54)	425	946

2 Acquisitions and disposals includes deferred tax assets on the acquisition of MTC (£16m) and Tenix Defence (£9m), and the finalisation of fair values relating to the Armor Holdings, Inc. acquisition in 2007 (£7m), less deferred tax liabilities on the acquisition of Detica (£23m) and the deferred tax asset transferred on formation of the BVT joint venture (£31m).

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2009 £m	2008 £m
Deductible temporary differences	**10**	23
Capital losses carried forward	**58**	58
Trading and other losses carried forward	**158**	90
	226	171

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be sufficiently accurately predicted at this time.

Due to changes in UK tax legislation during the year, there are no unrecognised deferred tax liabilities arising on the aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures (2008 £332m). Any withholding tax due on the remittance of future earnings is expected to be insignificant.

9. Disposals

Continuing operations for the year ended 31 December 2009

Profit on disposal of businesses of £68m comprises the finalisation of the accounting gain recognised in 2008 on the disposal of the Group's interests in the businesses contributed to the BVT joint venture following acquisition of VT Group's 45% interest in 2009 (£58m) and additional proceeds received in respect of the disposal in 2008 of the Group's interest in Flagship Training (£10m).

The Group received deferred consideration of £72m in the year ended 31 December 2009 in respect of the disposals of Flagship Training Limited in 2008 (£70m) and the Inertial Products business in 2007 (£2m) (note 27).

Continuing and discontinued operations for the year ended 31 December 2008

Name	Country of incorporation	Date of sale	Percentage share	Profit on disposal of businesses £m	Proceeds from sale of subsidiary undertakings £m	Proceeds from sale of equity accounted investments £m	Deferred consideration £m
Surveillance & Attack division	USA	22.02.08	100%	61	118	–	–
BAE Systems Surface Fleet Solutions Limited[1]	UK	01.07.08	45%	121	–	–	–
Flagship Training Limited[2]	UK	01.07.08	50%	56	–	16	53
Gregory backpack business	USA	14.03.08	100%	–	7	–	–
Continuing operations				238	125	16	53
Discontinued operations[3] – Mobile International business	USA	14.02.08	100%	–	6	–	–
				238	131	16	53

1 On 1 July 2008, the Group exchanged a 45% shareholding in BAE Systems Surface Fleet Solutions Limited (SFSL) as consideration for the contribution to SFSL of 100% of VT Group plc's shipbuilding and naval support businesses to form the joint venture BVT Surface Fleet Limited.

2 Discounted consideration of £67m had been deferred over three years, the discounted value of which was £53m and is included within other receivables at 31 December 2008.

3 The Group's Mobile International business was acquired with Armor Holdings, Inc. on 31 July 2007 with a view to immediate resale. Accordingly, it was classified as held for sale as at 31 December 2007. The sale was completed on 14 February 2008 for a cash consideration less transaction costs of £6m.

10. Earnings per share

	2009			2008		
	£m	**Basic pence per share**	**Diluted pence per share**	£m	Basic pence per share	Diluted pence per share
(Loss)/profit for the year attributable to equity shareholders	**(67)**	**(1.9)**	**(1.9)**	1,745	49.6	49.5
Add back/(deduct):						
Profit on disposal of businesses, post tax	**(65)**			(208)		
Pension curtailment gains, post tax	**(188)**			–		
Regulatory penalties	**278**			–		
Net financing charge/(credit) on pensions, post tax	**91**			(39)		
Market value movements on derivatives, post tax	**278**			(552)		
Amortisation and impairment of intangible assets, post tax	**384**			184		
Impairment of goodwill – subsidiaries	**725**			54		
Impairment of goodwill – equity accounted investments	**–**			121		
Underlying earnings, post tax	**1,436**	**40.7**	**40.6**	1,305	37.1	37.0

	Millions	**Millions**	Millions	Millions
Weighted average number of shares used in calculating basic earnings per share	**3,532**	**3,532**	3,519	3,519
Incremental shares in respect of employee share schemes		**4**		9
Weighted average number of shares used in calculating diluted earnings per share		**3,536**		3,528

Underlying earnings per share is presented in addition to that required by IAS 33, *Earnings per Share*, to align the adjusted earnings measure with the performance measure reviewed by the directors. The directors consider that this gives a more appropriate indication of underlying performance.

In the 12 months to 31 December 2009, outstanding share options were anti-dilutive and so have been excluded from the diluted loss per share in accordance with IAS 33.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

11. Intangible assets

	Goodwill £m	Programme and customer related[1] £m	Other[2] £m	Total £m
Cost or valuation				
At 1 January 2008	10,661	1,180	271	12,112
Additions:				
Acquired separately	–	–	30	30
Internally developed	–	–	2	2
Acquisition of subsidiaries (note 29)	903	144	69	1,116
Adjustment on finalisation of provisional goodwill[4]	6	–	–	6
Disposals	(251)	–	(15)	(266)
Asset reclassifications	–	–	5	5
Exchange adjustments	1,882	404	55	2,341
At 31 December 2008	13,201	1,728	417	15,346
Additions:				
Acquired separately	–	–	28	28
Internally developed	–	–	14	14
Reclassification from equity accounted investments (note 14)[5]	253	–	–	253
Acquisition of subsidiaries (note 29)	367	225	–	592
Adjustment on finalisation of provisional goodwill[4]	5	11	–	16
Disposals	–	–	(7)	(7)
Transfer from property, plant and equipment	–	–	4	4
Exchange adjustments	(655)	(144)	(8)	(807)
At 31 December 2009	13,171	1,820	448	15,439
Amortisation and impairment				
At 1 January 2008	2,213	253	87	2,553
Disposals	(59)	–	(11)	(70)
Amortisation charge[3]	–	199	48	247
Impairment charge	54	–	2	56
Asset reclassifications	–	–	3	3
Exchange adjustments	125	104	22	251
At 31 December 2008	2,333	556	151	3,040
Disposals	–	–	(7)	(7)
Amortisation charge[3]	–	219	67	286
Impairment charge	725	240	8	973
Exchange adjustments	(55)	(48)	(3)	(106)
At 31 December 2009	3,003	967	216	4,186
Net book value				
At 31 December 2009	**10,168**	**853**	**232**	**11,253**
At 31 December 2008	10,868	1,172	266	12,306
At 1 January 2008	8,448	927	184	9,559

1 Relates to intangible assets recognised on acquisition of subsidiary companies, mainly in respect of ongoing programme relationships and the acquired order book.
2 Other intangibles includes patents, trademarks, software and internally funded development costs.
3 Amortisation is included in operating costs in the income statement.
4 Adjustment on finalisation of provisional goodwill relating to the acquisition of MTC Technologies, Inc., Tenix Defence Holdings Pty Limited, Tenix Toll Defence Logistics Pty Limited, Detica Group Plc and IST Dynamics in 2008, and Armor Holdings, Inc. in 2007. The amounts are not considered material for the restatement of comparative information.
5 Goodwill arising on the formation of the BVT joint venture in the year ended 31 December 2008 and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited has been reclassified from equity accounted investments to intangible assets in accordance with IFRS 3, *Business Combinations*, in 2009 upon acquisition of VT Group's 45% shareholding in the BVT joint venture.

The Group has no indefinite life intangible assets other than goodwill. The Group's approach to goodwill impairment testing is set out in the accounting policies on page 125.

Impairment testing

The Group's goodwill of £10.2bn (2008 £10.9bn) is allocated across 23 cash-generating units (CGUs). In order to calculate the recoverable amount of the Group's goodwill, all goodwill balances have been considered with regard to value in use calculations. These calculations use risk-adjusted future cash flow projections based on the Group's five-year Integrated Business Plan (IBP) and include a terminal value based on the projections for the final year of that plan, with an inflationary growth rate assumption applied. The IBP process uses historic experience, available government spending data and the Group's order book. Pre-tax discount rates, derived from the Group's post-tax weighted average cost of capital of 7.72% (adjusted for risks specific to the market in which the CGU operates), have been used in discounting these projected risk-adjusted cash flows.

11. Intangible assets *continued*

Significant CGUs
The Group has three CGUs with allocated goodwill which is significant in comparison with the total carrying amount of goodwill. These are the US-based electronic warfare, network and mission solutions business in the Electronics, Intelligence & Support (EI&S) operating group (£2.6bn), and the US-based ex-United Defense Industries, Inc. (UDI) (£2.0bn) and ex-Armor Holdings, Inc. (Armor) (£1.7bn pre-impairment below) businesses in the Land & Armaments operating group. The key assumptions underpinning the cash flow projections for the EI&S CGU are the continuing demand from the US government for electronic warfare systems, mission solutions and other technology-based solutions, and from non-military agencies for network solutions. The key assumptions underpinning the cash flow projections for the Land & Armaments CGUs are the continued demand in the Group's home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support. The pre-tax discount rates used to discount the risk-adjusted five-year cash flow projections were 9.9%, 9.8% and 10.3%, respectively. The growth rate assumption applied to the final year of these projections was 3% (2% for Armor), reduced from 4% in the prior year reflecting increased uncertainty in the US defence budgets.

Whilst there are no other CGUs with allocated goodwill balances exceeding 15% of the Group's total goodwill balance, the majority of the projected cash flows within the remaining CGUs are underpinned by the expected continuation of levels of government spending on aerospace, defence and security, and the Group's ability to capture a broadly consistent market share.

The directors have not identified any reasonably possible material changes relating either specifically to the global military vehicle market, or to the levels of defence spending in the Group's home markets, particularly in the US, that would cause the carrying value of goodwill to exceed its recoverable amount.

Impairment – goodwill
The total goodwill impairment charge of £725m mainly arises in three of the CGUs, Armor (£526m), Products Group, acquired as part of the Armor transaction in 2007 (£156m), and Detica (£34m).

The Armor impairment charge reflects both the non-award of a follow-on contract for production of vehicles under the Family of Medium Tactical Vehicles (FMTV) programme and the subsequent impact on the growth prospects of the business.

The Products Group impairment charge reflects a weaker outlook for the business as spending from customer discretionary budgets has reduced in both domestic and export markets. The pre-tax discount rate used was 9.5%.

The Detica impairment charge relates to the discontinued financial services element of the business. The pre-tax discount rate used was 10.0%.

Impairment – intangible assets
The total intangible assets impairment charge of £248m comprises £240m relating to programme and customer related intangibles, and £8m relating to other intangibles. The charge impacts the EI&S (£8m), Land & Armaments (£236m) and International (£4m) operating groups.

The charge relating to Land & Armaments includes £108m in respect of the Products Group business, £66m relating to the FMTV non-award and a number of individually small items each calculated on a programme-by-programme basis.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

12. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Cost				
At 1 January 2008	1,386	2,095	602	4,083
Additions	269	209	42	520
Acquisition of subsidiaries (note 29)	40	72	–	112
Transfers from inventories	2	–	–	2
Reclassification between categories	5	(5)	–	–
Disposals	(15)	(69)	(12)	(96)
Disposal of subsidiaries	(46)	(76)	–	(122)
Exchange adjustments	331	303	194	828
At 31 December 2008	1,972	2,529	826	5,327
Additions	245	187	48	480
Acquisition of subsidiaries (note 29)	85	53	–	138
Transfers from inventories	–	2	–	2
Transfer to investment properties	(2)	–	–	(2)
Transfer to other intangible assets	–	(4)	–	(4)
Reclassification between categories	28	(28)	–	–
Disposals	(23)	(78)	(43)	(144)
Exchange adjustments	(110)	(110)	(72)	(292)
At 31 December 2009	2,195	2,551	759	5,505
Depreciation and impairment				
At 1 January 2008	494	1,426	389	2,309
Depreciation charge for the year	68	167	55	290
Impairment charge for the year	2	29	9	40
Reclassification between categories	(3)	3	–	–
Disposals	(14)	(63)	(3)	(80)
Disposal of subsidiaries	(17)	(42)	–	(59)
Exchange adjustments	75	170	136	381
At 31 December 2008	605	1,690	586	2,881
Depreciation charge for the year	80	184	51	315
Impairment charge for the year	11	2	10	23
Reclassification between categories	(5)	5	–	–
Disposals	(20)	(73)	(32)	(125)
Exchange adjustments	(27)	(63)	(51)	(141)
At 31 December 2009	644	1,745	564	2,953
Net book value:				
Freehold property	1,313	–	–	1,313
Long leasehold property	185	–	–	185
Short leasehold property	53	–	–	53
Plant and machinery	–	697	–	697
Fixtures, fittings and equipment	–	109	–	109
Aircraft	–	–	195	195
At 31 December 2009	**1,551**	**806**	**195**	**2,552**
At 31 December 2008	1,367	839	240	2,446
At 1 January 2008	892	669	213	1,774

Impairment

The impairment charge of £23m in 2009 mainly comprises charges in respect of aircraft carrying values within the Regional Aircraft business (£8m) and a £13m charge following the reassessment of the carrying value of certain assets within the International operating group. The impairment impacts the International (£13m), HQ & Other Businesses (£8m) and Land & Armaments (£2m) segments.

The impairment in 2008 mainly comprises charges in respect of the spares and support business, and aircraft carrying values within the Regional Aircraft business (£32m). The impairment impacts the HQ & Other Businesses (£36m), Programmes & Support (£3m) and International (£1m) segments.

12. Property, plant and equipment *continued*

Assets in the course of construction

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Assets in the course of construction (including investment property (note 13))				
At 31 December 2009	**133**	**76**	**–**	**209**
At 31 December 2008	355	107	–	462

Finance leases

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Net book value of assets held as capitalised finance leases				
At 31 December 2009	**–**	**–**	**5**	**5**
At 31 December 2008	–	–	23	23

At 31 December 2009, none of the assets held under finance leases are sublet under operating leases (2008 £15m).

Operating leases
The aircraft fleet that is held under capitalised finance lease arrangements is leased to airline companies under operating leases. The leases have varying terms, escalation clauses and renewal rights.

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

	2009 £m	2008 £m
Receipts due:		
Not later than one year	**78**	104
Later than one year and not later than five years	**201**	241
Later than five years	**23**	62
	302	407

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations. Within the above lease income is £nil (2008 £17m) relating to assets held by the Group under capitalised finance leases.

13. Investment property

	£m
Cost	
At 1 January 2008	158
Disposals	(5)
At 31 December 2008	153
Transfer from property, plant and equipment	2
At 31 December 2009	155
Depreciation and impairment	
At 1 January 2008	45
Depreciation charge for the year	1
Disposals	(5)
At 31 December 2008	41
Depreciation charge for the year	3
At 31 December 2009	44
Net book value of investment property	
At 31 December 2009	**111**
At 31 December 2008	112
At 1 January 2008	113

Fair value of investment property

At 31 December 2009	**166**
At 31 December 2008	149

The fair values above are based on and reflect current market values as prepared by in-house professionals. The valuations were prepared by persons having the appropriate professional qualification and with recent experience in valuing properties in the location and the type of property being valued.

	2009 £m	2008 £m
Rental income from investment property	**20**	21

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

14. Equity accounted investments

Carrying value of equity accounted investments

	Share of net assets £m	Purchased goodwill £m	Carrying value £m
At 1 January 2008	321	460	781
Share of results after tax – continuing operations	139	–	139
Acquired	12	178	190
Adjustment on finalisation of provisional goodwill	(48)	48	–
Disposal	(13)	(4)	(17)
Impairment	–	(121)	(121)
Dividends	(89)	–	(89)
Market value adjustments in respect of derivative financial instruments, net of tax	(7)	–	(7)
Actuarial losses on defined benefit pension schemes, net of tax	(43)	–	(43)
Reclassified from trade and other receivables	4	–	4
Foreign exchange adjustment	98	99	197
At 31 December 2008	374	660	1,034
Share of results after tax – continuing operations	203	–	203
Disposal	28	–	28
Reclassification to intangible assets (note 11)	–	(253)	(253)
Dividends	(77)	–	(77)
Market value adjustments in respect of derivative financial instruments, net of tax	5	–	5
Actuarial losses on defined benefit pension schemes, net of tax	(38)	–	(38)
Foreign exchange adjustment	(31)	(25)	(56)
At 31 December 2009	**464**	**382**	**846**

On 30 October 2009, the BVT Surface Fleet Limited (BVT) joint venture became a wholly-owned subsidiary of the Group after VT Group plc (VT) exercised its option to sell its 45% shareholding in BVT to BAE Systems (note 29). As part of the transaction, the Group's shareholding in Fleet Support Limited also increased to 100% (2008 55%). On the date of the transaction, the Group gained full control of BVT, which was previously jointly controlled with VT.

From 1 January 2009 to the date of completion, the Group equity accounted the results of BVT to reflect the Group's 55% interest held. From the date of completion, the results and net assets of BVT, renamed BAE Systems Surface Ships Limited, have been consolidated in the Group's accounts as a wholly-owned subsidiary.

Goodwill of £225m arising on the formation of the BVT joint venture, comprising £177m on the initial formation of the joint venture and £48m reflecting adjustments to the provisional fair values assigned to the net assets acquired, and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited (£28m), has been reclassified to intangible assets (note 11) in accordance with IFRS 3, *Business Combinations*.

Included within purchased goodwill is £89m (2008 £94m) relating to the goodwill arising on acquisitions made by the Group's equity accounted investments subsequent to their acquisition by the Group.

The market value of the Group's shareholding in Saab AB at 31 December 2009 was £229m (2008 £140m).

Share of results of equity accounted investments by operating group

	2009 £m	2008 £m
Share of results excluding finance costs and taxation expense:		
Electronics, Intelligence & Support	**1**	–
Land & Armaments	**(3)**	–
Programmes & Support	**77**	44
International	**158**	88
	233	132
Financial (expense)/income	**(7)**	44
Taxation expense	**(23)**	(37)
	203	139

Share of the assets and liabilities of equity accounted investments

	2009 £m	2008 £m
Assets:		
Non-current assets	**990**	1,308
Current assets	**3,313**	3,768
	4,303	5,076
Liabilities:		
Non-current liabilities	**(678)**	(807)
Current liabilities	**(2,779)**	(3,235)
	(3,457)	(4,042)
Carrying value	**846**	1,034

14. Equity accounted investments *continued*

Contingent liabilities

The Group is exposed to actual and contingent liabilities arising from commercial aircraft financing and RVGs given by Saab AB. Provision is made against the expected net exposures on a net present value basis within the accounts of Saab. The Group's share of such exposure is limited to its percentage shareholding in Saab.

The Group is not aware of any other material contingent liabilities in respect of equity accounted investments.

Principal equity accounted investments

Joint ventures	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
Eurofighter Jagdflugzeug GmbH *(Held by BAE Systems plc)*	Management and control of the Typhoon programme	33% ordinary	Germany	Germany
MBDA SAS *(Held via BAE Systems Electronics Limited and BAE Systems (Overseas Holdings) Limited)*	Development and manufacture of guided weapons	37.5% ordinary	Europe	France
Saab AB *(Held via BAE Systems (Sweden) AB)*	Defence and commercial aerospace activities	20.5% Series A&B	Sweden	Sweden

The Group comprises a large number of equity accounted investments and it is not practical to include all of them in the above list. The list therefore only includes those equity accounted investments which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2009 will be annexed to the Company's next annual return filed with the Registrar of Companies.

15. Other investments

	2009 £m	2008 £m
Non-current		
Available-for-sale financial assets		
Equity securities	**6**	6
	6	6
Current		
Available-for-sale financial assets		
Government bonds[1]	**211**	–
	211	–

Reconciliation of movements

	2009 £m	2008 £m
Non-current		
At 1 January and 31 December	**6**	6
Current		
At 1 January	**–**	164
Additions	**209**	–
Disposals	**–**	(164)
Fair value movements	**2**	–
At 31 December	**211**	–

1 The £211m government bonds at 31 December 2009 are held in a Reservoir Trust in respect of the Group's UK pension schemes (see the Financial review on page 33).

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

16. Trade and other receivables

	2009 £m	2008 £m
Non-current		
Other receivables	**156**	122
Pension prepayment (note 21)	**42**	37
Prepayments and accrued income	**3**	3
	201	162
Current		
Long-term contract balances	**7,034**	6,215
Less: attributable progress payments	**(5,941)**	(5,410)
Amounts due from contract customers	**482**	484
Amounts due from customers for contract work[1]	**1,575**	1,289
Trade receivables	**1,452**	1,653
Amounts owed by equity accounted investments (note 31)	**207**	200
Other receivables	**274**	426
Pension prepayment (note 21)	**–**	3
Prepayments and accrued income	**256**	260
	3,764	3,831

1 There are no retentions against long-term contracts (2008 £nil) and no amounts that are past due within amounts due from customers for contract work (2008 £nil).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2009 are estimated to be £36.9bn (2008 £35.7bn).

The ageing of trade receivables is detailed below:

	2009			2008		
	Gross £m	**Provision £m**	**Net £m**	Gross £m	Provision £m	Net £m
Not past due and not impaired	**1,194**	**–**	**1,194**	1,176	–	1,176
Not past due and impaired	**–**	**–**	**–**	2	(2)	–
Up to 180 days overdue and not impaired	**233**	**–**	**233**	175	–	175
Up to 180 days overdue and impaired	**9**	**(2)**	**7**	15	(15)	–
Past 180 days overdue and not impaired	**18**	**–**	**18**	302	–	302
Past 180 days overdue and impaired	**45**	**(45)**	**–**	33	(33)	–
	1,499	**(47)**	**1,452**	1,703	(50)	1,653

Trade receivables are disclosed net of a provision for impairment losses. Movement on the provision is as follows:

	2009 £m	2008 £m
At 1 January	**50**	53
Created	**36**	32
Released	**(27)**	(37)
Exchange adjustments	**(2)**	7
Acquisitions	**2**	–
Utilised	**(12)**	(5)
At 31 December	**47**	50

The other classes within trade and other receivables do not contain assets which are considered to be impaired.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, the provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk.

17. Other financial assets and liabilities

	2009 Assets £m	2009 Liabilities £m	2008 Assets £m	2008 Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	**100**	**(95)**	309	(100)
Other foreign exchange/interest rate contracts	**6**	**(166)**	2	(283)
Debt-related derivative financial instruments – assets[1]	**27**	**–**	203	–
	133	**(261)**	514	(383)
Current				
Cash flow hedges – foreign exchange contracts	**158**	**(54)**	502	(237)
Other foreign exchange/interest rate contracts	**46**	**(40)**	172	(88)
Fair value of put option held by VT Group plc	**–**	**–**	–	(37)
Debt-related derivative financial instruments – assets[2]	**12**	**–**	–	–
	216	**(94)**	674	(362)

1 Includes fair value hedges of £26m (2008 £55m).
2 Includes fair value hedges of £12m (2008 £nil).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (note 19).

The notional principal amounts of the outstanding contracts are detailed in note 30.

Cash flow hedges
The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts debited to the hedging reserve in respect of cash flow hedges were £393m (2008 credit £469m).

The amount reclassified from equity to the income statement was £nil (2008 £nil). The amount debited from equity and included in contract-related non-financial assets and liabilities was £39m (2008 £32m). The ineffective portion recognised in the income statement that arises from cash flow hedges amounts to £nil (2008 £nil).

Fair value hedges
The loss arising in the income statement on fair value hedging instruments was £20m (2008 £37m gain). The gain arising in the income statement on the fair value of the underlying hedged items was £20m (2008 £38m loss). The ineffective portion recognised in the income statement that arises from fair value hedges amounts to a gain of £4m (2008 £3m).

18. Inventories

	2009 £m	2008 £m
Short-term work-in-progress	**451**	424
Raw materials and consumables	**312**	370
Finished goods and goods for resale	**124**	132
	887	926

The Group recognised £35m (2008 £46m) as a write down of inventories to net realisable value in 2009.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

19. Loans and overdrafts

	2009 £m	2008 £m
Non-current		
US$500m 4.75% bond, repayable 2010	**–**	361
US$1bn 6.4% bond, repayable 2011	**645**	728
Class B and Class G certificates, final instalments 2011/2013	**379**	547
Euro-Sterling £100m 10¾% bond, repayable 2014	**100**	100
US$500m 4.95% bond, repayable 2014	**308**	–
US$750m 5.2% bond, repayable 2015	**463**	516
Albertville Hangar Bond, repayable 2018	**6**	7
US$1bn 6.375% bond, repayable 2019	**608**	–
US$500m 7.5% bond, repayable 2027	**307**	341
Obligations under finance leases	**1**	8
Debt-related derivative financial instruments – liabilities	**23**	–
	2,840	2,608
Current		
Bank loans and overdrafts	**15**	35
European Investment Bank loan, final instalment 2009	**–**	4
Alvis loan notes, redeemable 2009	**–**	1
US$500m 4.75% bond, repayable 2010	**322**	–
Class B and Class G certificates, final instalment 2011/2013	**110**	121
Obligations under finance leases	**6**	12
	453	173

The maturity of the Group's borrowings is as follows:

	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
At 31 December 2009				
Carrying amount[1]	453	1,453	1,387	3,293
Debt-related derivative financial instruments – assets	(12)	(26)	(1)	(39)
Carrying amount including debt-related derivative financial instruments – assets	**441**	**1,427**	**1,386**	**3,254**
Contractual cash flows, including future interest payments	**583**	**1,849**	**1,890**	**4,322**
At 31 December 2008				
Carrying amount[1]	173	1,644	964	2,781
Debt-related derivative financial instruments – assets	–	(87)	(116)	(203)
Carrying amount including debt-related derivative financial instruments – assets	173	1,557	848	2,578
Contractual cash flows, including future interest payments	292	1,881	1,314	3,487

1 The carrying amount of loans and overdrafts at 31 December 2009 excludes debt-related derivative financial assets of £39m (2008 £203m) presented as other financial assets.

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

The US$500m 4.75% bond, repayable 2010, was converted on issue to a floating rate bond by utilising interest rate swaps giving an effective rate during 2009 of 1.96%.

The US$1bn 6.4% bond, repayable 2011, has been partially converted to a floating rate bond by utilising a series of interest rate swaps. US$500m has been swapped to a floating rate until maturity of the bond in 2011. This has been overlaid by US$300m of floating to fixed interest rate swaps that fix the interest payments at a lower rate than the original coupon. The effective interest rate during 2009 was 5.29% with an interest rate split on the bond at 31 December 2009 being US$800m fixed and US$200m floating.

The Class B and Class G certificates are repayable in 2011 and 2013, respectively, with fixed US$ coupon rates of 7.16% and 6.66%, giving a weighted average interest rate of 6.88%. At 31 December 2009, the gross outstanding principal due is US$772m. Of this balance, US$235m has been converted to a sterling floating rate bond by utilising a series of cross-currency swaps and interest rate swaps which resulted in an effective interest rate during 2009 of 2.84% on this element.

In 2009, two US bonds were issued with the following maturities, US$500m 4.95% bond, repayable 2014 and US$1bn 6.375% bond, repayable 2019. The US$500m 4.95% bond was converted on issue to a floating rate bond utilising a series of interest rate swaps giving an effective rate during 2009 of 1.08%. US$500m of the US$1bn 6.375% bond has been partially converted to a floating rate bond utilising a series of interest rate swaps that mature in December 2014 and give an effective rate during 2009 of 6.1%.

The Albertville Hangar Bond is a floating rate bond with an effective interest rate of 3.06%. This bond has been converted to a fixed rate using a floating to fixed rate swap, fixing the rate at 3.52%.

The US$500m 7.5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising a cross-currency swap and has an effective interest rate of 7.73%.

19. Loans and overdrafts *continued*

The debt-related derivative financial instruments represent the fair value of certain interest rate and cross-currency derivatives which are hedging specific loans disclosed within the above note, the US$500m 4.75% bond, repayable 2010, the US$1bn 6.4% bond, repayable 2011, Class B and G certificates, final instalments 2011/2013, the US$1bn 6.375% bond, repayable 2019, and the US$500m 7.5% bond repayable 2027. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

Finance lease obligations

The Group has a number of non-cancellable finance lease arrangements predominantly in respect of aircraft. The maturity of these lease liabilities from the balance sheet date is shown below.

	2009 £m	2008 £m
Finance lease liabilities – minimum lease payments due:		
Not later than one year	**7**	13
Later than one year and not later than five years	**1**	9
	8	22
Future finance charges on finance leases	**(1)**	(2)
Present value of finance lease liabilities	**7**	20
Present value of finance lease liabilities – payments due:		
Not later than one year	**6**	12
Later than one year and not later than five years	**1**	8
	7	20

Under the terms of the lease agreements, no contingent rents are payable.

The average interest rate on finance lease payables at 31 December 2009 was 5% (2008 7%).

20. Trade and other payables

	2009 £m	2008 £m
Non-current		
Amounts due to long-term contract customers	**142**	275
Cash received on customers' account[1] for long-term contracts	**5**	–
Other payables	**332**	329
Accruals and deferred income	**43**	97
	522	701
Current		
Amounts due to long-term contract customers	**5,533**	4,494
Amounts due to other customers	**216**	348
Cash received on customers' account[1]:		
Long-term contracts	**14**	5
Others	**1**	2
Trade payables	**1,063**	1,004
Amounts owed to equity accounted investments (note 31)	**1,353**	1,476
Other taxes and social security costs	**51**	67
Other payables[2]	**851**	400
Accruals and deferred income	**1,136**	1,369
	10,218	9,165

Included above:

	2009 £m	2008 £m
Amounts due to long-term contract customers	**5,694**	4,774
Advances from long-term contract customers, including progress payments in respect of work not yet performed	**5,416**	4,501

1 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance.
2 Other payables includes the regulatory penalties of £278m in 2009 reflecting the global settlement of the regulatory investigations by the US Department of Justice and the UK's Serious Fraud Office referred to in the Chairman's letter on page 3.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

21. Retirement benefit obligations

Pension plans

BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans, and the assets are held in separate trustee administered funds. The plans in other countries are unfunded or defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19, *Employee Benefits*, deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans 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 and updated to take account of the requirements of IAS 19 in order to assess the deficit of the plans at 31 December each year. Plan assets are shown at the bid value at 31 December each year.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2009. These plans were rolled forward to reflect the information at 31 December 2009. The method of accounting for these is similar to that used for defined benefit pension plans.

The financial assumptions used to calculate liabilities for the principal plans are:

	UK			US		
	2009 %	2008 %	2007 %	**2009** %	2008 %	2007 %
Inflation rate	**3.5**	2.9	3.3	**3.0**	3.0	3.0
Rate of increase in salaries	**4.5**	3.9	4.3	**4.5**	5.5	5.8
Rate of increase for pensions in payment	**2.3 – 3.7**	2.2 – 3.4	2.3 – 3.3	**–**	–	–
Rate of increase for deferred pensions	**3.5**	2.9	3.3	**n/a**	n/a	n/a
Discount rate	**5.7**	6.3	5.8	**5.9**	6.5	6.5
Long-term healthcare cost increases	**n/a**	n/a	n/a	**5.3**	5.3	5.4

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid value of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of plan liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, as at 31 December are shown in the tables below.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2009, continued to use PA 00 medium cohort 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 plan members. In addition, this mortality has been subject to a minimum assumed rate of future annual mortality improvements of 1%. For its US pension arrangements, the mortality tables used for pensioners and non-pensioners are RP 2000 projected to 2010. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 19 to 23 years for current male pensioners at age 65 and 22 to 25 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 9% in 2009 reducing to 5% by 2015 for pre-retirement and 10% in 2009 reducing to 5% for post-retirement.

A summary of the movements in the retirement benefit obligations is shown below. The full disclosures, as required by IAS 19, are provided in the subsequent information.

Additional disclosure – summary of movements of the retirement benefit obligations

	UK £m	US and other £m	**Total £m**
Deficit in defined benefit pension plans at 1 January 2009	(3,072)	(1,083)	**(4,155)**
Actual return on assets above expected return	994	264	**1,258**
Increase in liabilities due to changes in assumptions	(3,120)	(222)	**(3,342)**
One-off contributions	85	160	**245**
Recurring contributions in excess of service cost	244	(14)	**230**
Past service cost	(18)	(3)	**(21)**
Curtailment gains	–	261	**261**
Net financing charge	(119)	(26)	**(145)**
Exchange translation	–	96	**96**
Deficit in defined benefit pension plans at 31 December 2009	(5,006)	(567)	**(5,573)**
US healthcare plans	–	(43)	**(43)**
Total IAS 19 deficit	(5,006)	(610)	**(5,616)**
Allocated to equity accounted investments and other participating employers	979	–	**979**
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers	(4,027)	(610)	**(4,637)**

21. Retirement benefit obligations *continued*

The increase in the liabilities due to changes in assumptions is primarily due to a fall in corporate bond yields combined with an increase in the expected inflation rate which have combined to reduce the real discount rates used to calculate the liabilities of the pension plans as at 31 December 2009.

The curtailment gain recognised in the year relates to pension benefit restructuring in the US.

During the year, the Group contributed £225m into Trust for the benefit of the Group's main pension scheme. The contribution is reported within other investments – current (£211m after a fair value gain of £2m) and cash and cash equivalents (£16m) in the consolidated balance sheet at 31 December 2009, and the use of these assets is restricted under the terms of the Trust. However, the Group considers this contribution to be equivalent to the other one-off contributions it makes into the Group's pension schemes and, accordingly, presents below a definition of the pension deficit to include this contribution.

	31 December 2009 £m
Group's share of IAS 19 deficit	**(4,637)**
Assets held in Trust	**227**
Pension deficit as defined by the Group	**(4,410)**

Amounts recognised on the balance sheet

	2009				2008			
	UK defined benefit pension plans £m	**US and other pension plans £m**	**US healthcare plans £m**	**Total £m**	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Present value of unfunded obligations	**(10)**	**(115)**	**(11)**	**(136)**	(10)	(132)	(11)	(153)
Present value of funded obligations	**(17,776)**	**(2,587)**	**(140)**	**(20,503)**	(14,221)	(2,770)	(142)	(17,133)
Fair value of plan assets	**12,780**	**2,135**	**108**	**15,023**	11,159	1,819	92	13,070
Total IAS 19 deficit, net	**(5,006)**	**(567)**	**(43)**	**(5,616)**	(3,072)	(1,083)	(61)	(4,216)
Allocated to equity accounted investments and other participating employers	**979**	**–**	**–**	**979**	891	–	–	891
Group's share of IAS 19 deficit, net	**(4,027)**	**(567)**	**(43)**	**(4,637)**	(2,181)	(1,083)	(61)	(3,325)
Represented by:								
Pension prepayments (within trade and other receivables)	**–**	**42**	**–**	**42**	–	25	15	40
Retirement benefit obligations	**(4,027)**	**(609)**	**(43)**	**(4,679)**	(2,181)	(1,108)	(76)	(3,365)
	(4,027)	**(567)**	**(43)**	**(4,637)**	(2,181)	(1,083)	(61)	(3,325)
Group's share of IAS 19 deficit of equity accounted investments	**(128)**	**–**	**–**	**(128)**	(168)	–	–	(168)

Amounts for the current and previous four years are as follows:

Defined benefit pension plans	**2009 £m**	2008 £m	2007 £m	2006 £m	2005 £m
Defined benefit obligations	**(20,488)**	(17,133)	(17,109)	(17,456)	(17,767)
Plan assets at bid value	**14,915**	12,978	15,110	14,289	12,461
Total deficit before tax and allocation to equity accounted investments and other participating employers	**(5,573)**	(4,155)	(1,999)	(3,167)	(5,306)
Actuarial (loss)/gain on plan liabilities	**(3,342)**	1,433	952	473	(2,100)
Actuarial gain/(loss) on plan assets at bid value	**1,258**	(3,724)	(156)	521	1,138

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £3.4bn (2008 £1.4bn).

Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during the year ended 31 December 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments. In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

21. Retirement benefit obligations *continued*

Assets of defined benefit pension plans

	2009							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	**8,195**	**64**	**8.25**	**1,384**	**65**	**9.25**	**9,579**	**64**
Bonds	**3,411**	**27**	**4.8**	**551**	**26**	**6.0**	**3,962**	**27**
Property	**960**	**7**	**6.0**	**101**	**5**	**7.0**	**1,061**	**7**
Other	**214**	**2**	**1.0**	**99**	**4**	**4.0**	**313**	**2**
Total	**12,780**	**100**	**7.0**	**2,135**	**100**	**8.1**	**14,915**	**100**

	2008							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	6,964	62	8.25	1,110	61	9.25	8,074	62
Bonds	3,170	28	5.1	441	24	6.0	3,611	28
Property	846	8	6.0	193	11	7.0	1,039	8
Other	179	2	2.0	75	4	5.0	254	2
Total	11,159	100	7.1	1,819	100	8.07	12,978	100

When setting the overall expected rate of return on plan assets, historical markets are studied and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

Changes in the fair value of plan assets are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Value of plan assets at 1 January 2008	13,192	1,918	95	15,205
Assets acquired on acquisitions[1]	99	–	–	99
Expected return on assets	901	165	8	1,074
Actuarial loss	(2,956)	(768)	(39)	(3,763)
Actual return on assets	(2,055)	(603)	(31)	(2,689)
Contributions by employer	425	61	8	494
Contributions by employer in respect of employee salary sacrifice arrangements	112	–	–	112
Total contributions by employer	537	61	8	606
Members' contributions (including Department for Work and Pensions rebates)	42	11	–	53
Currency gain	–	533	25	558
Benefits paid	(656)	(101)	(5)	(762)
Value of plan assets at 31 December 2008	11,159	1,819	92	13,070
Expected return on assets	765	141	6	912
Actuarial gain	994	264	13	1,271
Actual return on assets	1,759	405	19	2,183
Contributions by employer	421	216	13	650
Contributions by employer in respect of employee salary sacrifice arrangements	107	–	–	107
Total contributions by employer	528	216	13	757
Members' contributions (including Department for Work and Pensions rebates)	36	18	–	54
Currency loss	–	(198)	(10)	(208)
Benefits paid	(702)	(125)	(6)	(833)
Value of plan assets at 31 December 2009	**12,780**	**2,135**	**108**	**15,023**

1 Acquired on formation of the BVT Surface Fleet Limited joint venture.

21. Retirement benefit obligations *continued*

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Defined benefit obligations at 1 January 2008	(15,100)	(2,009)	(116)	(17,225)
Net liabilities assumed on acquisitions[1]	(107)	–	–	(107)
Current service cost	(109)	(56)	(2)	(167)
Contributions by employer in respect of employee salary sacrifice arrangements	(112)	–	–	(112)
Total current service cost	(221)	(56)	(2)	(279)
Members' contributions (including Department for Work and Pensions rebates)	(42)	(11)	–	(53)
Past service cost	(23)	21	–	(2)
Actuarial gain/(loss) on liabilities	1,471	(38)	8	1,441
Interest expense	(865)	(137)	(8)	(1,010)
Currency loss	–	(773)	(40)	(813)
Benefits paid	656	101	5	762
Defined benefit obligations at 31 December 2008	(14,231)	(2,902)	(153)	(17,286)
Current service cost	(92)	(70)	(3)	(165)
Contributions by employer in respect of employee salary sacrifice arrangements	(107)	–	–	(107)
Total current service cost	(199)	(70)	(3)	(272)
Members' contributions (including Department for Work and Pensions rebates)	(36)	(18)	–	(54)
Past service cost	(18)	(3)	–	(21)
Actuarial loss on liabilities	(3,120)	(222)	(8)	(3,350)
Curtailment gains	–	261	–	261
Interest expense	(884)	(167)	(9)	(1,060)
Currency gain	–	294	16	310
Benefits paid	702	125	6	833
Defined benefit obligations at 31 December 2009	**(17,786)**	**(2,702)**	**(151)**	**(20,639)**

1 Acquired on formation of the BVT Surface Fleet Limited joint venture.

Contributions

The Group contributions made to the defined benefit plans in the year ended 31 December 2009 were £546m (2008 £399m) excluding those amounts allocated to equity accounted investments and participating employers (£91m). This includes an incremental contribution of $250m (£160m) which the Group made to the US pension schemes during the year. In 2010, the Group expects to make regular contributions at a similar level to those made in 2009.

The Group incurred a charge in respect of the cash contributions of £127m (2008 £84m) paid to defined contribution plans for employees. It expects to make a contribution of £141m to these plans in 2010.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

21. Retirement benefit obligations *continued*

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2009				2008			
	UK defined benefit pension plans £m	**US and other pension plans £m**	**US healthcare plans £m**	**Total £m**	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Included in operating costs:								
Current service cost	**(80)**	**(70)**	**(3)**	**(153)**	(83)	(56)	(2)	(141)
Past service cost	**(14)**	**(3)**	**–**	**(17)**	(21)	–	–	(21)
	(94)	**(73)**	**(3)**	**(170)**	(104)	(56)	(2)	(162)
Included in other income:								
Past service credit	**–**	**–**	**–**	**–**	–	21	–	21
Curtailment gains	**–**	**261**	**–**	**261**	–	–	–	–
	–	**261**	**–**	**261**	–	21	–	21
Included in finance costs:								
Expected return on plan assets	**630**	**141**	**6**	**777**	673	165	8	846
Interest on obligations	**(724)**	**(167)**	**(9)**	**(900)**	(650)	(137)	(8)	(795)
	(94)	**(26)**	**(3)**	**(123)**	23	28	–	51
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	**(9)**	**–**	**–**	**(9)**	(8)	–	–	(8)
Group's share of equity accounted investments' finance costs	**(3)**	**–**	**–**	**(3)**	2	–	–	2

A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	One percentage point increase £m	One percentage point decrease £m
(Increase)/decrease in the aggregate of service cost and interest cost	(0.2)	0.1
(Increase)/decrease in defined benefit obligations	(2.1)	1.7

A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect:

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Decrease/(increase) in defined benefit obligations	1.6	(1.6)

22. Provisions

	Aircraft financing £m	Warranties and after-sales service £m	Reorganisations – continuing operations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	30	104	10	238	77	459
Current	41	68	58	148	71	386
At 1 January 2009	71	172	68	386	148	845
Created	1	89	133	168	48	439
Released	–	(53)	(10)	(68)	(29)	(160)
Utilised	(37)	(51)	(44)	(61)	(16)	(209)
Provisions and fair values arising on acquisitions (note 29)	–	8	–	4	–	12
Discounting	4	–	–	16	5	25
Exchange adjustments	(1)	(2)	–	(13)	(7)	(23)
At 31 December 2009	**38**	**163**	**147**	**432**	**149**	**929**
Represented by:						
Non-current	20	99	21	169	68	377
Current	18	64	126	263	81	552
	38	**163**	**147**	**432**	**149**	**929**

Aircraft financing
The provision includes probable exposures under residual value guarantees issued by the Group on previous sales transactions. The Group has provided residual value guarantees in respect of certain commercial aircraft sold. At 31 December 2009, the Group's gross exposure to make future payments in respect of these arrangements was £48m (2008 £97m). The Group's net exposure to these guarantees is covered by the provisions held of £32m (2008 £58m) and the residual values of the related aircraft of £12m (2008 £37m). Such costs are generally incurred within five years.

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. Such costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum but not the timing of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels.

Reorganisations – continuing operations
The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Such costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

Legal, contractual and environmental provisions
The Group holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period.

These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

Other provisions
There are no individually significant provisions included within other provisions.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

23. Contingent liabilities and commitments

Guarantees and performance bonds
The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business. Provision is made for any amounts that the directors consider may become payable under such arrangements.

Operating lease commitments – where the Group is the lessee
The Group leases various offices, factories, shipyards and aircraft under non-cancellable operating lease agreements. The leases have varying terms including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2009 £m	2008 £m
Payments due:		
Not later than one year	**180**	177
Later than one year and not later than five years	**571**	546
Later than five years	**704**	679
	1,455	1,402
Total of future minimum sublease income under non-cancellable subleases	**286**	259

Capital commitments
Capital expenditure contracted for but not provided for in the accounts is as follows:

	2009 £m	2008 £m
Property, plant and equipment	**126**	133
Intangible assets	**7**	7
	133	140

24. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2008	3,574	90	1	1	90
Exercise of options	8	–	–	–	–
At 1 January 2009	3,582	90	1	1	90
Exercise of options	3	–	–	–	–
At 31 December 2009	**3,585**	**90**	**1**	**1**	**90**

Special Share
One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain parts of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These articles include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, the requirement that decisions of the directors at their meetings, in their committees or via resolution must be approved by a majority of British directors and the requirement that the Chief Executive and any executive chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Treasury shares
As at 31 December 2009, 43,952,360 (2008 55,038,953) ordinary shares of 2.5p each with an aggregate nominal value of £1,098,809 (2008 £1,375,974) were held in treasury. During 2009, 11,086,593 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme.

Authorised share capital
As agreed by the shareholders at the 2009 Annual General Meeting, the Company's Articles of Association were amended with effect from 1 October 2009 to remove the requirement for the Company to have an authorised share capital, the concept of which was abolished under the Companies Act 2006.

Other reserves

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Total £m
At 1 January 2009	4,589	202	–	787	396	5,974
Total recognised income and expense	–	–	74	(302)	(283)	(511)
At 31 December 2009	**4,589**	**202**	**74**	**485**	**113**	**5,463**

Merger reserve
The merger reserve arose on the acquisition of the Marconi Electronic Systems (MES) business by British Aerospace in 1999 to form BAE Systems, and represents the amount by which the fair value of the shares issued by British Aerospace as consideration exceeded their nominal value.

Statutory reserve
Under Section 4 of the British Aerospace Act 1980 the statutory reserve may only be applied in paying up unissued shares of the Group to be allotted to members of the Group as fully paid bonus shares.

Revaluation reserve
The revaluation reserve relates to the revaluation at fair value of the net assets previously held as an equity accounted investment relating to the BVT joint venture on the acquisition of the remaining 45% interest in 2009.

Translation reserve
The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

Hedging reserve
The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

Own shares held
Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

24. Share capital and other reserves *continued*

BAE Systems ESOP Trust
The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and December 2009.

At 31 December 2009, the ESOP held 3,644,598 (2008 2,093,818) ordinary shares of 2.5p each with a market value of £13m (2008 £8m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2009 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and December 2009 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

Capital
The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2009, the Group's capital was £4,614m (2008 £6,893m), which comprises total equity of £4,727m (2008 £7,289m), less amounts accumulated in equity relating to cash flow hedges of £113m (2008 £396m). Net cash as defined by the Group was £403m (2008 £39m).

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. The Group's policy is to maintain an investment grade credit rating. The Group's dividend policy is to grow the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

25. Share-based payments

Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 90 to 111.

Executive Share Option Scheme (ExSOS)
Equity-settled options

	2009		2008	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**23,731**	**3.49**	31,728	3.33
Exercised during the year	**(1,931)**	**2.40**	(6,921)	2.67
Expired during the year	**(3,570)**	**4.14**	(1,076)	4.19
Outstanding at the end of the year	**18,230**	**3.48**	23,731	3.49
Exercisable at the end of the year	**13,506**	**3.09**	13,628	2.78

Cash-settled share appreciation rights

	2009		2008	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**12,667**	**2.65**	16,993	2.67
Exercised during the year	**(1,420)**	**2.15**	(3,963)	2.71
Expired during the year	**(1,159)**	**3.54**	(363)	2.95
Outstanding at the end of the year	**10,088**	**2.62**	12,667	2.65
Exercisable at the end of the year	**10,088**	**2.62**	12,522	2.64

	2009		2008	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	**1.72 – 4.79**	**1.72 – 3.98**	1.72 – 4.79	2.01 – 4.21
Weighted average remaining contracted life (years)	**6**	**3**	6	4
Expense/(credit) recognised for the year (£m)	**2**	**(2)**	5	(18)

25. Share-based payments *continued*

Performance Share Plan (PSP)
Equity-settled options

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	**20,880**	20,952
Granted during the year	**12,701**	7,507
Exercised during the year	**(4,445)**	(6,433)
Expired during the year	**(2,941)**	(1,146)
Outstanding at the end of the year	**26,195**	20,880
Exercisable at the end of the year	**2,212**	2,151

Cash-settled options

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	**3,143**	7,949
Exercised during the year	**(2,291)**	(4,368)
Expired during the year	**(35)**	(438)
Outstanding at the end of the year	**817**	3,143

No options were exercisable at the end of the year.

	2009		2008	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Weighted average remaining contracted life (years)	**5**	**2**	5	3
Weighted average fair value of options granted (£)	**2.81**	**–**	3.78	–
Expense/(credit) recognised for the year (£m)	**8**	**1**	10	(1)

The exercise price for the PSP is £nil (2008 £nil).

Restricted Share Plan (RSP)
All awards are equity-settled.

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	**216**	603
Exercised during the year	**(216)**	(385)
Expired during the year	**–**	(2)
Outstanding at the end of the year	**–**	216
Exercisable at the end of the year	**–**	3

	2009	2008
Weighted average remaining contracted life (years)	**–**	–
Expense recognised for the year (£m)	**–**	–

The exercise price for the RSP is £nil (2008 £nil).

Share Matching Plan (SMP)
All awards are equity-settled.

	2009 Number of shares '000	2008 Number of shares '000
Outstanding at the beginning of the year	**1,811**	463
Granted during the year	**7,661**	1,470
Exercised during the year	**(94)**	(110)
Expired during the year	**(698)**	(12)
Outstanding at the end of the year	**8,680**	1,811
Exercisable at the end of the year	**–**	–

	2009	2008
Weighted average remaining contracted life (years)	**2**	2
Weighted average fair value of options granted (£)	**3.43**	4.79
Expense recognised for the year (£m)	**3**	2

The exercise price for the SMP is £nil (2008 £nil).

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

25. Share-based payments *continued*

Save-As-You-Earn (SAYE)
Equity-settled options

	2009		2008	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**4,636**	**1.56**	9,477	1.25
Exercised during the year	**(4,550)**	**1.56**	(4,597)	0.94
Expired during the year	**(82)**	**1.54**	(244)	1.31
Outstanding at the end of the year	**4**	**1.56**	4,636	1.56
Exercisable at the end of the year	**4**	**1.56**	94	0.92

Cash-settled share appreciation rights

	2009		2008	
	Number of shares '000	**Weighted average exercise price £**	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	**2,895**	**3.56**	5,154	3.14
Exercised during the year	**(349)**	**3.56**	(1,949)	2.46
Expired during the year	**(2,546)**	**3.56**	(310)	3.53
Outstanding at the end of the year	**–**	**–**	2,895	3.56
Exercisable at the end of the year	**–**	**–**	2,895	3.56

	2009		2008	
	Equity-settled	**Cash-settled**	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	**1.56**	**–**	0.93 – 1.56	3.85
Weighted average remaining contracted life (years)	**–**	**–**	1	–
(Credit)/expense recognised for the year (£m)	**–**	**(1)**	1	(4)

Details of options granted in the year
The fair value of both equity-settled awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

PSP – Monte Carlo
SMP – Dividend valuation model

	2009	2008
Range of share price at date of grant (£)	**3.23 – 3.43**	3.48 – 5.05
Exercise price (£)	**–**	–
Expected option life (years)	**3 – 4**	3 – 4
Volatility	**34%**	25 – 32%
Spot dividend yield	**4.2 – 4.6%**	3.0 – 4.4%
Risk free interest rate	**1.7 – 1.8%**	2.4 – 3.9%

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £3.44 (2008 £4.33).

The liability in respect of the cash-settled elements of the schemes shown above and reported within liability provisions at 31 December 2009 is £12m (2008 £26m).

The intrinsic value of cash-settled options that have vested at 31 December 2009 is £10m (2008 £15m).

Share Incentive Plan
The Group also incurred a charge of £31m (2008 £28m) in respect of the all-employee free shares element of the Share Incentive Plan.

26. Reconciliation of operating business cash flow

	2009 £m	2008 £m
Cash inflow from operating activities	**2,232**	2,009
Purchases of property, plant and equipment	**(483)**	(520)
Purchases of intangible assets	**(42)**	(32)
Proceeds from the sale of property, plant and equipment	**36**	44
Proceeds from the sale of investment property	**–**	5
Dividends received from equity accounted investments	**77**	89
Assets contributed to Trust	**(225)**	–
Operating business cash flow	**1,595**	1,595

Electronics, Intelligence & Support	**380**	380
Land & Armaments	**480**	467
Programmes & Support	**285**	651
International	**816**	163
HQ & Other Businesses	**(366)**	(66)
Operating business cash flow	**1,595**	1,595

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

27. Net cash as defined by the Group

	2009 £m	2008 £m
Debt-related derivative financial instrument assets – current	**12**	–
Debt-related derivative financial instrument assets – non-current	**27**	203
Other investments – current	**211**	–
Cash and cash equivalents	**3,693**	2,624
	3,943	2,827
Loans – non-current	**(2,840)**	(2,608)
Loans – current	**(438)**	(154)
Overdrafts – current	**(15)**	(19)
Loans and overdrafts – current	**(453)**	(173)
Cash received on customers' account[1]	**(20)**	(7)
Assets held in Trust	**(227)**	–
	(3,540)	(2,788)
Closing net cash as defined by the Group	**403**	39

Movement in net cash as defined by the Group

	2009 £m	2008 £m
Operating business cash flow	**1,595**	1,595
Interest	**(186)**	(98)
Taxation	**(350)**	(261)
Free cash inflow	**1,059**	1,236
Acquisitions and disposals	**(253)**	(1,001)
Debt acquired on acquisition of subsidiary undertakings	**(1)**	(37)
Proceeds from issue of share capital	**5**	16
Equity dividends paid	**(534)**	(478)
Dividends paid to minority interests	**(5)**	(11)
Purchase of own shares	**(25)**	(43)
Cash inflow/(outflow) from matured derivative financial instruments	**36**	(440)
Cash (outflow)/inflow from movement in cash collateral	**(11)**	106
Other non-cash movements	**(157)**	339
Foreign exchange	**262**	(374)
Movement in cash received on customers' account[1]	**(12)**	26
Movement in net cash as defined by the Group	**364**	(661)
Opening net cash as defined by the Group	**39**	700
Closing net cash as defined by the Group	**403**	39

1 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance. It is included within trade and other payables in the Group's balance sheet.

Cash flows in relation to acquisitions and disposals

	Subsidiaries					Equity accounted investments		
	BVT £m	Advanced Ceramics Research £m	**Total acquisitions £m**	Inertial Products £m	**Total disposals £m**	Flagship Training £m	Diamond Detectors £m	**Total £m**
Cash (consideration)/proceeds	(348)	(9)	**(357)**	2	**2**	70	(1)	**(286)**
Cash and cash equivalents net of overdrafts acquired	33	–	**33**	–	**–**	–	–	**33**
Acquisitions and disposals	(315)	(9)	**(324)**	2	**2**	70	(1)	**(253)**
Debt acquired on acquisition of subsidiary	–	(1)	**(1)**	–	**–**	–	–	**(1)**
	(315)	(10)	**(325)**	2	**2**	70	(1)	**(254)**

28. Dividends

Equity dividends	2009 £m	2008 £m
Prior year final 8.7p dividend per ordinary share paid in the year (2008 7.8p)	**307**	274
Interim 6.4p dividend per ordinary share paid in the year (2008 5.8p)	**227**	204
	534	478

After the balance sheet date, the directors proposed a final dividend of 9.6p (2008 8.7p). The dividend, which is subject to shareholder approval, will be paid on 1 June 2010 to shareholders registered on 23 April 2010. The ex-dividend date is 21 April 2010.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 10 May 2010.

29. Acquisition of subsidiaries

Acquisition of subsidiaries for the year ended 31 December 2009
The most significant acquisition made by the Group during the year ended 31 December 2009 was of the 45% shareholding in BVT Surface Fleet Limited (BVT) held by VT Group plc (VT). If the acquisition had occurred on 1 January 2009, combined sales of Group and equity accounted investments would have been £22.8bn, revenue £21.3bn and loss for the year ended 31 December 2009 £58m.

BVT (now BAE Systems Surface Ships)
On 30 October 2009, the BVT joint venture became a wholly-owned subsidiary of the Group after VT Group plc exercised its option to sell its 45% shareholding in BVT to BAE Systems. Consideration paid including transaction costs for the remaining 45% interest was £348m. The now wholly-owned company has been renamed BAE Systems Surface Ships Limited (Surface Ships). The Group previously held a 55% interest in BVT, and accounted for its share of the results and net assets of BVT in accordance with IAS 31, *Interests in Joint Ventures*.

Total provisional goodwill arising amounted to £584m. This consists of £225m which arose on the initial formation of the BVT joint venture in the year ended 31 December 2008 and £359m arising on the acquisition of the 45% interest.

In the period from acquisition to 31 December 2009, Surface Ships contributed revenue and profit after tax of £338m and £34m, respectively, to the Group's consolidated results as a wholly-owned subsidiary.

Surface Ships is a leading designer, manufacturer and integrator of surface ships and their support vessels. It delivers complex engineering, integration and through-life support across the lifecycle of a ship. Bringing Surface Ships into full ownership of BAE Systems further strengthens the Group's global maritime business and is consistent with the strategy to establish a sustainable and profitable through-life business in air, land and sea. Surface Ships has a solid order book, a clear strategy to transform the UK maritime sector and a commitment to deliver existing and future programmes.

The acquisition of BVT had the following effect on the Group's assets and liabilities. The figures in the table below represent a 100% interest in BVT.

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	–	–	225	225
Property, plant and equipment	136	–	–	136
Inventories	61	–	–	61
Receivables	225	–	–	225
Deferred tax assets	2	–	3	5
Payables	(433)	–	(164)	(597)
Current tax liabilities	(16)	–	–	(16)
Deferred tax liabilities	(6)	–	(63)	(69)
Provisions	(12)	–	–	(12)
Cash and cash equivalents	33	–	–	33
Net (liabilities)/assets acquired	**(10)**	**–**	**1**	**(9)**
Goodwill				**584**
Fair value of net liabilities acquired and goodwill arising				**575**

Components of cost of acquisitions:	
Fair value of consideration for initial 55% shareholding in 2008	189
Fair value of consideration for remaining 45% shareholding in 2009	348
Total cost of acquisition	537
Losses under equity method of initial 55% shareholding	(36)
Gain on revaluation of step acquisition	74
Fair value of net liabilities acquired and goodwill arising	575

Consideration satisfied by:	
Cash paid on acquisition of remaining 45% shareholding in 2009	346
Directly attributable costs:	
Paid	2
Cash consideration	348
Fair value of net assets contributed to BVT joint venture for initial 55% shareholding in 2008	178
Directly attributable costs:	
Paid	11
Total cost of acquisition	537

The intangible assets acquired as part of the acquisition of BVT can be analysed as follows:

	£m
Order backlog	225
	225

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

29. Acquisition of subsidiaries *continued*

Advanced Ceramics Research
The Group acquired Advanced Ceramics Research, Inc. in the US on 8 June 2009 for a consideration of $14m (£9m). The net assets and goodwill included in the Group's consolidated balance sheet as a result of this acquisition are £1m and £8m, respectively.

Acquisition of subsidiaries for the year ended 31 December 2008
The Group acquired MTC Technologies, Inc. (MTC) in the US on 9 June 2008, Tenix Defence in Australia on 27 June 2008 and Detica Group plc (Detica) on 25 September 2008. If the acquisitions had occurred on 1 January 2008, combined sales of Group and equity accounted investments would have been £19.0bn, revenue £17.2bn and profit for the year ended 31 December 2008 £1.8bn.

MTC
On 9 June 2008, the Group acquired 100% of the issued share capital of MTC in the US for a cash consideration including transaction costs of $375m (£188m). Goodwill arising on consolidation amounted to £131m.

Based in Dayton, Ohio, MTC provides technical and professional services, and equipment integration and modernisation for the US military and intelligence agencies.

In the period from acquisition to 31 December 2008, MTC contributed revenue and loss after tax of £98m and £1m, respectively, to the Group's consolidated results.

The acquisition of MTC complements the existing US business in the Electronics, Intelligence & Support operating group. It allows for synergies in professional services, aircraft integration centres, and modification and sustainment. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within the Electronics, Intelligence & Support operating group supporting the goodwill.

The MTC acquisition had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	12	–	13	25
Property, plant and equipment	14	(1)	5	18
Inventories	4	–	1	5
Receivables	48	–	–	48
Deferred tax assets	1	–	15	16
Payables	(23)	–	(1)	(24)
Deferred tax liabilities	(4)	–	4	–
Provisions	–	–	(1)	(1)
Cash and cash equivalents	2	–	–	2
Loans	(32)	–	–	(32)
Net assets/(liabilities) acquired	**22**	**(1)**	**36**	**57**
Goodwill				**131**
Consideration				**188**

Consideration satisfied by:	
Cash	184
Directly attributable costs:	
Paid	4
	188

The intangible assets acquired as part of the acquisition of MTC can be analysed as follows:

	£m
Customer relationships	21
Technology	4
	25

29. Acquisition of subsidiaries *continued*

Tenix Defence

Tenix Defence Holdings Pty Limited (Tenix Defence), a leading Australian defence contractor, comprises four businesses in the Land, Aerospace, Electronic Systems and Marine sector.

On 27 June 2008, the Group acquired 100% of the issued share capital of Tenix Defence for a cash consideration including transaction costs paid of A$697m (£328m), subject to adjustment according to the level of working capital in the business at the acquisition date.

In the period from acquisition to 31 December 2008, Tenix Defence contributed revenue, EBITA[1] and loss after tax of £130m, £12m loss and £39m, respectively, to the Group's consolidated results. Included within the loss after tax of £39m is an amortisation expense on intangible assets of £29m.

The acquisition of Tenix Defence complements the existing Australian business enabling BAE Systems to establish a greater presence in the Australian defence market and in particular to expand into the Australian land and marine sectors. These opportunities do not translate into separately identifiable intangible assets, but represent much of the assessed value within Tenix Defence supporting the recognised goodwill.

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

The acquisition of Tenix Defence had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	5	(2)	91	94
Property, plant and equipment	36	(2)	43	77
Receivables	68	–	–	68
Deferred tax assets	–	–	9	9
Payables	(99)	(21)	(118)	(238)
Provisions	(1)	(3)	1	(3)
Net assets/(liabilities) acquired	**9**	**(28)**	**26**	**7**
Provisional goodwill				**323**
Consideration				**330**

	£m
Consideration satisfied by:	
Cash	323
Directly attributable costs:	
Paid	5
Accrued	2
	330

The fair value adjustment to payables of £118m is in respect of provisions for contract losses.

The intangible assets acquired as part of the acquisition of Tenix Defence can be analysed as follows:

	£m
Programmes	75
Order backlog	4
Patents	15
	94

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

29. Acquisition of subsidiaries *continued*

Detica

On 25 September 2008, the Group's offer for the acquisition of Detica for £543m including assumption of net debt became wholly unconditional. Detica is a specialist business and technology consultancy with expertise in information exploitation, security and resilience, threat intelligence and customer insight.

In the period from acquisition to 31 December 2008, Detica contributed revenue and profit after tax of £60m (UK £55m) and £1m, respectively, to the Group's consolidated results.

The acquisition of Detica provides access to UK and US government contracting opportunities in the intelligence, security and resilience market and significant cross-selling opportunities, particularly in our home markets. The combination of capabilities within Detica and BAE Systems will provide innovative solutions in this growing sector. The opportunities presented by these circumstances do not translate to separately identifiable intangible assets, but represent much of the assessed value within BAE Systems supporting the recognised goodwill.

The acquisition of Detica had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	3	–	91	94
Property, plant and equipment	15	–	–	15
Inventories	2	–	–	2
Receivables	69	–	–	69
Deferred tax assets	2	–	–	2
Payables	(46)	–	–	(46)
Current tax liabilities	–	–	(1)	(1)
Deferred tax liabilities	(1)	–	(24)	(25)
Overdrafts	(4)	–	–	(4)
Loans	(5)	–	–	(5)
Net assets acquired	**35**	**–**	**66**	**101**
Provisional goodwill				**442**
Consideration				**543**

Consideration satisfied by:	
Cash	531
Directly attributable costs:	
Paid	12
	543

The intangible assets acquired as part of the acquisition of Detica can be analysed as follows:

	£m
Order backlog	22
Customer relationships	22
Trademarks	30
Software	20
	94

Other acquisitions

Other acquisitions included the acquisitions of 100% of the issued share capital of Tenix Toll Defence Logistics Pty Limited, formerly a joint venture between Tenix and Toll Holdings Pty Limited, for A$24m (£12m) and 100% of the issued share capital of IST Dynamics for £7m. As a result of these acquisitions, £7m of goodwill was generated in the year ended 31 December 2008.

Certain of the fair values assigned to the net assets at the dates of acquisition were provisional, and in accordance with IFRS 3, *Business Combinations*, the Group has adjusted the fair values attributable to these acquisitions in the year ended 31 December 2009, resulting in a net increase in goodwill of £5m. This has not had a material impact on the consolidated accounts and, as such, the Group has not restated the balance sheet as at 31 December 2008.

30. Financial risk management

A discussion of the Group's treasury objectives and policies and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net cash/(debt) (note 27) together with other financial assets and other financial liabilities (note 17) and other instruments deemed to be financial instruments under IAS 32, *Financial Instruments: Presentation*, including non-current receivables, non-current payables and non-current provisions.

Hedging instruments

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

	31 December 2009				31 December 2008			
Foreign exchange contracts	**Not exceeding one year £m**	**Between one year and five years £m**	**More than five years £m**	**Total £m**	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Net forward (sales)/purchase contracts								
US dollar	**(614)**	**202**	**53**	**(359)**	(1,199)	248	8	(943)
Euro	**1,882**	**392**	**17**	**2,291**	2,286	620	4	2,910
Other	**44**	**71**	**–**	**115**	132	2	–	134
	1,312	**665**	**70**	**2,047**	1,219	870	12	2,101

	31 December 2009				31 December 2008			
Interest rate contracts	**Not exceeding one year £m**	**Between one year and five years £m**	**More than five years £m**	**Total £m**	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Interest rate swap contracts								
US dollar	**310**	**1,115**	**–**	**1,425**	–	896	–	896
Sterling	**31**	**115**	**–**	**146**	33	146	–	179
	341	**1,230**	**–**	**1,571**	33	1,042	–	1,075

	31 December 2009				31 December 2008			
Cross-currency swap contracts	**Not exceeding one year £m**	**Between one year and five years £m**	**More than five years £m**	**Total £m**	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Net forward purchase contracts								
US dollar	**51**	**965**	**310**	**1,326**	58	303	345	706
	51	**965**	**310**	**1,326**	58	303	345	706

Fair value of financial instruments

The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

– the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;

– the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates; and

– the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

30. Financial risk management *continued*

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date[1].

	Net carrying amount 2009 £m	**Estimated fair value 2009 £m**	Net carrying amount 2008 £m	Estimated fair value 2008 £m
Assets				
Non-current				
Other receivables[2]	**159**	**159**	125	125
Other financial assets	**133**	**133**	514	514
Current				
Available-for-sale investments	**211**	**211**	–	–
Other financial assets	**216**	**216**	674	674
Cash and cash equivalents	**3,693**	**3,693**	2,624	2,624
Liabilities				
Non-current				
Loans	**(2,840)**	**(3,266)**	(2,608)	(3,090)
Other financial liabilities	**(261)**	**(261)**	(383)	(383)
Current				
Loans and overdrafts	**(453)**	**(454)**	(173)	(173)
Other financial liabilities	**(94)**	**(94)**	(362)	(362)

1 The estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date.
2 Net carrying amount approximates to estimated fair value as there is no active market.

Fair value hierarchy

Effective 1 January 2009, the Group adopted the amendment to IFRS 7, *Financial Instruments: Disclosures,* for financial instruments that are measured in the balance sheet at fair value. This requires disclosure of fair value measurements by level of the following fair value measurement hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

The following table presents the Group's assets and liabilities that are measured at fair value at 31 December 2009.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Available-for-sale investments	211	–	–	211
Derivatives used for hedging	197	61	–	258
Financial assets at fair value through profit or loss	46	6	–	52
Debt-related derivative financial instruments	–	39	–	39
Total assets	454	106	–	560
Liabilities				
Loans and receivables	–	(1,118)	–	(1,118)
Derivatives used for hedging	(68)	(81)	–	(149)
Financial liabilities at fair value through profit or loss	(43)	(163)	–	(206)
Debt-related derivative financial instruments	–	(23)	–	(23)
Total liabilities	(111)	(1,385)	–	(1,496)

Level 1 includes foreign exchange hedges valued at unadjusted quoted prices at less than two years' maturity. Level 2 includes all other fair value items and foreign exchange hedges greater than two years' maturity.

Interest rate risk

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m	Beyond 2014 £m
Assets						
Current						
Cash and cash equivalents	3,693	–	–	–	–	–
Liabilities						
Non-current						
Loans	(865)	(865)	(714)	(689)	(619)	(310)
Current						
Loans and overdrafts	(349)	–	–	–	–	–

30. Financial risk management *continued*

Collateral

As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2009 totalled £11m (2008 £nil).

Liquidity risk

Cash flow forecasting is performed by each line of business as part of the Integrated Business Planning process and as part of the monthly reporting cycle. The Group monitors a rolling forecast of liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities at all times so that it does not breach borrowing limits or covenants.

Surplus cash held by the operating groups over and above balances required for working capital management is loaned to the Group's centralised treasury department. Surplus cash is invested in interest bearing current accounts, term deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient headroom as determined by the line of business cash forecasts.

At 31 December 2009, the Group had a committed Revolving Credit Facility (RCF) of £1.455bn (2008 £1.5bn). The £45m commitment in the RCF from Lehman Brothers Commercial Paper Inc. was cancelled during 2009 following an all bank consent process. The RCF is contracted until 2012, although the available amount for the final year reduces to £1.3bn. The RCF remained undrawn throughout the year.

Interest rate risk

The objective of interest rate risk management is to reduce the Group's exposure to interest rate fluctuations on borrowings and deposits through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps.

The Group's current interest rate management policy is that a minimum of 50% (2008 25%) and a maximum of 75% (2008 75%) of debt is maintained at fixed interest rates. At 31 December 2009, the Group had 62% (2008 73%) of fixed rate debt and 38% (2008 27%) of floating rate debt based on a gross debt of £3.3bn including debt-related derivative financial assets (2008 £2.6bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2009, the Group had a total of $1.9bn (2008 $1.3bn) of this type of swap outstanding with a weighted average duration of 4.2 years (2008 2.4 years). In respect of the fixed rate debt the weighted average period in respect of which interest is fixed was 6.4 years (2008 7 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 3.4% (2008 5.2%), 3.0% on US dollars and 2.3% on sterling (2008 3.5% on US dollars and 8% on sterling). The cost of the fixed rate debt was 6.3% (2008 6.8%). A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £12m (2008 £6m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £17m (2008 £12m).

Credit risk

The Group is exposed to credit risk on its cash and cash equivalents to the extent of non-performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. The Group has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2009 of £3,693m (2008 £2,624m) was invested with 26 (2008 14) financial institutions. The system assigns a maximum exposure based on the counterparty's size, a composite credit rating and credit default swap price. These limits are regularly monitored and updated. The Group has material receivables due from the UK and US governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 5% of the balance (2008 2%).

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has reduced its exposure to credit risk through this process.

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

The Group's objective is to reduce its exposure to volatility in earnings and cash flows as a result of movements in foreign currency exchange rates. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.

The Group is exposed to movements in foreign currency exchange rates in respect of foreign currency denominated transactions. To mitigate this risk, the Group's policy is to hedge all material firm transactional exposures, unless otherwise approved as an exception by the Treasury Review Management Committee, as well as to manage anticipated economic cash flows over the medium term. The Group aims, where possible, to apply hedge accounting treatment for all derivatives that hedge material transactional foreign currency exposures.

The Group is also exposed to movements in foreign currency exchange rates in respect of the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of overseas subsidiaries and equity accounted investments it regards as long-term investments. Hedges are, however, undertaken in respect of investments that are not considered long-term or core to the Group.

NOTES TO THE GROUP ACCOUNTS *CONTINUED*

31. Related party transactions

The Group has a related party relationship with its directors and key management (as disclosed in the Remuneration report on pages 90 to 111 and in note 7), its equity accounted investments (note 14) and the pension plans (note 21).

Transactions occur with the equity accounted investments in the normal course of business and are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

Related party	Sales to related party 2009 £m	Sales to related party 2008 £m	Purchases from related party 2009 £m	Purchases from related party 2008 £m	Amounts owed by related party 2009 £m	Amounts owed by related party 2008 £m	Amounts owed to related party 2009 £m	Amounts owed to related party 2008 £m	Lease income/(expense) with related party 2009 £m	Lease income/(expense) with related party 2008 £m	Management recharges 2009 £m	Management recharges 2008 £m
BVT Surface Fleet Limited[1]	**64**	74	**4**	1	**–**	4	**–**	54	**–**	–	**–**	–
Eurofighter Jagdflugzeug GmbH	**1,073**	889	**–**	–	**132**	61	**159**	221	**–**	–	**–**	–
Gripen International KB	**1**	1	**–**	–	**59**	114	**98**	161	**–**	–	**–**	–
MBDA SAS	**46**	56	**302**	10	**4**	9	**1,080**	1,034	**2**	–	**18**	15
Panavia Aircraft GmbH	**52**	57	**103**	127	**9**	11	**15**	4	**–**	–	**6**	2
Saab AB	**5**	4	**17**	9	**–**	1	**1**	2	**–**	–	**–**	–
CTA International SAS	**–**	–	**–**	–	**3**	–	**–**	–	**–**	–	**–**	–
	1,241	1,081	**426**	147	**207**	200	**1,353**	1,476	**2**	–	**24**	17

1 To date of acquisition (30 October 2009).

32. Group entities

Principal subsidiary undertakings	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
BAE Systems (Operations) Limited *(Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)*	Defence and commercial aerospace activities	100% Ordinary	UK	England and Wales
BAE Systems Information and Electronic Systems Integration Inc. *(Held via BAE Systems, Inc.)*	Designs, develops and manufactures electronic systems and subsystems	100% Common	US	US
BAE Systems Controls Inc. *(Held via BAE Systems, Inc.)*	Designs, develops and manufactures military defence electronics equipment	100% Common	US	US
BAE Systems Land & Armaments LP *1300 North 17th Street, Suite 1400, Arlington VA 22209, USA* *(Partners: BAE Systems Land & Armaments Inc. and BAE Systems Land & Armaments Holdings Inc.)*	Manufactures and supports military vehicles	100%	US	US
Armor Holdings, Inc. *(formerly BAE Systems AH Inc.)* *(Held via BAE Systems, Inc.)*	Manufactures military vehicles and supplies vehicle and armour systems	100% Common	US	US
BAE Systems Tactical Vehicle Systems LP *5000 Interstate 10 West, Sealy, TX 77474, USA* *(Partners: BAE Systems TVS Holdings LLC and BAE Systems TVS Inc.)*	Mobility and protection systems	100%	US	US

The Group comprises a large number of subsidiary undertakings and it is not practical to include all of them in the above list. The list therefore only includes those subsidiary undertakings which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2009 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group consolidation.

33. Events after the balance sheet date

On 5 February 2010, the Group announced a global settlement with the US Department of Justice and the UK's Serious Fraud Office in respect of investigations announced by these two authorities in 2007 and 2004, respectively. This is an adjusting event after the balance sheet date in accordance with IAS 10, *Events after the Reporting Period,* and, accordingly, the penalties totalling £278m have been reflected in the Group's accounts for the year ended 31 December 2009.

On 15 February 2010, the Group announced that it had been informed that the decision by the US Department of Defense not to award a follow-on contract for production of vehicles under the Family of Medium Tactical Vehicles (FMTV) programme to BAE Systems had been confirmed. This is an adjusting event after the balance sheet date in accordance with IAS 10 and, accordingly, impairment of goodwill and other intangible assets amounting to £592m relating to the Armor Holdings, Inc. transaction and specifically the FMTV product line have been reflected in the Group's accounts for the year ended 31 December 2009.

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Condensed consolidated income statement

	Notes	Six months ended 30 June 2011 £m	Six months ended 30 June 2011 £m	Restated[1] Six months ended 30 June 2010 £m	Restated[1] Six months ended 30 June 2010 £m
Continuing operations					
Combined sales of Group and share of equity accounted investments	2		**9,229**		10,582
Less: Share of sales of equity accounted investments	2		**(549)**		(479)
Revenue	2		**8,680**		10,103
Operating costs			**(8,009)**		(9,369)
Other income			**52**		64
Group operating profit excluding amortisation and impairment of intangible assets		**871**		1,017	
Amortisation	2	**(126)**		(211)	
Impairment	2	**(22)**		(8)	
Group operating profit			**723**		798
Share of results of equity accounted investments excluding finance costs and taxation expense		**42**		62	
Financial income of equity accounted investments	3	**4**		2	
Taxation expense of equity accounted investments		**(12)**		(13)	
Share of results of equity accounted investments			**34**		51
EBITA[2] excluding non-recurring items	2	**968**		1,097	
Loss on disposal of businesses[3]	2	**(6)**		–	
Regulatory penalties[3]	2	**(49)**		(18)	
EBITA[2]		**913**		1,079	
Amortisation	2	**(126)**		(211)	
Impairment	2	**(22)**		(8)	
Financial income of equity accounted investments	3	**4**		2	
Taxation expense of equity accounted investments		**(12)**		(13)	
Operating profit			**757**		849
Finance costs	3				
Financial income		**826**		905	
Financial expense		**(892)**		(973)	
			(66)		(68)
Profit before taxation			**691**		781
Taxation expense					
UK taxation		**(82)**		(96)	
Overseas taxation		**(109)**		(133)	
			(191)		(229)
Profit for the period – continuing operations			**500**		552
(Loss)/profit for the period – discontinued operations	4		**(16)**		73
Profit for the period			**484**		625
Attributable to:					
BAE Systems shareholders			**478**		618
Non-controlling interests			**6**		7
			484		625
Earnings per share	5				
Basic earnings per share			**14.0p**		17.7p
Diluted earnings per share			**14.0p**		17.7p
Earnings per share – continuing operations	5				
Basic earnings per share			**14.5p**		15.6p
Diluted earnings per share			**14.5p**		15.6p

1 Restated following the classification of the Regional Aircraft line of business as a discontinued operation (see note 4).
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
3 Included in operating costs.

Condensed consolidated statement of comprehensive income

	Six months ended 30 June 2011			Six months ended 30 June 2010		
	Other reserves £m	**Retained earnings £m**	**Total £m**	Other reserves £m	Retained earnings £m	Total £m
Profit for the period	**–**	**484**	**484**	–	625	625
Other comprehensive income						
Currency translation on foreign currency net investments:						
Subsidiaries	**(58)**	**–**	**(58)**	243	–	243
Equity accounted investments	**33**	**–**	**33**	(29)	–	(29)
Amounts charged to hedging reserve	**–**	**–**	**–**	(93)	–	(93)
Net actuarial losses on defined benefit pension schemes:						
Subsidiaries	**–**	**(228)**	**(228)**	–	(595)	(595)
Equity accounted investments	**–**	**(16)**	**(16)**	–	(9)	(9)
Fair value movements on available-for-sale investments	**–**	**1**	**1**	–	14	14
Recycling of fair value movements on available-for-sale investments	**–**	**(5)**	**(5)**	–	–	–
Recycling of cumulative currency translation reserve on disposal	**–**	**–**	**–**	(17)	–	(17)
Recycling of cumulative net hedging reserve on disposal	**–**	**–**	**–**	(4)	–	(4)
Current tax on items taken directly to equity	**–**	**22**	**22**	–	18	18
Deferred tax on items taken directly to equity:						
Subsidiaries	**–**	**41**	**41**	24	170	194
Tax rate adjustment[1]	**–**	**(26)**	**(26)**	–	–	–
Equity accounted investments	**–**	**5**	**5**	–	3	3
Total other comprehensive income for the period (net of tax)	**(25)**	**(206)**	**(231)**	124	(399)	(275)
Total comprehensive income for the period	**(25)**	**278**	**253**	124	226	350
Attributable to:						
Equity shareholders	**(25)**	**272**	**247**	124	219	343
Non-controlling interests	**–**	**6**	**6**	–	7	7
	(25)	**278**	**253**	124	226	350

Condensed consolidated statement of changes in equity

	Attributable to equity holders of the parent						
	Issued share capital £m	Share premium £m	Other reserves[3] £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2011	90	1,249	5,470	(1,477)	5,332	71	5,403
Profit for the period	–	–	–	478	478	6	484
Total other comprehensive income for the period	–	–	(25)	(206)	(231)	–	(231)
Share-based payments	–	–	–	25	25	–	25
Share options:							
Purchase of own shares	–	–	–	(11)	(11)	–	(11)
Other	–	–	–	–	–	(2)	(2)
Ordinary share dividends	–	–	–	(359)	(359)	(18)	(377)
At 30 June 2011	**90**	**1,249**	**5,445**	**(1,550)**	**5,234**	**57**	**5,291**
At 1 January 2010	90	1,243	5,399	(2,141)	4,591	72	4,663
Profit for the period	–	–	–	618	618	7	625
Total other comprehensive income for the period	–	–	124	(399)	(275)	–	(275)
Share-based payments	–	–	–	26	26	–	26
Share options:							
Proceeds from shares issued	–	5	–	–	5	–	5
Purchase of own shares	–	–	–	(22)	(22)	–	(22)
Purchase of treasury shares	–	–	–	(464)	(464)	–	(464)
Other	–	–	–	–	–	2	2
Ordinary share dividends	–	–	–	(335)	(335)	(32)	(367)
At 30 June 2010 (restated[2])	**90**	**1,248**	**5,523**	**(2,717)**	**4,144**	**49**	**4,193**

1 The UK current tax rate was reduced from 28% to 26% with effect from 1 April 2011.
2 Other reserves reduced by £5m in the second half of 2010 following finalisation of fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited.
3 The net decrease in other reserves in 2011 of £25m comprises translation reserve. The net increase in other reserves in 2010 of £124m comprised translation reserve (£197m), less hedging reserve (£73m).

Condensed consolidated balance sheet

	Notes	**30 June 2011 £m**	31 December 2010 £m
Non-current assets			
Intangible assets		**11,514**	11,216
Property, plant and equipment		**2,506**	2,714
Investment property		**140**	134
Equity accounted investments		**838**	787
Other investments		**6**	11
Other receivables		**304**	282
Other financial assets		**112**	110
Deferred tax assets		**1,101**	1,160
		16,521	16,414
Current assets			
Inventories		**697**	644
Trade and other receivables including amounts due from customers for contract work		**3,572**	3,559
Current tax		**50**	51
Other investments		**274**	260
Other financial assets		**168**	289
Cash and cash equivalents		**1,727**	2,813
Assets of disposal group held for sale	4	**154**	–
		6,642	7,616
Total assets		**23,163**	24,030
Non-current liabilities			
Loans		**(1,822)**	(2,133)
Trade and other payables		**(557)**	(694)
Retirement benefit obligations	6	**(3,557)**	(3,456)
Other financial liabilities		**(216)**	(255)
Deferred tax liabilities		**(40)**	(6)
Provisions		**(397)**	(425)
		(6,589)	(6,969)
Current liabilities			
Loans and overdrafts		**(1,011)**	(920)
Trade and other payables		**(9,005)**	(9,352)
Other financial liabilities		**(86)**	(109)
Current tax		**(628)**	(625)
Provisions		**(503)**	(652)
Liabilities of disposal group held for sale	4	**(50)**	–
		(11,283)	(11,658)
Total liabilities		**(17,872)**	(18,627)
Net assets		**5,291**	5,403
Capital and reserves			
Issued share capital		**90**	90
Share premium		**1,249**	1,249
Other reserves		**5,445**	5,470
Accumulated losses		**(1,550)**	(1,477)
Total equity attributable to equity holders of the parent		**5,234**	5,332
Non-controlling interests		**57**	71
Total equity		**5,291**	5,403

Condensed consolidated cash flow statement

	Notes	Six months ended 30 June 2011 £m	Six months ended 30 June 2010 £m
Profit for the period		**484**	625
Taxation expense		**196**	227
Share of results of equity accounted investments		**(34)**	(53)
Net finance costs		**69**	68
Depreciation, amortisation and impairment		**366**	393
Gain on disposal of property, plant and equipment		**(9)**	(6)
Gain on disposal of investment property		**(2)**	–
Loss/(gain) on disposal of businesses		**6**	(52)
Cost of equity-settled employee share schemes		**25**	26
Movements in provisions		**(185)**	(54)
Decrease in liabilities for retirement benefit obligations		**(98)**	(112)
(Increase)/decrease in working capital:			
Inventories		**(53)**	228
Trade and other receivables		**(67)**	(109)
Trade and other payables		**(522)**	(1,366)
Cash inflow/(outflow) from operating activities		**176**	(185)
Interest paid		**(129)**	(97)
Interest element of finance lease rental payments		**–**	(1)
Taxation paid		**(117)**	(257)
Net cash outflow from operating activities		**(70)**	(540)
Dividends received from equity accounted investments		**6**	24
Interest received		**33**	15
Income from financial assets at fair value through profit or loss		**4**	–
Purchase of property, plant and equipment		**(153)**	(159)
Purchase of investment property		**(9)**	(4)
Purchase of intangible assets		**(7)**	(11)
Proceeds from sale of property, plant and equipment		**23**	30
Proceeds from sale of investment property		**–**	1
Purchase of subsidiary undertakings	8	**(580)**	–
Cash and cash equivalents acquired with subsidiary undertakings	8	**43**	–
Purchase of equity accounted investments		**–**	(2)
Proceeds from sale of subsidiary undertakings		**7**	–
Cash and cash equivalents disposed of with subsidiary undertakings		**(4)**	–
Proceeds from sale of equity accounted investments		**–**	92
Proceeds from sale of financial assets at fair value through profit or loss		**152**	–
Purchase of other deposits/securities		**(13)**	(26)
Net cash outflow from investing activities		**(498)**	(40)
Capital element of finance lease rental payments		**–**	(7)
Proceeds from issue of share capital		**–**	5
Purchase of treasury shares		**–**	(449)
Purchase of own shares		**(11)**	(22)
Equity dividends paid		**(359)**	(335)
Dividends paid to non-controlling interests		**(18)**	(25)
Cash inflow/(outflow) from matured derivative financial instruments		**38**	(82)
Cash (outflow)/inflow from movement in cash collateral		**(3)**	11
Cash inflow from loans		**592**	527
Cash outflow from repayment of loans		**(741)**	(248)
Net cash outflow from financing activities		**(502)**	(625)
Net decrease in cash and cash equivalents		**(1,070)**	(1,205)
Cash and cash equivalents at 1 January		**2,802**	3,678
Effect of foreign exchange rate changes on cash and cash equivalents		**(21)**	8
Cash and cash equivalents at end of period		**1,711**	2,481
Comprising:			
Cash and cash equivalents		**1,727**	2,492
Cash and cash equivalents (included within assets of disposal group held for sale)	4	**15**	–
Overdrafts (included within loans and overdrafts)		**(31)**	(11)
Cash and cash equivalents at end of period		**1,711**	2,481

Notes to the condensed half-yearly financial statements

1. Accounting policies

Basis of preparation and statement of compliance
These condensed consolidated half-yearly financial statements of BAE Systems plc (the Group) have been prepared in accordance with International Accounting Standard (IAS) 34, *Interim Financial Reporting*. The annual consolidated financial statements of the Group are prepared on the basis of International Financial Reporting Standards (IFRSs) and International Financial Reporting Interpretations Committee interpretations (IFRICs) as adopted by the European Union. These condensed consolidated half-yearly financial statements do not comprise statutory accounts within the meaning of Section 435 of the Companies Act 2006, and should be read in conjunction with the Annual Report 2010. The comparative figures for the year ended 31 December 2010 are not the Group's statutory accounts for that financial year. Those accounts have been reported upon by the Group's auditors and delivered to the registrar of companies. The report of the auditors was unqualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report and did not contain statements under section 498(2) or (3) of the Companies Act 2006.

Except as described below, the accounting policies adopted in the preparation of these condensed consolidated half-yearly financial statements to 30 June 2011 are consistent with the accounting policies applied by the Group in its consolidated financial statements as at, and for the year ended, 31 December 2010 as required by the Disclosure and Transparency Rules of the UK's Financial Services Authority.

Changes in accounting policies
The following amendments to published standards and interpretations are effective for the Group for the half year ended 30 June 2011:

- Amendment to IAS 32, *Financial instruments: Presentation: Classification of Rights Issues*;
- IFRIC 19, *Extinguishing Financial Liabilities with Equity Instruments*;
- IAS 24, *Related Party Disclosures*; and
- Amendment to IFRIC 14, *IAS 19, The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*.

The Group has reviewed the effect of these amendments and interpretations, and has concluded that they have no impact on these condensed consolidated half-yearly financial statements.

2. Segmental analysis – continuing operations

	Combined sales of Group and share of equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
		Restated[1]						Restated[1]
	Six months ended 30 June 2011 £m	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m
Electronics, Intelligence & Support	**2,573**	2,624	**(23)**	–	**23**	22	**2,573**	2,646
Land & Armaments	**1,846**	3,074	**(14)**	(12)	**–**	–	**1,832**	3,062
Programmes & Support	**3,140**	3,035	**(642)**	(582)	**600**	538	**3,098**	2,991
International	**1,862**	2,078	**(527)**	(476)	**–**	–	**1,335**	1,602
HQ & Other Businesses	**78**	74	**–**	–	**–**	–	**78**	74
	9,499	10,885	**(1,206)**	(1,070)	**623**	560	**8,916**	10,375
Intra-operating group sales/revenue	**(270)**	(303)	**13**	8	**21**	23	**(236)**	(272)
	9,229	10,582	**(1,193)**	(1,062)	**644**	583	**8,680**	10,103

	Underlying EBITA[2]		Non-recurring items[3]		Amortisation of intangible assets		Impairment of intangible assets		Operating group result	
		Restated[1]								Restated[1]
	Six months ended 30 June 2011 £m	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m
Electronics, Intelligence & Support	**298**	296	**–**	–	**(20)**	(12)	**–**	(6)	**278**	278
Land & Armaments	**180**	316	**(6)**	–	**(63)**	(157)	**–**	(2)	**111**	157
Programmes & Support	**285**	316	**–**	–	**(39)**	(29)	**(22)**	–	**224**	287
International	**221**	218	**–**	–	**(4)**	(12)	**–**	–	**217**	206
HQ & Other Businesses	**(16)**	(49)	**(49)**	(18)	**–**	(1)	**–**	–	**(65)**	(68)
	968	1,097	**(55)**	(18)	**(126)**	(211)	**(22)**	(8)	**765**	860
Financial income of equity accounted investments									**4**	2
Taxation expense of equity accounted investments									**(12)**	(13)
Operating profit									**757**	849
Finance costs									**(66)**	(68)
Profit before taxation									**691**	781
Taxation expense									**(191)**	(229)
Profit for the period									**500**	552

1 Restated following the classification of the Regional Aircraft line of business as a discontinued operation (see note 4).
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.
3 Non-recurring items in 2011 comprises the £49m US Department of State fine (see page 2) and a £6m loss on disposal of the Swiss-Photonics business. Non-recurring items in 2010 comprised the US dollar exchange rate movement on payment of the global settlement of the regulatory investigation by the US Department of Justice.

Notes to the condensed half-yearly financial statements *continued*

3. Finance costs – continuing operations

	Six months ended 30 June 2011 £m	Restated[1] Six months ended 30 June 2010 £m
Net finance costs:		
Group	**(66)**	(68)
Share of equity accounted investments	**4**	2
	(62)	(66)
Analysed as:		
Net interest:		
Interest income	**29**	5
Interest expense	**(137)**	(92)
Income from financial assets at fair value through profit or loss	**4**	–
Facility fees	**(4)**	(2)
Net present value adjustments	**(15)**	(11)
Share of equity accounted investments	**6**	4
	(117)	(96)
Other finance costs:		
Group:		
Net financing credit/(charge) on pensions	**12**	(45)
Market value and foreign exchange movements on financial instruments and investments[2]	**45**	77
Share of equity accounted investments	**(2)**	(2)
	(62)	(66)

1 Restated following the classification of the Regional Aircraft line of business as a discontinued operation (see note 4).
2 Includes a £17m (translated at average exchange rates) fair value gain in 2011 in respect of the remaining shareholding in Saab AB, which was sold in June 2011 (2010 loss £8m).

4. Discontinued operations and disposal group held for sale

Regional Aircraft
On 26 May 2011, the Group announced that it had agreed the sale of its Regional Aircraft Asset Management business. The disposal subsequently completed on 15 July 2011.

In addition, the Group has an active programme for the proposed sale of the Regional Aircraft Support & Engineering business and expects to sell the business within a year of the balance sheet date.

The Asset Management and Support & Engineering businesses comprised the Group's Regional Aircraft line of business within the HQ & Other Businesses operating group. Accordingly, the Regional Aircraft line of business is presented as a disposal group held for sale at 30 June 2011 and, as it represented a separate major line of business, it has been presented within discontinued operations for the current and prior periods.

Saab AB
In June 2010, the Group sold half of its 20.5% shareholding in Saab AB. Following the loss of significant influence over the company, the Group discontinued the use of the equity method. Accordingly, the profit on this disposal, together with the Group's share of the results of Saab AB to the date of this disposal, are shown within discontinued operations in the prior period.

Results from discontinued operations

	Six months ended 30 June 2011 £m	Six months ended 30 June 2010 £m
Revenue	**56**	67
Operating costs	**(74)**	(53)
Other income	**10**	3
Group operating profit	**(8)**	17
Share of results of equity accounted investments	**–**	2
Operating profit	**(8)**	19
Financial income	**–**	3
Financial expense	**(3)**	(3)
(Loss)/profit before taxation	**(11)**	19
Taxation (expense)/credit	**(5)**	2
(Loss)/profit for the period	**(16)**	21
Profit on disposal of discontinued operations	**–**	52
(Loss)/profit for the period – discontinued operations	**(16)**	73
Regional Aircraft	**(16)**	19
Saab AB	**–**	54
(Loss)/profit for the period – discontinued operations	**(16)**	73

Cash flows from discontinued operations

	Six months ended 30 June 2011 £m	Six months ended 30 June 2010 £m
Net cash inflow from operating activities	**15**	19
Net cash inflow from investing activities	**10**	87
Net cash outflow from financing activities	**(39)**	(1)
Cash flows from discontinued operations	**(14)**	105
Regional Aircraft	**(14)**	9
Saab AB	**–**	96
Cash flows from discontinued operations	**(14)**	105

Notes to the condensed half-yearly financial statements *continued*

4. Discontinued operations and disposal group held for sale *continued*

Assets and liabilities of disposal group held for sale – Regional Aircraft

	30 June 2011 £m
Property, plant and equipment	**96**
Inventories	**8**
Trade and other receivables	**22**
Deferred tax assets	**13**
Cash and cash equivalents	**15**
Assets of disposal group	**154**
Trade and other payables	**(37)**
Current tax payable	**(6)**
Provisions	**(7)**
Liabilities of disposal group	**(50)**

5. Earnings per share

	Six months ended 30 June 2011			Restated[1] Six months ended 30 June 2010		
	£m	**Basic pence per share**	**Diluted pence per share**	£m	Basic pence per share	Diluted pence per share
Profit for the period attributable to equity shareholders	**478**	**14.0**	**14.0**	618	17.7	17.7
Represented by:						
Continuing operations	**494**	**14.5**	**14.5**	545	15.6	15.6
Discontinued operations	**(16)**	**(0.5)**	**(0.5)**	73	2.1	2.1
Add back/(deduct):						
Loss on disposal of businesses	**6**			–		
Regulatory penalties	**49**			18		
Net financing (credit)/charge on pensions, post tax	**(9)**			33		
Market value movements on derivatives, post tax	**(32)**			(55)		
Charges relating to early redemption of debt, post tax	**30**			–		
Amortisation and impairment of intangible assets, post tax	**93**			155		
Impairment of goodwill	**22**			–		
Underlying earnings, post tax	**637**	**18.7**	**18.6**	769	22.0	22.0
Represented by:						
Continuing operations	**653**	**19.2**	**19.1**	696	19.9	19.9
Discontinued operations	**(16)**	**(0.5)**	**(0.5)**	73	2.1	2.1
	637	**18.7**	**18.6**	769	22.0	22.0

		Millions	**Millions**		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		**3,411**	**3,411**		3,495	3,495
Incremental shares in respect of employee share schemes			**13**			2
Weighted average number of shares used in calculating diluted earnings per share			**3,424**			3,497

1 Restated following the classification of the Regional Aircraft line of business as a discontinued operation (see note 4).

Underlying earnings per share is presented in addition to that required by IAS 33, *Earnings per Share*, to align the adjusted earnings measure with the performance measure reviewed by the directors. The directors consider that this gives a more appropriate indication of underlying performance.

6. Retirement benefit obligations

	UK £m	US and other £m	**Total £m**
Total IAS 19 deficit at 1 January 2011	(3,438)	(665)	**(4,103)**
Actual return on assets above expected return	22	30	**52**
Increase in liabilities due to changes in assumptions	(387)	(42)	**(429)**
Additional contributions	71	–	**71**
Recurring contributions above/(below) service cost	89	(16)	**73**
Past service cost	(21)	(2)	**(23)**
Net financing (charge)/credit	(7)	17	**10**
Exchange translation	–	15	**15**
Movement in US healthcare plans	–	6	**6**
Total IAS 19 deficit at 30 June 2011	(3,671)	(657)	**(4,328)**
Allocated to equity accounted investments and other participating employers	823	–	**823**
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers at 30 June 2011	(2,848)	(657)	**(3,505)**
Represented by:			
Pension prepayments (within trade and other receivables)	–	52	**52**
Retirement benefit obligations	(2,848)	(709)	**(3,557)**
	(2,848)	(657)	**(3,505)**

Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of in 2006. As these plans are multi-employer plans, the Group has allocated an appropriate share of the IAS 19, *Employee Benefits*, pension deficit to the equity accounted investments and Airbus SAS based upon a consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to equity accounted investments is included in the balance sheet within equity accounted investments. In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote.

During the period, the Group contributed an additional £25m into Trust for the benefit of the Group's main pension scheme (2010 £25m). The cumulative contributions totalling £275m, plus fair value gains of £12m, are reported within other investments (£274m), and cash and cash equivalents (£13m) at 30 June 2011. The use of these assets is restricted under the terms of the Trust. The Group considers these contributions to be equivalent to the other lump sum contributions it makes into the Group's pension schemes and, accordingly, presents below a definition of the pension deficit including them.

	30 June 2011 £m	31 December 2010 £m
Group's share of IAS 19 deficit, net	**(3,505)**	(3,407)
Assets held in Trust	**287**	261
Pension deficit (as defined by the Group)	**(3,218)**	(3,146)

The above deficit is £2.2bn (31 December 2010 £2.1bn) after tax.

7. Dividends

Equity dividends	**Six months ended 30 June 2011 £m**	Six months ended 30 June 2010 £m
Prior year final 10.5p dividend per ordinary share paid in the period (2010 9.6p)	**359**	335

The directors have declared an interim dividend of 7.5p per ordinary share (2010 7.0p), totalling £256m (2010 £239m). The dividend will be paid on 30 November 2011 to shareholders registered on 21 October 2011. The ex-dividend date is 19 October 2011.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 9 November 2011.

8. Acquisitions

Subsidiaries acquired during the half year ended 30 June 2011
The Group has acquired L-1 Identity Solutions, Inc.'s Intelligence Services Group (L-1 ISG), Norkom Group plc (Norkom), ETI A/S (ETI) and stratsec.net Pty Limited (stratsec) in the Cyber & Intelligence Services market segment. The Group also acquired Fairchild Imaging, Inc. (Fairchild) in the market segment of Electronic Systems.

If the acquisitions had occurred on 1 January 2011, combined sales of Group and equity accounted investments would have been £9.3bn, revenue £8.7bn and profit £492m from continuing operations for the half year ended 30 June 2011.

For all acquisitions made in the period, fair values remain provisional, but will be finalised within 12 months of acquisition.

Summary

Acquisition	Description	Acquisition date	Percentage share acquired	Total consideration Currency	Total consideration £m
L-1 ISG	Leading provider of security and counter threat capabilities to the US government	15 February 2011	100%	$291m[1]	180
Norkom	Market-leading provider of innovative anti-money laundering solutions to counter financial crime to the global financial services industry	18 February 2011	100%	€209m	177
ETI	Leading provider of advanced technology products and services to government and commercial clients worldwide	21 March 2011	100%	DKK1.2bn	135
Fairchild	Provider of solid-state electronic imaging components, cameras, and systems for aerospace, industrial, medical and scientific imaging applications	1 April 2011	91.3%	$88m	55
stratsec	Australian information security company supplying government and commercial customers	14 January 2011	100%	A$25m	16

1 Total consideration is $297m, less a working capital adjustment of $6m.

IFRS 3, *Business Combinations*, disclosures are provided individually for the L-1 ISG, Norkom and ETI acquisitions below. The acquisitions of Fairchild and stratsec are neither individually nor collectively material.

Material acquisitions

		Consolidated results for the period from acquisition to 30 June 2011		
Acquisition	Support for residual goodwill[1]	Revenue £m	EBITA[2] £m	Loss after tax[3] £m
L-1 ISG	– Complements Intelligence & Security's existing security and intelligence capabilities; – Enhances existing knowledge and expertise, and better positions the Group to compete for future upgrades and new contracts; – Increases penetration of target markets through existing sales, marketing and in-service support capabilities; and – Provides a skilled assembled workforce with high level security clearance.	50	4	(1)
Norkom	– Complements Detica's existing enterprise fraud products, particularly Detica NetReveal®; – The combination of two of the sector's strongest technologies creates a market-leading offering to compete for new customers in new geographies; – Creates opportunities for cost synergies; and – Provides a skilled assembled workforce.	16	3	(6)
ETI	– Complements Detica's existing communications and interception businesses; – Creates a stronger end-to-end solution and a top tier market competitor, which enhances the Group's ability to compete for new customers in new geographies; and – Provides a skilled assembled workforce with high level security clearance.	19	2	(3)

1 Goodwill recognised is attributable to specific opportunities and synergies which do not translate into separately identifiable intangible assets, but represent a proportion of the assessed value within each acquired entity.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense excluding integration costs.
3 Loss after tax includes amortisation charges on acquired intangible assets totalling £18m.

The post-acquisition results above exclude acquisition-related costs of £6m incurred by the Group on the L-1 ISG (£1m), Norkom (£4m) and ETI (£1m) acquisitions. These expenses relate to external legal fees and due diligence costs, and are included in operating costs.

8. Acquisitions *continued*

Fair values

The acquisitions had the following effect on the Group's assets and liabilities:

	L-1 ISG £m	Norkom £m	ETI £m	Other £m	Total £m
Intangible assets	63	99	79	29	270
Property, plant and equipment	–	1	8	2	11
Equity accounted investments	–	1	–	–	1
Inventories	–	–	10	8	18
Trade receivables	13	8	3	7	31
Other receivables	10	7	–	1	18
Deferred tax assets	–	2	7	3	12
Trade and other payables	(15)	(24)	(22)	(6)	(67)
Current tax payable	–	–	(8)	–	(8)
Deferred tax liabilities	–	(20)	(22)	(8)	(50)
Provisions	–	–	(3)	(1)	(4)
Cash and cash equivalents	–	37	5	1	43
Net assets acquired	**71**	**111**	**57**	**36**	**275**
Goodwill	109	66	78	40	293
Less: Fair value of existing interest in Fairchild	–	–	–	(5)	(5)
Total consideration	**180**	**177**	**135**	**71**	**563**
Add: Deferred consideration paid in respect of 2010 acquisitions	–	–	–	13	13
Add: Amounts receivable in respect of purchase price adjustments	4	–	–	–	4
Cash consideration	**184**	**177**	**135**	**84**	**580**

The cumulative remeasurement to fair value of the Group's existing 8.7% interest in Fairchild was a gain of £5m, which has been recycled from retained earnings to financial income during the period. There was no material change in the fair value from 1 January 2011 to the date of acquisition of the remaining 91.3% interest.

Purchase of subsidiary undertakings in the condensed consolidated cash flow statement includes $22m (£13m) of deferred consideration in respect of the acquisition of OASYS Technology, LLC (OASYS) in 2010.

The goodwill expected to be deductible for tax purposes is £109m relating to L-1 ISG.

Intangible assets

Acquisition	Customer relationships £m	Software £m	Trade names/ trademarks £m	Other £m	Total £m
L-1 ISG	62	–	1	–	63
Norkom	74	21	3	1	99
ETI	22	48	5	4	79
Other					29
					270

Trade receivables

Acquisition	Gross contractual amounts due £m	Unrecoverable amount £m	Fair value £m
L-1 ISG	13	–	13
Norkom	8	–	8
ETI	7	(4)	3
Other			7
			31

Subsidiaries acquired in 2010

During the year ended 31 December 2010, the Group acquired Atlantic Marine Holding Company and OASYS. Certain of the fair values assigned to the net assets at the dates of acquisition were provisional and, in accordance with IFRS 3, the Group has adjusted the fair values attributable to these acquisitions during the half year ended 30 June 2011. The net increase in goodwill of £5m mainly reflects additional consideration payable. This has not had a material impact on the consolidated accounts and, as such, the Group has not restated the balance sheet as at 31 December 2010.

9. Related party transactions

The Group has a related party relationship with its directors and key management, its equity accounted investments and the pension plans.

Transactions occur with the equity accounted investments in the normal course of business, and are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

	Six months ended 30 June 2011 £m	Six months ended 30 June 2010 £m
Sales to related parties	**644**	583
Purchases from related parties	**159**	200

	30 June 2011 £m	31 December 2010 £m
Amounts owed by related parties	**251**	307
Amounts owed to related parties	**1,238**	1,232

10. Events after the balance sheet date

On 15 July 2011, the Group completed the disposal of its Regional Aircraft Asset Management business (see note 4).

11. Annual General Meeting

The Annual General Meeting of BAE Systems plc will be held on 2 May 2012.

INDEX TO OTHER INFORMATION

* The information provided in this document has been extracted from the 2010 Annual Report of BAE Systems. As the information only represents extracts of the 2010 Annual Report, there are certain references made to pages of the 2010 Annual Report which have different pagination in this Offering Memorandum, or to other pages of the 2010 Annual Report that have not been included in this Offering Memorandum. Copies of the Annual Report for 2010 can be obtained through the website maintained by BAE Systems at http://www.baesystems.com. Information on BAE Systems' website is not incorporated by reference into this Offering Memorandum.

Corporate governance

"A year in which we have continued to evaluate our governance arrangements against our own experiences and changes in best practice."

Dick Olver
Chairman

Dear Shareholders,

Change is inevitable and desirable, and this is as applicable to companies as it is to most things in life. Managing change as part of an ongoing process of improvement is a fundamental part of good governance; driven as it is by the demands of the business environment and wider social and political influences. Boards need to look forward and put their companies in the best position possible, not just reacting to change but managing it for the benefit of our various stakeholders. Last year, I mentioned the reports produced by Sir David Walker and the Financial Reporting Council reviewing corporate governance in the UK, and the changes that they recommended. In 2010, a number of important changes were made to the UK's Corporate Governance Code. We welcome the new Code as a statement of the evolving nature of good corporate governance practice – and one that must continue to change if we are to learn lessons from the past and go on to build the successful, robust commercial enterprises that are fundamental to our economic and social well being.

The Board has reviewed the new UK Corporate Governance Code during the year, and has taken action to ensure that what we do reflects fully its principles and that we comply with its provisions. As I have said before in these reports, the Code principles, embodying as they do the essence of good governance practice, are the most important part of the Code. In the next few pages, we seek to explain how they have been applied by the BAE Systems Board. I will begin by highlighting a number of important areas that have been the subject of further development during the year.

Board membership

Too often we talk of boards in the abstract and overlook the obvious point that a board is essentially a group of individuals. The quality of those individuals largely determines the quality of the board, so consequently, through the Nominations Committee, we pay a good deal of attention to the composition of the Board and succession planning. We look at composition from a number of different angles, including:

- Knowledge and experience
- Diversity
- Key skills
- Executive/non-executive mix
- BAE Systems' Board experience

We seek to achieve the right balance across these different dimensions. However, I believe that to be effective a board needs a core of business people who have deep knowledge and experience in running companies. In particular, as BAE Systems' business is characterised primarily by its complex long-term contracting nature, we seek to retain core non-executive knowledge and competence gained in similar industries. In addition, we look for individuals with board level experience with international and global companies.

Diversity

BAE Systems places particular emphasis on diversity and inclusion, and this is reflected in the objectives that the Board has set for management – and is one of the factors influencing annual executive reward. This is an area in which the Board needs to show leadership and gender diversity is a factor we consider when appointing new directors. With the assistance of our recruitment consultants, we have taken steps to ensure that there are no obstacles to the Nominations Committee having visibility of suitable candidates for possible appointment to the

Board, regardless of gender. Companies such as BAE Systems have to accept that performance to date in achieving a more equitable representation for women at the highest levels has been poor and that this is something we have to address. When women make up half of the population, those companies that fail to have diverse leaders at the highest levels risk putting themselves at a competitive disadvantage.

Developing the quality of the senior management 'pipe-line' – which ultimately leads to the Board – is an area that chairmen and boards do get involved in. As part of this activity, the Board and our Nominations and Corporate Responsibility committees have been monitoring how we manage diversity and inclusion across the Group, and it is good to see progress being made, particularly in developing the behaviours and culture that in the long term will be the main determinants of success in this area. Quotas and tokenism could superficially solve the diversity issue – at least at board level. However, that would not be good for companies and equally would not be good for women. I believe that the best way forward is to set the right behavioural expectations at the very top of the company and encourage management to develop appropriate solutions to meet that challenge. In terms of Board governance, the Corporate Responsibility Committee undertakes a specific role in monitoring progress against our diversity and inclusion objectives (as it does with other non-financial performance measures), and makes recommendations to the Remuneration Committee for reward purposes based on actual achievement.

As chairman of both the Board and the Nominations Committee, I recognise that I have particular responsibilities for leading the work in developing the Board, and its composition is a very important element of board effectiveness. Reflecting on the gender diversity issue, progress has been made – both within the executive and non-executive areas. Linda Hudson, one of our three executive directors, is the President and Chief Executive Officer of our US-managed businesses, which account for more than half of our sales. Together with strong operational management experience, she brings a deep understanding of the US defence market. I am also pleased that in 2010 Harriet Green joined the Board as a non-executive director. She is Chief Executive Officer of a UK-listed international electronics distribution company, and brings international and operational experience to the Board. Progress, but more to do, particularly in respect of long-term executive development work from which many of our future executive directors will be found, and importantly, will provide candidates for non-executive director positions in other companies.

Succession planning and directors' induction

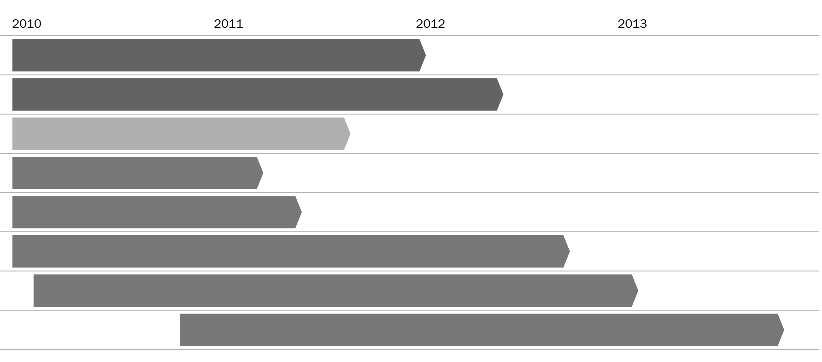
Returning to the opening theme, change is inevitable but it is also risky. Good succession planning recognises that you can mitigate succession risk through well informed and timely decisions being made by experienced and knowledgeable people. The table below details the non-executive members of the Board and their terms of office. The Nominations Committee regularly reviews this information to help plan the membership of the Board. This includes having people on the Board's committees with the right skills and experience. For example, in 2009, the committee identified a need for an individual with appropriate skills and financial experience to sit on our Audit Committee, and provide expertise and long-term cover for Michael Hartnall, who has done an excellent job in chairing the committee since 2003. I am pleased that we were able to appoint Nick Rose to the Board in February 2010, and he brings the experience and skills gained in his role as Chief Financial Officer of Diageo plc to our Audit Committee, and also to our Remuneration Committee. Also, when we recruited Paul Anderson in October 2009 we recognised he had the background and qualities required for a future chairman of the Corporate Responsibility Committee, and he was appointed to that role in September last year.

With regards to the executive directors on the Board, the most significant event during the year was the search for the right candidate to succeed George Rose as Group Finance Director. This was undertaken by the Nominations Committee and for this purpose it co-opted an additional independent non-executive, Nick Rose. The search process is detailed in the Nominations Committee report on page 94.

Too much change around the board table can be a risk in itself. No matter how experienced and knowledgeable an incoming non-executive director is it will always take time for that individual to develop a detailed understanding of the Company. For this reason a properly tailored induction programme is very important. Done well, it should reduce the time taken for a new member of the Board to become fully effective. Over the last few years, we have worked at improving the induction programme we offer new directors, combining a mixture of subject specific one-to-one meetings with senior management covering matters such as core control processes and investor relations, through to site visits to various Company locations around the world. For information, an example of a typical induction programme is shown on page 84. Maintaining the right level of experience and company knowledge within a board, whilst at the same time introducing new people who bring a new perspective and a 'fresh pair of eyes', is a necessary but difficult balance to maintain. We recognise it as such and remain diligent in trying to get the balance right.

BOARD SUCCESSION – NON-EXECUTIVE DIRECTORS

Director	Date of appointment
Sir Peter Mason	22.01.2003
Michael Hartnall	10.06.2003
Roberto Quarta	07.09.2005
Ravi Uppal	02.04.2008
Carl Symon	11.06.2008
Paul Anderson	08.10.2009
Nick Rose	08.02.2010
Harriet Green	01.11.2010



Roles and responsibilities
The revisions to the Combined Code made in 2010 provided more definition to the roles of both the Chairman and the Senior Independent Director. As a result, the Board has amended the requirements of the roles as detailed in our Board Charter (see page 83). The changes to the Senior Independent Director's role and responsibilities reflect the need for one of the non-executive Board members to act as a sounding board for the Chairman and, in the normal course of events, facilitate an annual review of the Chairman's performance. If events do not run such a normal course, he will also act as an intermediary for the other directors if they have specific concerns regarding the Chairman and how the Board is being run. Having a robust senior director on the Board who is both the natural person to turn to when I need to discuss Board matters, and is open and frank in giving feedback on my performance, is invaluable to me as Chairman, and an important part of board governance.

The relationship between a chairman and the chief executive is probably the key personal dynamic within a board. Again it is a matter of balance, this time between being supportive of a chief executive in delivering the agreed strategy and the need to have the right level of challenge. Within BAE Systems, it is for others to say whether I get this balance right, and here the Board's annual performance evaluation provides all directors with the opportunity to speak to our external facilitator about my performance – we specifically ask directors for their views on the chairman/chief executive relationship – and for any issues to be fed back to me via the Senior Independent Director. Likewise, the Chief Executive is subject to the same evaluation process, receiving formal feedback once a year from the Board but having the opportunity to engage with members of the Board, both formally and informally, throughout the year.

Managing risk
The management of risk in major companies is an issue to which directors and those responsible for public policy have given a good deal of thought in recent years. When reviewing the changes to the Combined Code last year, the Board noted the change to the Main Principle in the Risk Management and Internal Control section of the Code, regarding a board being responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The Board has agreed that this should be an integral part of the process we use to develop and agree strategy, which is based on strategy review sessions, separate from our formal board meetings.

The Risk Management and Internal Control principle also requires that boards maintain sound risk management and internal control systems. There has been some debate regarding the need for all listed company boards to have risk committees. Whilst the detailed monitoring of the quality of our risk management and internal control systems forms part of the regular work undertaken by the Audit and Corporate Responsibility committees, importantly the Board as a whole is ultimately responsible for the management of risk. We ensure that risk is a regular agenda item for the Board and this provides all directors with the opportunity to evaluate the quality of our risk management processes, to challenge the quality of the judgements made on risk and the quality of risk mitigation planning.

In addition to the specific inclusion of risk management within the UK Corporate Governance Code's principles, provisions concerning remuneration have also been amended to require that remuneration incentives are compatible with risk policies and systems. In relation to this, it should be noted that within BAE Systems, risk management is embedded into the recognition of profit on long-term contracts.

In the accounting policy notes on page 134 you will find the following words:

"No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved."

For us, the management of risk on our programmes is a core management discipline and, therefore, management reward for profit performance is inextricably linked to managing risk, with reward and profit not recognised until outcomes can be reliably estimated.

Board performance evaluation
One of the other key changes to the Combined Code in 2010 was the change to the evaluation section, with the addition of a requirement that, at least every three years, the annual board evaluation should be externally facilitated. During my time as Chairman, we have undertaken an externally facilitated performance evaluation exercise annually, covering the performance of the Board, its committees and individual directors (including myself). This is now a core process that we have refined over the past six years and one that I believe adds real value to the work of the Board. We have used the same facilitator throughout this period, which has helped to build trust in the process and an appreciation of its value in improving the effectiveness of the Board.

For us, the use of an external facilitator has been a positive one. I certainly don't see the exercise as an audit or inspection that is undertaken by an outsider with the aim of telling us what we are doing wrong. Rather, it is more about providing a process through which directors can speak candidly at length to our facilitator and in doing so analyse our performance over the past year. She then presents what she has heard, and collectively the directors discuss this and agree any actions required to improve our effectiveness. Feedback on the performance of the Board's committees is provided separately to committee chairmen so that this can be discussed with committee members, and I meet with the facilitator to discuss feedback on individual performance before holding one-to-one meetings with directors. Similarly, the Senior Independent Director, following discussions with the facilitator and the other non-executive directors, provides me with feedback on my performance.

For the last few years we have provided details of the annual objectives the Board has set following the evaluation process and information on how we think we did in addressing the prior year's objectives. We report on the evaluation we have just completed opposite.

Shareholder engagement
As Chairman, I am responsible for ensuring that all directors are aware of any issues and concerns that major shareholders may have. The Company has a comprehensive investor relations programme, through which the Chief Executive and Group Finance Director engage regularly with our larger shareholders on a one-to-one basis. The Board receives reports on these meetings covering the general nature of matters communicated and discussed. However, it is important that the Board has a number of channels providing access to shareholder views. These additional channels include an annual survey that our investor relations consultants undertake of the views of our largest shareholders, and which are reported directly to the Board. Also, I write to major shareholders each year updating them on matters concerning the Company and inviting them to meet with me if they wish to discuss any particular matter. The Chairman of our Remuneration Committee undertakes a similar exercise on the subject of remuneration policy.

BOARD PERFORMANCE – 2010 OBJECTIVES AND ACHIEVEMENTS	
2010 objectives	**2010 summary of achievements**
– Maintain focus on developing the Company’s strategy and progress in achieving the Strategic Actions agreed by the Board in 2009.	– Through a number of different forums the Board undertook a wide-ranging review of Group strategy in 2010. At the strategy review sessions in June and November, the Board reviewed progress against the Strategic Actions agreed in 2009, and at the end of 2010, updated the Group Strategic Framework (see page 14) to recognise progress in achieving prior year actions.
– The Board and the Corporate Responsibility Committee to continue to monitor the development of a Total Performance culture, including implementation of the Woolf Committee recommendations.	– During 2010, performance against the responsible business conduct objectives was integrated into the Company’s regular management reporting requirements, and consequently was reported at all scheduled Board meetings. – At regular meetings held throughout the year, the Corporate Responsibility Committee monitored performance against the CR-related objectives set for the development of a Total Performance culture. In addition, the Committee agreed the approach (including external assessments) that will be used to determine progress in meeting the Company’s three-year commitment to addressing the 23 recommendations made by the Woolf Committee (see page 48).
– Focus on monitoring operational performance, including cost and efficiency metrics.	– Operational performance targets were integrated into the 2010 Integrated Business Plan (IBP). Performance against this plan was monitored by the Board throughout the year. In particular, as part of the development of the 2010 IBP, the Board reviewed the efficient management of the Group’s cost base, and the contribution that such activity is expected to make over the five-year planning period.
– Continue to monitor the development of the competencies and culture required to support the growth of our home markets.	– The Board reviewed with senior operational managers progress in developing our home markets. This has been reviewed both in terms of performance in individual markets and also in terms of the long-term management resource required to support our global business.
– The Chairman to facilitate continuing development for the non-executive directors, including their understanding and familiarity with the Company’s businesses and core processes and markets.	– To assist in developing an understanding of the Company’s businesses, the Board visited sites in the US and UK during the year. For example, it took the opportunity whilst visiting part of our US ship repair business to gain a deeper understanding of the development and dynamics of the US support services market. – Facilitated by the Chairman, directors participated in a Responsible Business Conduct Awareness Training session, utilising the materials used across the Group to discuss responsible business behaviour and to focus on the importance of ethical conduct to the Company.

BOARD PERFORMANCE – 2011 OBJECTIVES	
Strategy	Develop further the process by which the Board engages in the development of strategy.
Succession planning and implementation	Prioritise support for new Board members and long-term succession planning for key executive roles.
Operational performance monitoring	Develop the programme of ‘Deep Dives’ to complement and validate KPIs and deepen directors’ understanding of the Group’s operations and performance.
Risk and risk management	Monitor the development of crisis management planning and the role of the Board in such plans. Establish future milestones after completion of the Woolf Report three-year implementation review.
Stewardship and UK Corporate Governance codes	Engage with shareholders as they implement the Stewardship Code and find ways to expose non-executive directors more directly to shareholders’ views.
Brand	Think about ‘Brand’ in the context of the evolving nature of the business.

I believe that regular dialogue with shareholders is important to good governance. Establishing reliable lines of communication – even when there are no particular issues of concern for shareholders – is another of the valuable 'safety valves' that we need to firmly establish as part of our governance processes. Obviously, this requires engagement on the part of the investor community and I welcome the Stewardship Code which was launched last year in the UK with the aim of enhancing, "…the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities".

During 2011, we will be looking to continue to improve the quality of our engagement with shareholders and explore with investors the practical means by which we can give effect to the requirements of the Stewardship Code and UK Corporate Governance Code.

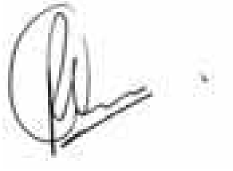
Stewardship is a word that sits equally comfortably with the directors of a company as it does with shareholders – maybe even more so for directors as the duty is more immediate and all embracing in its scope. Therefore, we naturally support the aims of this new code and look forward to developing its application.

At the centre of a company's engagement with its shareholders is the Annual General Meeting (AGM), and we should not lose sight of the importance of this meeting as it provides a forum for engagement with all shareholders. BAE Systems has thousands of shareholders, most of whom do not wish or are unable to attend the actual meeting. However, all shareholders have the opportunity to ensure that their shares are voted on. To help facilitate this we provide the following:

- Electronic and postal voting – shareholders can vote on all the resolutions either electronically via our website or by post.
- Questions & Answers – all shareholders have the opportunity to submit questions by e-mail or post and we address the issues that arise most frequently in these questions in answers provided on our website.
- Polls – all the resolutions detailed in the Notice of Meeting are voted on by way of a poll. This ensures that all votes are counted on the basis of one vote for every share held, as against voting on a show of hands, which results in only attendees at the meeting deciding on the resolutions.
- Results – we publish the results of the voting on all resolutions on our website.

Those who are able to attend our AGM have the opportunity to ask questions and hear the views of other shareholders before deciding how to cast their votes. One of the main changes to the provisions in the Combined Code is the change to require that all directors are subject to annual election by shareholders. Consequently, all members of the BAE Systems Board shall be standing for re-election this year and in future years.

This year's AGM is on 4 May 2011. I look forward to meeting those shareholders who are able to attend, and answering any questions they may have on these governance reports and other matters covered by the resolutions to be put to the meeting.



Dick Olver
Chairman

Corporate governance report

Applying the principles of the UK's Corporate Governance Code
The following report details how the Board has applied the principles in the Financial Reporting Council's Combined Code (the "Code"), as required by the UK Listing Rules. In June 2010, a revised code, the UK Corporate Governance Code, was published. Whilst reporting against the additional and revised principles contained within this revised code is not required for regulatory purposes until next year, the Board accepts that it represents an authoritative statement of best practice, and as such it has reviewed its practices relative to it. Consequently, the following report includes information on the application of the additions and revisions to the Code.

Leadership

***Principles* – An effective board collectively responsible for the long-term success of the company • A clear division of responsibilities at the head of the company between the running of the board and the executive • No one individual should have unfettered powers of decision • The chairman is responsible for the leadership of the board and ensuring its effectiveness on all aspects of its role • Non-executive directors should constructively challenge and help develop proposals on strategy.**

The Company's governance structure is based on the leadership principles in the new UK Corporate Governance Code. The core activities of the Board and its committees are documented and planned on an annual basis, and this forms the basic structure within which the Board operates. The Board has adopted a document, the Board Charter, in which there is a statement of governance principles that reflect the principles contained in the Code, and cover the following:

- Strategy – reviewing and agreeing strategy;
- Performance – monitoring the performance of the Group and also evaluating its own performance;
- Standards and values – setting standards and values to guide the affairs of the Group;
- Oversight – ensuring an effective system of internal controls is in place, ensuring that the Board receives timely and accurate information on the performance of the Group and the proper delegation of authority; and
- People – ensuring the Group is managed by individuals with the necessary skills and experience, and that appointments to the Board are managed effectively.

The Board Charter also details the separate and distinct roles of the Chairman and the Chief Executive, and also those of the Senior Independent Director and Company Secretary. These are detailed opposite, and have been reviewed and amended in light of changes made to the Code in 2010.

Whilst the Board is ultimately responsible for the success of the Company, given the size and complexity of its operations, all but the most important matters are managed on a delegated basis by the Chief Executive and the executives working for him. The Board appoints the Chief Executive and monitors his performance in leading the Company, and providing operational and performance management in delivering the agreed strategy. Specifically, he is responsible for developing, for the Board's approval, appropriate values and standards to guide all activities undertaken by the Company and also making recommendations on appropriate delegated responsibilities.

ROLES AND RESPONSIBILITIES

The role of the Chairman

The Chairman is responsible for creating the conditions for the effective working of the Board and is specifically responsible for the following:

- Chairing Board meetings and setting the agenda for such meetings, taking full account of the issues and concerns of all directors and encouraging their active engagement in Board discussion.
- Promoting the highest standards of corporate governance, including compliance with the UK Corporate Governance Code wherever possible.
- Promoting the requirement that all Board members are exemplars of the Company's values, principles and standards.
- Through the Nominations Committee, ensuring that the Board comprises individuals with an appropriate mixture of skills, experience and knowledge.
- Ensuring that the Company maintains effective communication with shareholders, and that their views and any concerns are understood by the Board.
- Working with the Chief Executive to ensure that the Board receives accurate and timely information on the performance of the Company.
- Representing the Company at the highest level and, in conjunction with the Chief Executive, developing strategic relationships with major customers and political leaders worldwide.
- Leading the evaluation of the performance of the Board, its committees and individual directors.
- Establishing an effective working relationship with the Chief Executive, providing support and advice whilst respecting executive responsibility.
- Ensuring that a well constructed induction programme is provided for new directors, that all directors have the opportunity to develop their understanding of the Company and that they are kept informed of matters affecting the Company.

The role of the Chief Executive

The Chief Executive is responsible for the leadership, and the operational and performance management of the Company within the strategy and business plan agreed by the Board.

The Chief Executive is specifically responsible for the following in respect of his/her relationship with the Board:

- Developing a business strategy for the Company to be approved by the Board on an annual basis.
- Producing business plans for the Company to be approved by the Board on an annual basis.
- Overseeing the management of the executive resource and succession planning processes, and presenting annually the output from these to the Board and Nominations Committee.
- Ensuring that effective business and financial controls, and risk management processes are in place across the Company, and that all relevant laws and regulations are complied with.
- Making recommendations to the Board on the appropriate delegation of authority within the Group.
- Keeping the Board informed regularly as to the performance of the Company and bringing promptly to the Board's attention all matters that materially affect, or are capable of materially affecting, the performance of the Company and the achievement of its strategy.
- Developing for the Board's approval appropriate values and standards to guide all activities undertaken by the Company.
- Providing clear and visible leadership in business conduct.
- Promoting the requirement that all Senior Leaders are exemplars of the Company's values, principles and standards.
- Owning the Company's commitment to all aspects of corporate responsibility.

The role of the Senior Independent Director

The Senior Independent Director is responsible for the following:

- Being available to shareholders if they have concerns which contact through the normal channels of Chairman, Chief Executive or other executive directors has failed to resolve or for which such contact is inappropriate.
- Providing a sounding board for the Chairman and serving as an intermediary for the other directors when necessary.
- Chairing the Nominations Committee when it is considering the Chairman's succession.
- Providing feedback on the Chairman's performance as derived from the evaluation exercise undertaken by the Board.

The role of the Company Secretary

The Company Secretary is specifically responsible for the following:

- Under the direction of the Chairman, ensuring good information flows within the Board and its committees, and between senior management and non-executive directors, as well as facilitating induction activities for directors and assisting with their development as required.
- Advising the Board through the Chairman on all governance matters.

The Operational Framework is the output from this process. It is a document that has evolved over time, subject to a formal six-monthly review process that culminates in the Board's review and approval. In approving it the Board has agreed the following:

– Performance requirements and values – i.e. Total Performance and the Values underpinning it.

– Organisation structure – the roles and accountabilities of the Board and certain senior individuals.

– Governance standards – the Group's trading principles, internal controls, operational assurance framework and risk management framework.

– Core business processes – covering business planning, project management, mergers and acquisitions, individual executive performance, and management of performance against business objectives, measures and milestones.

– Delegated responsibilities – dealing with the Board's delegation of authority concerning financial, commercial and legal matters.

The Board and its committees monitor the application of values, standards and processes. This includes a range of activities such as the formal review of the effectiveness of internal controls (see page 89).

To ensure that non-executive directors can constructively challenge and help develop proposals on strategy, the Board has adopted a process of reviewing the development of strategy and formally approving the agreed strategy for the Company on an annual basis. In 2010, the Board members were provided with opportunities to engage in strategy development through informal meetings and workshops as well as formal Board meetings.

Effectiveness

***Principles* – Board and committees having an appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively •A formal, rigorous and transparent procedure for the appointment of new directors •All directors to be able to allocate sufficient time to the company to discharge their responsibilities effectively •All directors to receive induction on joining and should regularly update and refresh skills and knowledge •The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties •The board should undertake a formal and rigorous annual evaluation of its performance, and that of its committees and individual directors •All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.**

Succession planning is used by the Board to deliver two key responsibilities, firstly to ensure that the Group is managed by executives with the necessary skills, experience and knowledge, and secondly to ensure that the Board itself has the right balance of individuals to be able to effectively discharge its responsibilities. The Nominations Committee has specific responsibilities in this area but the Board as a whole is also involved in overseeing the development of management resources in the Group with the aim of ensuring the Company has the individuals with the right skills to meet the needs of an increasingly complex and global business. The process adopted for the appointment of non-executive and executive directors is detailed in the Nominations Committee report.

All non-executive directors are advised of the likely time commitments at appointment and are asked to seek approval

Typical non-executive director induction programme

HEAD OFFICE FUNCTIONS (APPROXIMATELY TEN HOURS)

Matters covered	Facilitated by
Duties of a director, Board procedures, corporate governance, Code of Conduct	Company Secretary
Business planning and control, and risk management processes	Director Financial Control, Reporting and Treasury
Strategy and planning processes	Group Strategy Director
Enterprise Metrics – the measures used by the Board and management to measure and monitor performance	Managing Director, Performance Excellence
Investor Relations	Investor Relations Director
Corporate Responsibility	Managing Director, Corporate Responsibility
Internal Audit	Head of Internal Audit
Business Development	Group Business Development Director

MEETINGS WITH SENIOR EXECUTIVES (APPROXIMATELY SIX HOURS)

Matters covered	Facilitated by
UK and International (London-based)	
Programmes & Support (UK defence and security businesses)	Group Managing Director, Programmes & Support
International (Saudi Arabia, Australia, India, Oman)	Group Managing Director, International
US (Washington, DC)	
BAE Systems, Inc.	President and Chief Executive Officer of BAE Systems, Inc. Executive Vice Presidents, BAE Systems, Inc.

OPERATIONAL SITE VISITS (APPROXIMATELY FIVE DAYS)

UK	US
Military Air Solutions – Warton and Samlesbury, Lancashire	Electronic Solutions – Nashua, NH
Surface Ships – Portsmouth	US Combat Systems – York, PA

from the Nominations Committee if they wish to take on additional external appointments. The ability of individual directors to allocate sufficient time to the discharge of their responsibilities is considered as part of the directors' annual evaluation process overseen by the Chairman. Any issues concerning the Chairman's time commitment are dealt with by the Nominations Committee, chaired for this purpose by the Senior Independent Director.

An induction programme is agreed for all new directors aimed at ensuring that they are able to develop an understanding and awareness of the Company's core processes, its people and businesses. A typical induction programme is shown opposite.

The Chairman, with the assistance of the Chief Executive and Company Secretary, is responsible for ensuring that directors are supplied with information in a timely manner that is in a form and of a quality appropriate to enable them to discharge their duties. In the normal course of business, such information is provided by the Chief Executive in a regular report to the Board that includes information on operational matters, strategic developments, reports on the performance of Group operations, financial performance relative to the business plan, business development, corporate responsibility and investor relations.

In addition to the induction programme that all directors undertake on joining the Board, an ongoing programme of director development and Company awareness has been developed. For example, as part of the annual programme of Board meetings, directors will typically visit the Group's principal operations to meet employees and gain an understanding of the Group's products and services. In 2010, the Board visited the Company's Support Solutions and Information Solutions businesses in San Diego, and the Surface Ships business in Portsmouth. Also, the Board undertakes training sessions on particular matters, and last year directors participated in Responsible Business Awareness Training sessions facilitated by the Chairman. As part of the recently completed evaluation process, the Chairman is meeting with all directors individually, and agreeing training and development.

For the last six years the Board's annual effectiveness evaluations have been undertaken by Sheena Crane, an experienced consultant, whose only interest with BAE Systems is with regards to her work with the Board and undertaking similar performance evaluation work for the Executive Committee. She was appointed to perform this work in consultation with the Nominations Committee. The evaluation process is based on the facilitator interviewing each of the directors, and recording their views on the effectiveness of the Board and its committees' work, and on the performance of individual directors. Feedback on Board performance is presented to a meeting of the Board, which agrees actions and objectives for the following year based on the information the facilitator provides and the conclusions that the Board derived from this.

Individual directors are also subject to annual performance evaluation, and the Chairman meets with each director and provides feedback on a one-to-one basis – committee chairmen also get feedback on committee performance. Feedback on the Chairman's performance is provided by the facilitator directly to the Board's Senior Independent Director, who discusses this with the other non-executive directors before discussing this with the Chairman on a one-to-one basis. Subject to continued satisfactory performance, directors seek re-election on an annual basis.

Accountability

***Principles* – The board to present a balanced and understandable assessment of the company's position and prospects • The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives • The board should maintain sound risk management and internal control systems • The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor.**

Through this report and, as required, through other periodic financial statements, the Board is committed to providing shareholders with a clear assessment of the Company's position and prospects.

The arrangements established by the Board for the application of risk management and internal control principles are detailed on page 87. The Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors, further details of which can be found in the Audit Committee report on page 89.

Remuneration

***Principles* – Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose • A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance • There should be a formal and transparent procedure for developing policy on executive remuneration, and for fixing the remuneration packages of individual directors • No director should be involved in deciding his or her own remuneration.**

The Board has delegated to the Remuneration Committee responsibility for agreeing remuneration policy and the individual remuneration of the executive directors, the Chairman, members of the Executive Committee and the Company Secretary (see Remuneration report on pages 96 to 119). The Committee is formed exclusively of independent non-executive directors.

Relations with shareholders

***Principles* – There should be a dialogue with shareholders based on the mutual understanding of objectives • The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place • The board should use the AGM to communicate with investors and to encourage their participation.**

The Company has a well-developed investor relations programme managed by the Chief Executive, Group Finance Director and Investor Relations Director. In addition, the Chairman is in regular contact with major shareholders and looks to keep them informed of progress on corporate governance matters. In order to assist in developing an understanding of the views of major shareholders, each year the Company commissions a survey of investors undertaken by external consultants. The results of the survey are presented to the Board.

The Company maintains a comprehensive Investor Relations website that provides, amongst other things, information on investing in BAE Systems and copies of the presentation materials used for key shareholder presentations. This can be accessed via the Company's website, www.baesystems.com

The Company's AGM provides all shareholders with the opportunity to vote on the resolutions put to shareholders either electronically via the Company's website or by post. All resolutions detailed in the Notice of Meeting are voted on by way of a poll so as to ensure that all votes are counted on the basis of one vote for every share held. The result of the voting on all resolutions is published on the Company's website.

Compliance with the provisions of the Combined Code
The Company was compliant with the provisions of the Combined Code on Corporate Governance throughout 2010, except that between 1 January 2010 and 8 February the membership of the Remuneration Committee consisted of two independent non-executive directors and the Chairman of the Company (who had been independent on appointment to the position of Chairman). The Committee met once during this period and the only decision made concerning directors' remuneration was to introduce clawback provisions into the Company's executive share plans.

The Board
The Board comprises a non-executive chairman, eight non-executive directors and three executive directors.

The attendance by individual directors at meetings of the Board and its committees in 2010 is shown in the table below.

The Board considers all of the non-executive directors, with the exception of the Chairman, to be independent for the purposes of the Combined Code. Each of these directors has been identified on pages 76 and 77 of this report.

Mr Quarta is a partner in Clayton, Dubilier & Rice (CDR) and Mr Olver is an adviser to that firm. The Board has considered Mr Quarta's independence in light of the provisions in paragraph A.3.1 of the Combined Code (paragraph B.1.1 of the UK Corporate Governance Code) concerning significant links with other directors through involvement with other companies or bodies. Following review, the Board considers that, for the purposes of the Code, their relationship through CDR does not constitute a significant link. In reaching this determination the following matters were taken into consideration:

- as an adviser to CDR, Mr Olver has no management responsibilities or oversight obligations in respect of CDR or any of its investments; and
- Mr Olver has no involvement with the companies that Mr Quarta is a director of, or has management responsibility for, within CDR.

Mr Olver has undertaken to advise the Board should there be any material change in his relationship with CDR whilst Mr Quarta has an involvement with that firm.

Mr Symon and Mr Rose are both non-executive directors of BT Group plc and the Board has determined that, as they both serve in a non-executive capacity, both are independent for the purposes of paragraph A.3.1 of the Combined Code (paragraph B.1.1 of the UK Corporate Governance Code).

In 2010, the Board was scheduled to meet seven times and in addition two days were spent reviewing strategy. Additional Board meetings are called as required and in total the Board met 11 times during the year.

The Board has appointed Sir Peter Mason as the Senior Independent Director. Amongst the duties undertaken by Sir Peter during the year was to meet with the non-executive directors without the Chairman present to discuss the Chairman's performance.

The Company's Articles of Association require that all new directors seek re-election to the Board at the following AGM. In addition, the Board has agreed that in compliance with the UK Corporate Governance Code all directors shall seek re-election on an annual basis. The Board has set out in the Notice of Annual General Meeting their reasons for supporting the re-election of those directors seeking re-election at the forthcoming AGM.

ATTENDANCE BY INDIVIDUAL DIRECTORS AT MEETINGS OF THE BOARD AND ITS COMMITTEES IN 2010

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee	Non-Executive Directors' Fees Committee
Mr P M Anderson	10 (11)	–	3 (3)	6 (6)	–	–
Mr P J Carroll[1]	5 (5)	–	–	2 (2)	–	–
Ms H Green[2]	1 (2)	–	0 (1)	–	–	–
Mr M J Hartnall	10 (11)	6 (6)	–	–	–	–
Ms L P Hudson	10 (11)	–	–	–	–	1 (1)
Mr A G Inglis[3]	3 (6)	–	1 (2)	–	–	–
Mr I G King	11 (11)	–	–	–	–	1 (1)
Sir Peter Mason	11 (11)	5 (6)	4 (4)	8 (8)	–	–
Mr R L Olver	10 (11)	–	–	7 (8)	2 (2)	1 (1)
Mr R Quarta[4]	6 (11)	5 (6)	–	–	7 (7)	–
Mr G W Rose	11 (11)	–	–	–	–	–
Mr N C Rose[5]	7 (9)	5 (6)	–	–	3 (5)	–
Mr C G Symon	10 (11)	–	–	–	7 (7)	–
Mr R K Uppal	8 (11)	2 (5)	1 (1)	–	–	–

Figures in brackets denote the maximum number of meetings that could have been attended.
1 Retired from the Board on 5 May 2010.
2 Appointed to the Board on 1 November 2010.
3 Retired from the Board on 9 July 2010.
4 Attended six of the seven scheduled Board meetings held during the year.
5 Appointed to the Board on 8 February 2010.

Risk management and internal control
As reported in the Company's 2009 Annual Report, the Board has reviewed the historical control failures associated with the global settlement agreement with the UK Serious Fraud Office and the US Department of Justice announced in February 2010, and believes that the Company has systematically enhanced relevant compliance policies and processes since the behaviour referred to in the settlements occurred.

The Board has conducted a review of the effectiveness of the Group's system of risk management and internal control processes, including financial, operational and compliance controls and risk management systems, in accordance with the Code and the Turnbull guidance (as revised).

BAE Systems has developed a system of internal control that was in place throughout 2010 and to the date of this report, that encompasses, amongst other things, the policies, processes, tasks and behaviours that, taken together, seek to:

– facilitate the effective and efficient operation of the Company;

– enable it to respond appropriately to significant operational, financial, compliance and other risks that it faces in carrying out its business;

– assist in ensuring that internal and external reporting is accurate and timely, and based on the maintenance of proper records supported by robust information-gathering processes; and

– assist in ensuring that the Company complies with applicable laws and regulations at all times, and also internal policies in respect of the standards of behaviour and conduct mandated by the Board.

Details of the processes the Company has put in place to manage risk can be found on pages 56 and 57 of this report.

The Board has delegated to the Audit Committee responsibility for reviewing in detail the effectiveness of the Company's system of internal controls. Having undertaken such reviews, the Committee reports to the Board on its findings so that the Board as a whole can take a view on this matter. In order to assist the Audit Committee and the Board in this review, the Company has developed the Operational Assurance Statement (OAS) process (see below). This has been subject to regular review over a number of years, which has resulted in a number of refinements being made.

OPERATIONAL ASSURANCE STATEMENT (OAS) – KEY CHARACTERISTICS

A half-yearly review process to provide assurance that mandated policies and processes are being complied with, and a formal assessment of business risk.

All senior executives with specific profit or loss accountability for a line of business (Line Leaders) and functional directors are required to implement robust local processes to determine how their OAS should be completed. OAS returns are submitted to the Chief Executive and reviewed by the Audit Director and Director Financial Control, Reporting and Treasury. Results from the OAS are presented to the Audit and Corporate Responsibility committees, and form part of the Board's regular review of risk. All returns are made available to the Group's auditors for use in their audit activities.

The OAS is formed of the following two parts:

1. Assessment of compliance with the Operational Framework
– Line Leaders of all businesses and relevant functional directors are required to complete and sign off an OAS recording their formal review of compliance against the Company's Operational Framework covering, amongst other things, the following:
  – Health and safety
  – Environment
  – Product safety
  – Sponsorship and charitable giving
  – Product trading policy and pursuit of exports
  – Lobbying and political support
  – Advisers
  – Engineering
  – Business planning
  – Lifecycle Management (a core Group project management process)
  – Mergers, acquisitions and disposals
  – General compliance with the Operational Framework
  – Effectiveness of internal controls in joint ventures and associated undertakings
  – Ethical business conduct
  – Compliance with law, regulation and codes of practice
  – Delegated authorities
  – Financial controls
  – Risk management
  – People
  – Gifts and hospitality
  – Conflicts of interest
  – Security
  – Use of IT

– Where simple yes/no answers are not appropriate, an assessment of compliance is required to be made against structured qualitative guidance.

– Minimum satisfactory levels of compliance are set by policy. If not compliant, a robust plan to achieve compliance is mandated and monitored through the Group's performance management processes and at the relevant audit review board.

2. Identification and management of key risks
– Line Leaders of all businesses and functional directors are required to identify their key risks (nominally 20), and analyse them in terms of size of impact and probability. An owner is required to be assigned to each risk, and mitigation plans produced and managed by the relevant business.

– The Executive Committee conducts risk workshops to analyse and allocate management responsibility for the management of the Group's most significant non-financial risks.

Risks are identified on a 'bottom-up' basis as part of the OAS process. This process is mandated across the Group and requires that the heads of all businesses and functions identify their key risks. As part of this process, an assessment is made of the probability of the risk arising and its potential impact on the Group's business plan. All risks have an owner who is responsible for production and implementation of plans aimed at mitigating the risk. The output from the Group's risk processes is reviewed on a regular basis by the Executive Committee and it produces a register of non-financial risks. As with risks identified through the OAS process, all risks on the non-financial risks register have owners who are responsible for mitigating them.

The Audit Committee is responsible for reviewing the ongoing effectiveness of the Company's risk management processes as part of its review of the effectiveness of internal controls. Also, twice a year, the Audit Committee receives reports on the output from the OAS process, details of the changes in the risks identified by it and the status of mitigation plans. The Corporate Responsibility Committee undertakes a similar role in respect of the non-financial risk register. The Board receives reports from the chairmen of these two committees, providing details of the work they have undertaken. Once a year, the Audit and Corporate Responsibility committees hold a joint meeting to agree the annual programme for the Group's Internal Audit function.

Each year the Board specifically reviews the risks identified in the risk management processes. This is aimed at providing the Board with an appreciation of the key risks within the business and oversight of how they are being managed.

Reporting within the Company is structured so that key issues are escalated through the management team ultimately to the Board if appropriate. The Operational Framework provides a common framework across the Company for operational and financial controls, and is reviewed on a regular basis by the Board. The business policies and processes detailed within the Operational Framework draw on global best practice and their application is mandated across the organisation. Lifecycle Management (LCM) is such a process, and promotes the application of best practice programme execution and facilitates continuous improvement across the Group. It considers the whole life of projects from inception to delivery into service and eventual disposal, and its application is critical to our capability in delivering projects to schedule and cost.

Further key processes are Integrated Business Planning (IBP), Quarterly Business Reviews (QBR) and Total Performance Leadership (TPL). The IBP, approved annually by the Board, results in an agreed long-term strategy for each operating group, together with detailed near-term budgets. The QBRs evaluate progress against the IBP, and business performance against objectives, measures and milestones. TPL drives business success by linking individual goals to those of the organisation, enabling employees to understand how their own success contributes to the success of the whole business.

Whilst the quality of the control processes is fundamental to the overall control environment, the consistent application of these processes is equally important. The consistent application of world-class control processes is a key management objective. The Company is committed to the protection of its assets, which include human, property and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

The Internal Audit team independently reviews the risk identification procedures and control processes implemented by management. It provides objective assurance as to the operation and validity of the systems of internal control through a programme of cyclical reviews making recommendations for business and control improvements as required.

The overall responsibility for the system of internal control within BAE Systems rests with the directors of the Company. Responsibility for establishing and operating detailed control procedures lies with the Line Leaders of each operating business.

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

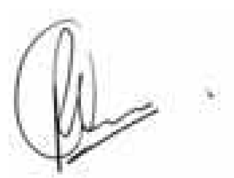
The responsibility for internal control procedures with joint ventures and other collaborations rests, on the whole, with the senior management of those operations. The Company monitors its investments and exerts influence through board representation.

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position, are set out in the operating group reviews on pages 66 to 74. The financial position of the Group, including information on order intake, cash flow, treasury policy and liquidity, can be found in the review of financial performance on pages 36 to 44. Principal risks are detailed on pages 58 to 63. In addition, the financial statements include, amongst other things, notes on finance costs (page 142), loans and overdrafts (page 158), and financial risk management (page 176).

After making due enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.

On behalf of the Board



Dick Olver
Chairman

Remuneration report

The Remuneration report is structured as follows:

Remuneration Committee report

Members
Carl Symon (Chairman)
Roberto Quarta
Nick Rose

Responsibilities

– Agreeing a policy for the remuneration of the Chairman, executive directors, members of the Executive Committee (EC), the Company Secretary and other senior executives.

– Within the agreed policy, determining individual remuneration packages for the Chairman, executive directors and EC members.

– Agreeing the policy on terms and conditions to be included in service agreements for the Chairman, executive directors, EC members, the Company Secretary and other senior executives, including termination payments and compensation commitments, where applicable.

– Approving any employee share-based incentive schemes and any performance conditions to be used for such schemes.

– Determining any share scheme performance targets.

The full terms of reference of the Remuneration Committee can be found on the Company's website or can be obtained from the Company Secretary.

Carl Symon
Remuneration
Committee Chairman

Governance
The members of the Committee are independent non-executive directors.

Dick Olver, the Company's Chairman (who was deemed to be independent on his appointment as Board Chairman on 1 July 2004), also served as a member of the Committee until 17 February 2010. Nick Rose was appointed to the Committee with effect from 17 February 2010.

The Chief Executive and the Company's Chairman, subsequent to his resignation from the Committee, attend Committee meetings by invitation only. They do not attend where their individual remuneration is discussed and no director is involved in deciding his own remuneration. The Company Secretary acts as secretary to the Committee.

In 2010, the Committee met seven times and details of attendance at these meetings are provided in the Corporate Governance report on page 86.

The Committee appointed Kepler Associates as its Independent Adviser in 2007 to provide advice to the Committee and its individual members on all aspects of the Committee's remit. Kepler Associates will not undertake any work for the Company whilst they are retained as the Committee's Independent Adviser. Representatives from Kepler Associates have attended each of the Committee meetings during 2010 and will be in attendance at all meetings unless specifically requested otherwise by the Committee.

During the year, the Committee also received material assistance and advice on remuneration policy from the Group's Human Resources Director, Alastair Imrie, and the Human Resources Director, Remuneration and Benefits, Graham Middleton. Dick Olver, Chairman, and Ian King, Chief Executive, also provided advice that was of material assistance to the Committee.

Legal advice to the Committee has been provided by Linklaters who are appointed by the Company, and who also provided services to the Company during the year. The Committee is satisfied that the services provided to it by Linklaters are of a technical nature and did not create any conflict of interest. If a conflict of interest were to arise in the future, the Committee would appoint separate legal advisers from those used by the Company.

PricewaterhouseCoopers (PwC), who are appointed by the Company and also provided services to the Company during the year, provided detailed information on market trends and the competitive positioning of packages. Hewitt New Bridge Street, who are appointed by the Committee, provided advice on the total shareholder return figures for assessing the performance condition under the Performance Share Plan.

ANNUAL TIMETABLE OF COMMITTEE ACTIVITIES

	Directors' and EC members' remuneration	Annual bonus	Share plans	Miscellaneous
Quarter 1	Shareholder consultation on remuneration review Approve remuneration for EC members	Review prior year performance against financial and non-financial performance. Where applicable, agree bonus amounts payable Set directors' and EC members' performance targets and objectives for current year	Approve Group All-Employee Free Shares Plan payments Grant of Spring awards to directors and executives	Review Remuneration Committee Terms of Reference and output of the Remuneration Committee performance evaluation Review Remuneration Report for recommendation to the Board
Quarter 2				Review pay review for senior executives below the EC
Quarter 3	Review directors' actual pay and bonus for previous year against comparator group actuals Set basis for annual remuneration review	Review progress of directors' and EC members' performance against targets	Grant of Autumn awards to directors and executives	
Quarter 4	Review market position (including pensions) Set bonus levels and share plan grant levels Set directors' salaries		Review share-based reward considering market trends, and review status of performance conditions, dilution levels and usage for following year Agree grant policy for Spring awards Approve Group All-Employee Free Shares Plan for following year	Review market position of package (including pensions) for senior executives below the EC

Activities and highlights
BAE Systems is one of the world's largest and most geographically diverse defence and security companies. We operate with a clearly defined strategy to deliver sustainable growth in value to shareholders, operating in a highly technologically complex market, with a presence in five key home markets. The Group faces a more challenging trading environment as governments look for cost savings to address budgetary pressures.

Our remuneration strategy is intended to recognise this business environment whilst fostering a Total Performance culture at all levels of the Company, taking into account seniority and local market practice. In addition, it reinforces our drive to continue to embed high levels of business conduct and our commitment to safety across the business.

The Committee is sensitive to the levels of the remuneration packages of other employees within the Group. In some areas, our workforce is heavily unionised. Many of our employees work at the very leading edge of technology. We have a diverse workforce operating in many countries. Employee remuneration packages are therefore determined locally to meet local needs, whilst respecting our culture and Values. In 2010, general salary increases for our two largest employee populations in the UK and US typically averaged 2.4% and 2.5%, respectively.

In determining the levels of executive reward, the Remuneration Committee also continues to place considerable emphasis on ensuring a strong link between actual remuneration received, and achievement of our strategic and business objectives.

In 2010, our performance against targets was good. We slightly exceeded our profit target, and exceeded our stretch cash targets. However, our Total Shareholder Return (TSR) performance reflects the sustained under-performance of our share price. Our Earnings per Share (EPS) was 40.5p. We also started to experience significant executive retention issues in North America.

Against this performance background, the main aspects of our remuneration policy and practice for the year were as follows:

– having been unchanged in 2009, the salaries of the Chief Executive and Group Finance Director were increased by 3.9% and 2.5%, respectively;

– the salary of the President and Chief Executive Officer of BAE Systems, Inc., Linda Hudson, has been increased by 12.2% to bring her nearer to market median. She was appointed in October 2009 having been promoted to that position from within the business. In setting her initial salary the Remuneration Committee was aware that she would be operating at a significantly higher level than was previously the case, and, whilst this salary was a clear step-up from her previous position, there was scope for future increases to bring her closer to market median provided her performance merited this. The increase awarded by the Remuneration Committee recognises where her initial salary was set in 2009 and that she is performing on a level which justifies a more market competitive package. This salary change was made with effect from 1 January 2011;

– annual bonus payouts for the executive directors under the annual incentive plan ranged from 69.1% to 89.1% of maximum;

– the growth of EPS over the three-year performance period for the 2008 awards under the long-term incentive plans was approximately 10.6% pa. Consequently:

  – the awards of matching shares granted under the Share Matching Plan (SMP) in 2008 vest in full; and

  – of the 50% of the awards of shares granted in Spring 2008 under the EPS portion of the Performance Share Plan (PSP), 94.55% vest.

– the Company's TSR for the 50% of awards of shares granted in March 2008 under the TSR portion of the PSP was below the median position when compared against the comparator group of 18 other defence and aerospace companies, and the related awards accordingly lapsed;

– the structure of our annual incentive and long-term incentives were left substantially unchanged (including the 'clawback' arrangements established last year) (see pages 101 and 108 for details);

– we retained the requirement for one-third of executive directors' annual incentives (25% for EC members and other senior executives) to be compulsorily deferred into the SMP;

– our requirement for executive directors to build up a shareholding of 200% of salary over time, remains unchanged. Both the Chief Executive and Group Finance Director comfortably exceed this level; at 31 December 2010, the President and Chief Executive Officer of BAE Systems, Inc. held shares representing approximately 144% of salary, reflecting her more recent appointment; and

– we are seeking shareholder approval to introduce a Restricted Share Plan (see page 102), principally to enable us to address key executive retention issues for US-based executives. The Plan would permit awards to executives in other countries, but specific Remuneration Committee approval will be required on each occasion. The President and Chief Executive Officer of BAE Systems, Inc. will be included in the Plan, but other Board members will not be included without further consultation with shareholders.

The Company's remuneration strategy, policy and details of executive remuneration are set out on pages 100 to 112 of this report.

Following the announcement of the retirement of George Rose as Group Finance Director, effective 31 March 2011, the Committee also agreed the package for Peter Lynas on his appointment as Group Finance Director and an executive director of BAE Systems plc, effective 1 April 2011.

On behalf of the Remuneration Committee

Carl Symon
Remuneration Committee Chairman

Non-Executive Directors’ Fees Committee report

Members
Dick Olver (Chairman)
Philip Bramwell
Linda Hudson
Ian King

Responsibilities
– Reviewing the fees payable to non-executive directors (excluding the Chairman) and making changes to such fees as deemed appropriate.

Dick Olver
Non-Executive Directors’ Fees Committee Chairman

Governance
The Non-Executive Directors’ Fees Committee has delegated authority from the Board to agree fees payable to non-executive directors on its behalf.

Activities
The Board has approved the following guidelines to be used by the Committee when discharging its responsibilities:

– fees shall be sufficient to attract and retain individuals with the necessary skills, experience and knowledge required to ensure that the Board is able to discharge its duties effectively;

– in setting fees the Committee shall have regard to the amount of time individual non-executive directors are required to devote to their duties, and also the scale and complexity of the business, and the responsibility involved;

– fees payable to non-executive directors shall be paid in cash and shall not be performance-related; and

– non-executive directors shall not participate in the Company’s share-based incentive schemes or pension scheme.

The Committee meets each year to consider the fees paid to the non-executive directors. Having reviewed the increasing time commitments expected of non-executive directors and the market competitive positioning of existing fee levels, the Committee agreed in January 2011 to increase the basic fee from £66,000 to £75,000 per annum. All other fees remain unchanged as detailed on page 113.

On behalf of the Non-Executive Directors’ Fees Committee

Dick Olver
Non-Executive Directors’ Fees Committee Chairman

Remuneration strategy, policy and packages

Following the annual review in November 2010, the Committee concluded that the current remuneration strategy remains generally appropriate, but the following changes have been introduced:

- to further emphasise the importance of business growth, order intake is being incorporated as one of the financial elements in the annual incentive plan targets (see page 101). Other elements of the Plan remain unchanged; and
- to address retention issues principally in our North American business, shareholder approval is being sought at the AGM to implement a Restricted Share Plan (see page 102).

Other than these changes, the Committee intends to continue with the executive remuneration policy as detailed in this report in 2011 and subsequent years for executive directors and EC members, and this policy will be flowed down to the most senior executives within the Group globally (approximately 280) to create a consistent global approach to reward. The principles of the remuneration strategy are applied consistently across the Group below this level, taking account of seniority and local market practice.

The Committee will continue to consult on material changes with principal shareholders.

The Committee has considered the new UK Corporate Governance Code requirement regarding remuneration incentives being compatible with risk policies and systems, and is satisfied that the Company is well placed to meet this requirement as profit recognition on long-term programmes is intrinsically linked to risk reduction.

REMUNERATION STRATEGY

The Company's remuneration strategy is to provide a remuneration package that:

- helps to attract, retain and motivate;
- is aligned to shareholders' interests;
- is competitive against the appropriate market;
- encourages and supports a Total Performance culture aligned to the achievement of the Company's strategic objectives;
- is fair and transparent; and
- can be applied consistently throughout the Group.

REMUNERATION POLICY

To achieve the strategy, the remuneration policy for executive directors and EC members is to:

- set base salary at around median of the relevant market competitive level;
- reward stretching superior performance with upper quartile reward;
- provide an appropriate balance between:
  - short-term and long-term reward; and
  - fixed and variable reward

  with the balance becoming more long term and more highly geared with seniority;
- directly align short-term and long-term reward through compulsory deferral of annual incentive into the Share Matching Plan; and
- provide a competitive package of benefits.

ELEMENTS OF PACKAGE	PURPOSE
Base salary	Recognise market value of role and individual's skills, experience and performance.
Annual incentive	Drive and reward annual performance of individuals, teams and the Company on both financial and non-financial metrics, including behaviours.
Share Matching Plan	Directly align short-term and long-term reward through compulsory deferral of annual incentive into shares, and drive and reward delivery of sustained long-term EPS performance through co-investment aligned to the interests of shareholders.
Performance Share Plan	Drive and reward delivery of sustained long-term EPS and TSR performance aligned to the interests of shareholders.
Restricted Share Plan	Provide long-term reward and address retention issues, through time-vesting awards principally in the Company's US market.
Pension provision	Provide competitive retirement benefits which reward long-term performance through seniority, and loyalty through long service.
Other benefits	Provide competitive cost effective benefits package through leveraging the Company's size and scale.
Global all-employee incentive plan	Reward all employees globally for Group performance, encouraging employee share ownership aligned to the interests of shareholders.

Appointment of new Group Finance Director

The Company announced on 10 December 2010 that George Rose would be retiring as Group Finance Director with effect from 31 March 2011 and that Peter Lynas would be appointed as Group Finance Director with effect from 1 April 2011. The salary packages for both George Rose, the outgoing Group Finance Director, which had been agreed as part of the 2010 remuneration review, and for Peter Lynas, the incoming Group Finance Director, which was agreed by the Committee subsequent to the 2010 remuneration review, are included in this report.

2010 remuneration review

The 2010 review not only considered the Company's executive remuneration packages against the market, but also the Company's performance to date and its corporate strategy for the next five years.

Information on the market for comparable management positions was provided by PwC so that the Committee could form a view as to where to position the various elements of the package relative to comparable companies.

The methodology used was to construct appropriate comparator groups for the individual positions, taking account of company size, scale of operations and breadth of role. The comparator group for the UK executive directors comprised the FTSE 50 companies (excluding financial services and retail) with market capitalisation nearest to that of BAE Systems. The Committee believes that using market capitalisation creates alignment between the value placed on the Company and the value placed on the executives who manage it. The six largest companies were also excluded as were several others to arrive at a comparator group of 20 companies (11 larger and 9 smaller) which the Committee believed appropriate for benchmarking UK executive directors' packages.

For the President and Chief Executive Officer of BAE Systems, Inc., the comparator group was drawn from companies in the US aerospace, defence and general industry sector, adjusted as appropriate, to produce market figures consistent with the size, scale and relative independence of the US business, and adjusting where necessary to reflect the extra responsibility for her plc Board role.

The base salary, total cash reward (base salary plus annual incentive), total direct reward (total cash reward plus long-term incentives) and total reward (total direct reward plus pension) were analysed at the lower quartile, median and upper quartile for the relevant posts in the comparator group companies. This gives the Committee a view on the competitiveness of the individual elements of the package as well as the package as a whole.

The Committee also reviewed market trends around the individual elements of remuneration to ensure that the structure of the package stays in line with market practice. The remuneration structure overall also takes account of the performance of the individual, the Company as a whole, and the pay and conditions of Group employees.

Overall, while the review indicated that the structure is broadly in line with the market, some minor adjustments were deemed necessary to ensure that it remained so. In addition, the base salaries for both the Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc. were behind their respective benchmarks.

Base salary

The Committee reviewed base salaries, taking into account the current economic climate, the challenges facing the business, their respective positions against benchmark, the pay environment for employees in general and that their salaries had been unchanged since 2009. In particular, the salary of the President and Chief Executive Officer of BAE Systems, Inc. has been increased to maintain the competitiveness of the package and bring her salary closer to market median. Further information on the rationale for this increase is provided on page 98.

The annual base salary levels of executive directors with effect from 1 January 2011 are as follows:

Name	2010 salary	**2011 salary**	Increase
Ian King	£900,000	**£935,000**	3.9%
George Rose	£622,500	**£638,000**	2.5%
Linda Hudson	$900,000	**$1,010,000**	12.2%

Incentives

The Group's strategy is set out on page 14 along with the Group Strategic Framework. This explains how the Group's mission is to deliver sustainable growth in shareholder value through its commitment to Total Performance – Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour. Underpinning the drive for Total Performance are the Group's Values – Trusted, Innovative and Bold. The Group's strategy focuses on delivering growth in the three market segments of Services, Electronic Systems and Platforms, in existing and new home markets, and in export markets. The six Strategic Actions, which translate the strategy into operational plans, are underpinned by the Integrated Business Plan (IBP), which sets out a five-year strategic and financial plan.

Each year, the Board agrees the Executive Committee's top ten objectives which are those key to delivering the Group's strategy. For 2011, these are set out on page 13, and are used as the basis to set the individual objectives for the executive directors and EC members which are agreed by the Chairman, Dick Olver, and the Committee. These then flow down to the senior leadership team to ensure that all businesses within the Group are aligned with the overall Group strategy.

The remuneration strategy incentivises and rewards executives to deliver their contribution to the achievement of the Group's strategy through the combination of short-term incentives targeted at business performance, Group performance, personal performance and leadership behaviours, and long-term incentives targeted at Group performance. To directly align short-term and long-term reward, executive directors will be required to invest at least one-third of their net 2011 annual incentive into the SMP when the annual incentive is paid in 2012. Further investment can be made on a voluntary basis up to a maximum investment of half their net annual incentive, except in the case of the US executive director who will participate in the Restricted Share Plan subject to its approval by shareholders at the 2011 AGM (further detail is provided on page 102).

Annual incentive plan

The annual incentives for 2011 continue to focus on a combination of in-year financial performance, and longer-term performance and risk management (both business risk and reputation risk). Two-thirds is driven off in-year financial performance, and one-third based on driving performance and improvement in business conduct and safety (reinforcing the importance of key aspects of the Group's corporate responsibility agenda) combined with the other non-financial objectives supporting the Group's strategy. No changes to this structure are proposed for 2011.

The financial targets are derived from the IBP, and are based on earnings and cash targets and, for 2011, also order intake. The relative proportions of the financial targets for profit, cash and order intake are 40:40:20. These are seen as the key indicators of both short-term and long-term financial performance and value creation, and are supported by the Company's major shareholders. At Group level, EPS is used whereas EBITA[1] is used to measure earnings performance at a business level. To incentivise improved phasing of cash generation throughout the year, a combination of year-end and average quarterly net cash/debt was introduced for 2009 and 2010, and will continue for 2011. Due to the stretching nature of the plan, the Committee introduced for 2010 a threshold paying 20% of maximum for the profit element. This will continue for 2011. The payout for on-target performance is 50% of maximum. Payout for performance between targets is calculated on a straight-line basis.

The table below summarises the overall structure of the annual incentives for executive directors.

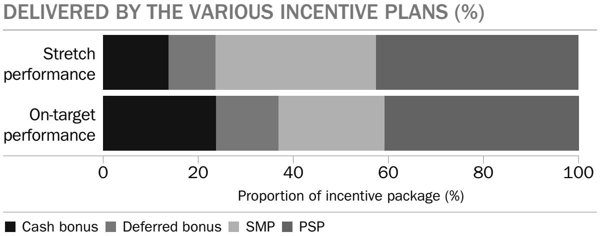
	Proportion of annual incentive	
Performance measure	2010	**2011**
In-year financial	66.6%	**66.7%**
Business conduct and safety	15.0%	**15.0%**
Other objectives	18.4%	**18.3%**

The Committee believes that the annual incentive targets for the executive directors are stretching but achievable. The structure of the 2011 annual incentive plan for executive directors is summarised in their individual sections on pages 103 to 106.

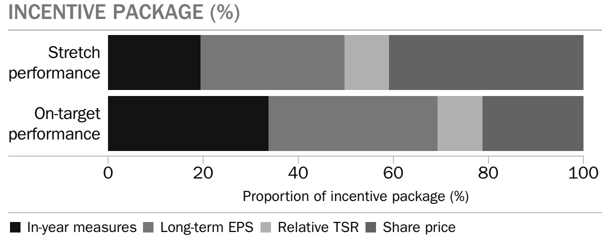
Long-Term Incentive Plans (LTIPs)
The Company operates two LTIPs (having ceased awards of share options in 2008) – the Performance Share Plan (PSP) and the Share Matching Plan (SMP). The structure of these plans remain unchanged. Full details of the PSP and SMP are contained on pages 108 and 109.

The combination of the annual incentive plan, SMP and PSP provides a balance between short-term cash reward and longer-term share-based reward as shown below. The proportion of the incentive package delivered through longer-term performance is significantly higher at stretch payout than at on-target payout, demonstrating that the package supports the achievement of superior long-term performance and strongly aligns the interests of executives to those of shareholders through long-term reward being delivered in shares. The second graph shows which performance metrics are driving the value of the incentives. This shows that, at on-target performance, the higher influence of the annual incentive means that in-year measures drive almost 40% of the package value, with long-term EPS (which underpins the SMP and half the PSP awards) accounting for a similar proportion. But, at stretch performance, the influence of the annual incentive is reduced, and the SMP and PSP account between them for nearly three-quarters of the value of the incentive package, with the most important drivers of value becoming long-term EPS and share price. This shows that achieving strong performance on the in-year measures is important but, to maximise the value of their incentive package, executives need to drive growth in long-term EPS and share price.

PROPORTION OF CHIEF EXECUTIVE'S INCENTIVE PACKAGE DELIVERED BY THE VARIOUS INCENTIVE PLANS (%)



PERFORMANCE DRIVERS OF CHIEF EXECUTIVE'S INCENTIVE PACKAGE (%)



Restricted Share Plan (RSP)
Within the Company's US peer group, our research indicates that performance-based LTIP awards only typically make up around a third of the overall long-term incentive package for a US executive. In comparison, the BAE Systems LTIP plans are 100% based on performance conditions, which provides much less retention value for senior US executives and can be 'bought out' by a competitor for a small cost.

Our US business is a fundamentally important part of the Group, and it is essential we are able to attract and retain high calibre staff. We do not wish to provide a completely different reward structure in the US compared to our global approach; nor will we increase the overall value of the Inc. reward package. However, the retention issue is sufficiently serious and potentially damaging to the business to require action.

Consequently, the Committee is proposing to introduce a time-vesting LTIP element within the overall US executive package. This will be achieved by introducing a Restricted Share Plan (RSP) without performance conditions other than time vesting. The Restricted Share Plan will provide 35% of the expected value of the total LTIP package, and will vest after three years. This Plan will require the approval of shareholders at the AGM in May 2011.

The expected value of the total LTIP package for US executives including the RSP will be maintained at its current level. Subject to shareholder approval of the RSP, this will be achieved by reducing existing LTIP award levels for participants as follows:

- removing the voluntary matching element of the SMP. This will apply to voluntary investment in the SMP in respect of the 2010 annual incentive plan payment, and onwards; and
- reducing overall PSP award levels.

Subject to shareholder approval, participants' awards of restricted stock will be confirmed after the AGM.

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

Whilst the Plan is primarily aimed at our US executives, the Plan would permit awards to executives in other countries, but specific Remuneration Committee approval will be required on each occasion. The President and Chief Executive Officer of BAE Systems, Inc. will be included in the Plan, but other Board members will not be included without further consultation with shareholders.

Personal shareholding policy

The Committee has agreed a policy whereby all executive directors are required to establish and maintain a minimum personal shareholding equal to 200% of base salary. As a minimum, a holding equal to 100% of base salary must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes or long-term incentive schemes, by using 50% of the shares that vest or 50% of the options which are exercised on each occasion. Thereafter, executive directors are required to increase their personal shareholding gradually, on each occasion using 25% of the shares that vest or 25% of the options exercised each year, until a personal shareholding equal to 200% of annual base salary is achieved and maintained. These limits are reviewed periodically. A similar arrangement applies to senior executives eligible for share-based long-term incentives with limits aligned to the levels of awards made under these plans.

Details of the directors' personal shareholdings are shown in Table A on page 114.

Pension provision

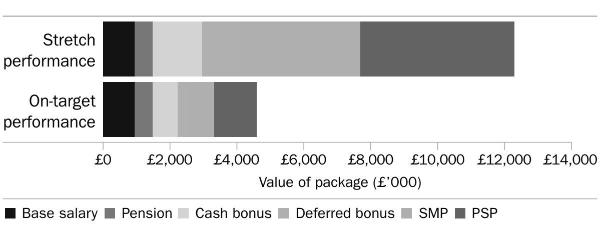
No changes to the pension arrangements for executive directors were made in 2010. A review of UK executive pension arrangements has been undertaken in the light of the changes announced to the taxation of members of UK registered pension arrangements from 6 April 2011. The underlying principles for this review were that the aggregate level of benefits provided to members under the new arrangements should be cost neutral to the Company compared to the existing arrangements. The approach addresses tax inefficiencies arising for existing employees as a consequence of the pensions tax changes, and members will be given the choice to remain in the current arrangements and pay the increased tax. Further detail is provided on page 111.

STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES

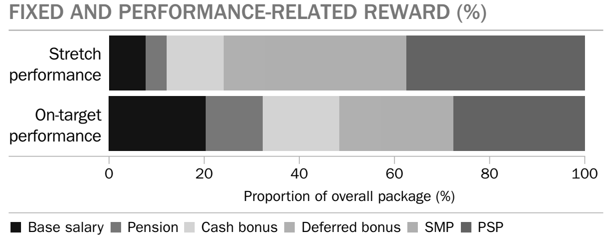
Ian King (Chief Executive)		**2011**		2010	
Base salary		**£935,000 pa**		£900,000 pa	
Annual incentive	Maximum/on-target (% of salary)	225%/112.5%			
	Structure (% of salary)	**On-target**	**Stretch**	On-target	Stretch
	Group EPS	**30%**	**60%**	36%	90%
	Group cash	**30%**	**60%**	24%	60%
	Order intake	**15%**	**30%**	Not applicable	
	Safety		**Up to 16.875%**		Up to 16.875%
	Business conduct		**Up to 16.875%**		Up to 16.875%
	Other objectives		**Up to 41.25%**		Up to 41.25%
	Deferral into SMP	⅓ compulsory plus voluntary up to total of 50% of net annual incentive			
SMP	Gross match	2:1			
	Performance condition	EPS growth of 5% – 11% pa			
PSP	Grant (% of salary)	250%			
	Performance condition	½ on relative TSR against 18 other global aerospace and defence companies, and ½ on EPS growth of 5% – 11% pa			
Pension accrual		1/30th of three-year final average salary from age 62 for 8% member's contributions			

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

VALUE OF PACKAGE (£'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)

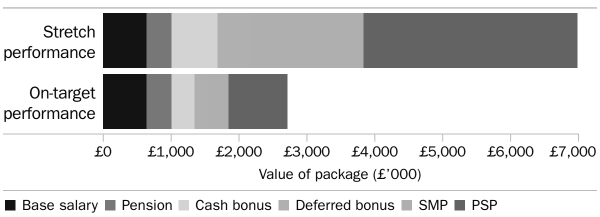


STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES *CONTINUED*

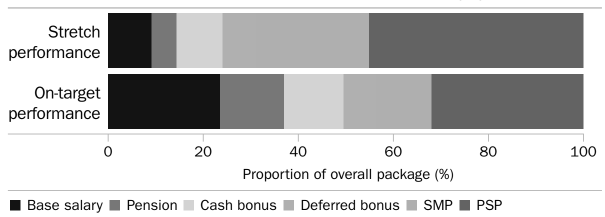
George Rose (Group Finance Director)		**2011***		2010	
Base salary		**£638,000 pa**		£622,500 pa	
Annual incentive	Maximum/on-target (% of salary)	150%/75%			
	Structure (% of salary)	**On-target**	**Stretch**	On-target	Stretch
	Group EPS	**20%**	**40%**	24%	60%
	Group cash	**20%**	**40%**	16%	40%
	Order intake	**10%**	**20%**	Not applicable	
	Safety		**Up to 11.25%**		Up to 11.25%
	Business conduct		**Up to 11.25%**		Up to 11.25%
	Other objectives		**Up to 27.5%**		Up to 27.5%
	Deferral into SMP	⅓ compulsory plus voluntary up to total of 50% of net annual incentive			
SMP	Gross match	2:1			
	Performance condition	EPS growth of 5% – 11% pa			
PSP	Grant (% of salary)	250%			
	Performance condition	½ on relative TSR against 18 other global aerospace and defence companies, and ½ on EPS growth of 5% – 11% pa			
Pension accrual		1/30th of three-year final average salary from age 60 for 9.29% member's contributions			

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

VALUE OF PACKAGE (£'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)



* As announced by the Company on 10 December 2010, George Rose will retire with effect from 31 March 2011. The 2011 salary package details and graphs above set out the position had he continued in his role throughout 2011. Details of his retirement arrangements are provided on page 112.

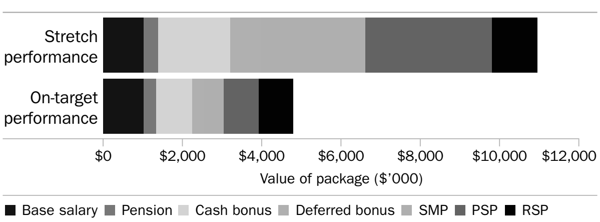
STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES ***CONTINUED***

Linda Hudson (President and Chief Executive Officer of BAE Systems, Inc.)		**2011**		2010	
Base salary		**$1,010,000 pa**		$900,000 pa	
Annual incentive	Maximum/on-target (% of salary)	225%/112.5%			
	Structure (% of salary)	**On-target**	**Stretch**	On-target	Stretch
	Group EPS	**10%**	**20%**	12%	30%
	Group cash	**10%**	**20%**	8%	20%
	Order intake	**5%**	**10%**	Not applicable	
	Business EBITA[1]	**20%**	**40%**	24%	60%
	Business cash	**20%**	**40%**	16%	40%
	Business order intake	**10%**	**20%**	Not applicable	
	Safety		**Up to 16.875%**		Up to 16.875%
	Business conduct		**Up to 16.875%**		Up to 16.875%
	Other objectives		**Up to 41.25%**		Up to 41.25%
	Deferral into SMP	**Compulsory ⅓ of net annual incentive. No voluntary element**		⅓ compulsory plus voluntary up to total of 50% of net annual incentive*	
SMP	Gross match	2:1			
	Performance condition	EPS growth of 5% – 11% pa			
PSP	Grant (% of salary)	**160%**		250%	
	Performance condition	½ on relative TSR against 18 other global aerospace and defence companies, and ½ on EPS growth of 5% – 11% pa			
RSP	% of salary	**65%**		Not applicable	
Pension accrual		Cash sum at retirement of 14.1% of career pay (salary plus bonus up to maximum of 150% of salary) for a contribution of 1.5% of pay, plus an 85% Company 401(k) match on contributions to a maximum of 6% of salary			

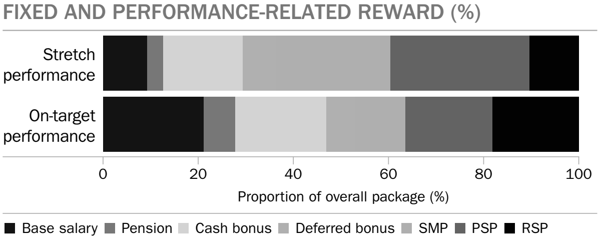
* Linda Hudson will be granted an award under the RSP in 2011, subject to shareholder approval of the RSP at the 2011 AGM, and will thus not be permitted to make any voluntary investment in the SMP in 2011 in relation to her 2010 net annual incentive payment.

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

VALUE OF PACKAGE ($'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)

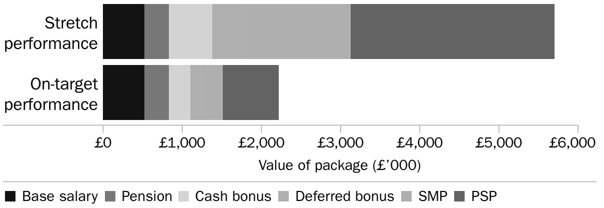


1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

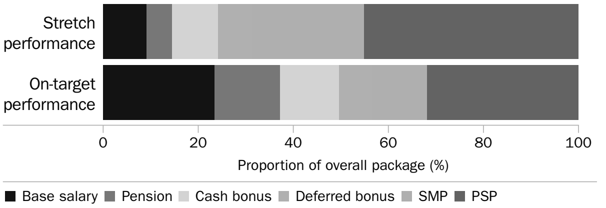
STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES *CONTINUED*			
Peter Lynas (Group Finance Director designate)		**Effective 1 April 2011**	
Base salary		**£520,000 pa**	
Annual incentive	On-target/maximum (% of salary)	**75%/150%**	
	Structure (% of salary)	**On-target**	**Stretch**
	Group EPS	**20%**	**40%**
	Group cash	**20%**	**40%**
	Order intake	**10%**	**20%**
	Safety		**Up to 11.25%**
	Business conduct		**Up to 11.25%**
	Other objectives		**Up to 27.5%**
	Deferral into SMP	**⅓ compulsory plus voluntary up to total of 50% of net annual incentive**	
SMP	Gross match	**2:1**	
	Performance condition	**EPS growth of 5% – 11% pa**	
PSP	Grant (% of salary)	**250%**	
	Performance condition	**½ on relative TSR against 18 other global aerospace and defence companies, and ½ on EPS growth of 5% – 11% pa**	
Pension accrual		**1/30th of three-year final average salary from age 62 for 8% member's contributions**	

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward as if Peter Lynas had been in post as Group Finance Director with effect from 1 January 2011.

VALUE OF PACKAGE (£'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)



Performance in 2010
The structure of the 2010 annual incentive plan was set out in last year's Remuneration report and is summarised in the individual sections for each of the executive directors on pages 103 to 106 of this report.

Financial performance: 2010 was a robust year in terms of financial performance following the Group's strong performance of recent years. At the Group level, EPS performance was above threshold, but well short of stretch performance. Stretch performance was achieved on both cash targets. At the operating group level, Programmes & Support exceeded its profit target but did not hit its stretch target, and achieved its stretch cash targets. International and BAE Systems, Inc. achieved stretch on all their financial targets.

Non-financial performance: Page 12 sets out the Executive Committee's top ten objectives for 2010 and the assessment of performance against these, whilst page 46 provides more detailed information on the performance against the specific objectives relating to business conduct and safety.

Business conduct: The Group targeted the successful implementation of the suite of revised policies and processes which had been updated as part of the Woolf implementation programme. All businesses are on target with their stated plans.

Safety: The Group has continued to drive improvement of safety management, using its Safety Maturity Matrix (SMM) as the mechanism to measure and drive performance. Sites with more than 150 personnel (other than those acquired during 2010) have now progressed to Level 4 on the SMM. In addition, the Group achieved an overall 31% reduction in the Lost Work Day Case Rate, exceeding a target 20% reduction, compared with performance during 2009. Some individual businesses did not achieve this target.

Other objectives: Of the remaining top ten Group objectives most have been successfully achieved, giving a result of 90% of maximum. This sets the starting point with further adjustment, up or down, depending on the assessment of overall performance and leadership behavioural performance of the individual executive.

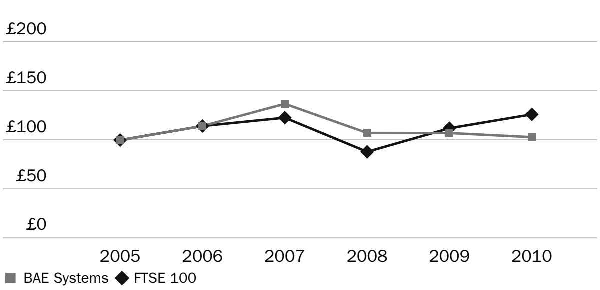
Accordingly, the Committee determined the payout under the 2010 annual incentive plan as follows:

2010 annual incentive payout	Ian King	Linda Hudson	George Rose
% of stretch	71.0%	89.1%	69.1%
% of base salary	159.7%	200.5%	103.7%
Amount	£1,437,075	$1,804,275	£645,533

In addition:

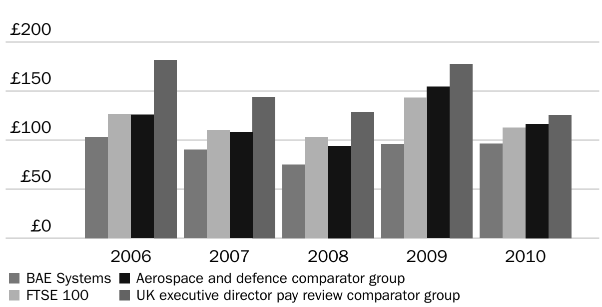
- the growth in EPS over the three years to 2010 was approximately 10.6% pa. Consequently:
  - the awards of matching shares granted under the SMP in 2008 vest in full; and
  - of the 50% of the awards of shares granted in Spring 2008 under the EPS portion of the PSP, 94.55% vest.
- the Company's TSR for the 50% of awards of shares granted in March 2008 under the TSR portion of the PSP was below the median position when compared against the comparator group of 18 other defence and aerospace companies, and the related awards accordingly lapsed.

VALUE AT 31 DECEMBER 2010 OF £100 INVESTMENT AT 31 DECEMBER 2005 (£)



This graph, which has been produced in accordance with the requirements of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, shows the value by 31 December 2010, on a total shareholder return basis, of £100 invested in BAE Systems on 31 December 2005 compared with the value of £100 invested in the FTSE 100 index. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity index. As BAE Systems is a constituent member of the FTSE 100, it was deemed to be the most appropriate general UK equity index.

VALUE AT 31 DECEMBER 2010 OF £100 INVESTMENT (£)



The graph above shows the value shareholders have achieved by their investment in BAE Systems over recent years as compared to (i) the FTSE 100 index; (ii) the companies forming the sectoral peer group for the Performance Share Plan; and (iii) the companies forming the comparator pay group for the 2010 executive pay review. The graph depicts the value for BAE Systems and the comparators at the end of 2010 of a single £100 investment made at the beginning of each of the last five years.

Summary of Long-Term Incentive Plans

Plan provisions
Performance conditions for grants of awards to be made under the Performance Share Plan and the Share Matching Plan in 2011 are detailed below. Performance conditions for grants of awards made prior to 2011 are detailed on pages 115 and 116.

Clawback arrangements operate in respect of these two plans from the 2010 awards onwards. The arrangements are intended to cover situations, for example, where results are restated or otherwise turn out to be materially inaccurate or where the executive's employment can be terminated for cause.

PERFORMANCE SHARE PLAN (PSP)

Key features for PSP awards in 2011:

– awards of shares are granted based on a percentage of salary and share price at the date of grant;

– the shares are subject to satisfaction of three-year performance conditions;

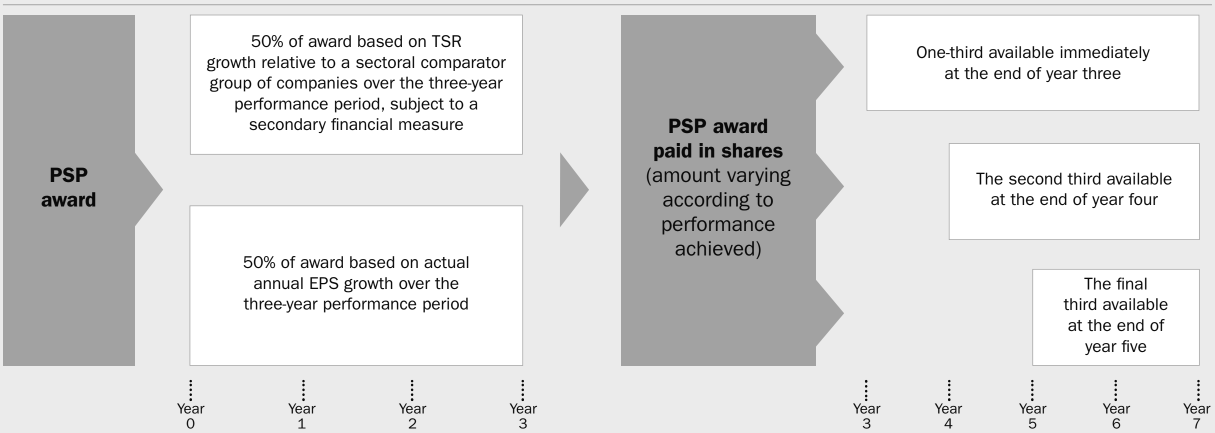
– half the PSP award will be based on a Total Shareholder Return (TSR) performance condition (PSP^{TSR}) and the other half on an Earnings per Share (PSP^{EPS}) performance condition;

– in addition, there is a further test on the PSP^{TSR} element to ensure that the TSR performance is supported by the underlying performance of the Company;

– shares under award after satisfaction of the performance condition vest in three equal tranches at the end of years three, four and five; and

– shares under award attract dividends prior to vesting.

HOW THE PSP OPERATES



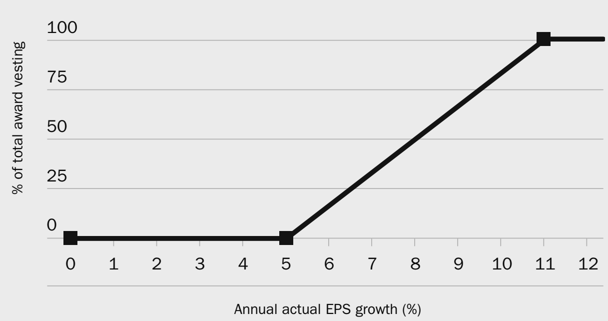
For the US executives, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition achieved.

PERFORMANCE CONDITION – PSP^{EPS}

The proportion of the award capable of exercise is determined by the rate of annual actual EPS growth over the three-year performance period, with nil vesting at annual actual EPS growth of 5% and 100% vesting at 11% growth as set out opposite (15% to 33% growth over three years).

The rationale for the EPS performance measure is that major investors consider EPS to be a key indicator of long-term financial performance and value creation.

Summary of EPS performance to 31 December 2010
2010 EPS was 40.5p, and is approximately 10.6% greater (per annum) than the 2007 EPS of 30.7p. This is near the top of the performance range of 5% to 11% growth per annum. Accordingly, 94.55% of the EPS portion of the Spring 2008 PSP awards vest.



PERFORMANCE CONDITION – PSP[TSR]

The proportion of the award capable of exercise determined by:

(i) the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 18 other international defence and aerospace companies as shown in the table opposite. There has been no change to the comparator group. None of the shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group and 100% vest if it is in the top quintile (i.e. top 20%) as set out opposite; and

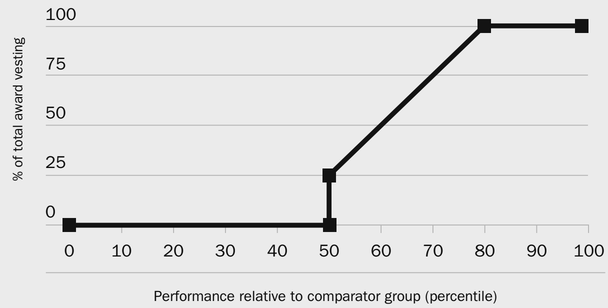
(ii) whether there has been a sustained improvement in the Company's underlying financial performance and whether it is appropriate to release some or all of the awards. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA[1]; order book; turnover; risk; and underlying project performance.

The rationale for TSR performance measures is that major investors regard TSR as an important indication of both earnings and capital growth relative to other major companies in the same sector and to ensure that awards only vest if there has been a clear improvement in the Company's performance over the relevant period.

PSP[TSR] – sectoral peer group

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

PERFORMANCE CONDITION – PSP[TSR]



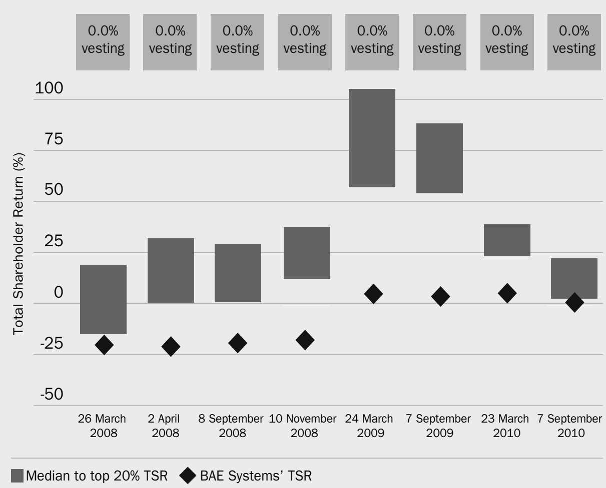
SUMMARY OF TSR PERFORMANCE TO 31 DECEMBER 2010

The chart opposite summarises the position on the TSR element for all outstanding awards under the PSP as at 31 December 2010.

The coloured box shows the range of TSR required for 25% vesting to full vesting, and the diamond shows BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.

This shows that the TSR portion of the 2008 PSP award lapsed as the Company's TSR return was below that of the comparator group.

TSR PERFORMANCE UNDER THE PERFORMANCE SHARE PLAN



SHARE MATCHING PLAN (SMP)

Key features for grants of awards in 2011:

– stand-alone share investment plan with the investment linked to the award under the annual incentive plan;

– participants are granted a conditional award of matching shares against the gross value of the annual incentive invested;

– matching shares attract dividends during the three-year deferral period, released on vesting of any matching shares;

– executive directors are required to invest one-third of their 2010 net annual incentive into the SMP; and

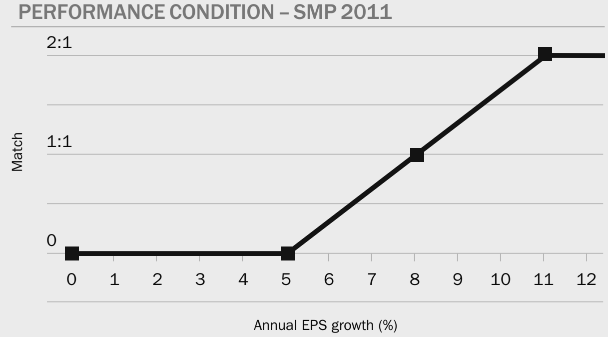
– maximum level of investment will be 50% of the net annual incentive.

Match and performance condition

– Nil match for actual EPS growth of 5% per annum (with nil vesting below that level) increasing uniformly to a 2:1 match at 11% per annum growth (15% to 33% growth over three years).

– Rationale for performance measure: major investors consider EPS to be a key indicator of long-term financial performance and value creation.

PERFORMANCE CONDITION – SMP 2011



2008 SMP award

The 2008 SMP awards were based on nil match for actual EPS growth of 5% per annum increasing uniformly to a 1:1 match at 8% per annum growth. 2010 EPS was 40.5p, and is approximately 10.6% greater (per annum) than the 2007 EPS of 30.7p. Accordingly, the 2008 SMP award vests in full.

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

Restricted Share Plan (RSP)*

Key features of awards in 2011:

– conditional awards of shares are granted based on a percentage of salary and share price at the date of grant;

– the shares are subject only to the condition that the participant remains employed by the Group at the end of the vesting date (three years after the award date); and

– shares under award attract dividends prior to vesting.

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US, as detailed on page 102. Clawback arrangements will operate in respect of this Plan.

* Introduction of the RSP is subject to shareholder approval at the 2011 AGM.

Share Incentive Plan (SIP)

During 2010, the UK executive directors were eligible to participate in the all-employee free shares element of the Share Incentive Plan. As a result of the Company's performance in 2010, all eligible employees (including the UK executive directors) will be entitled to receive shares worth £391.50. A similar arrangement operates for non-UK employees on a cash or shares basis depending on local tax and security laws.

The Company operates a share purchase arrangement (Partnership Shares) under the Share Incentive Plan. Under this arrangement, UK-based employees (including executive directors) may purchase ordinary shares in BAE Systems by either monthly investments of between £10 and £125 a month, or lump sum investments of between £10 and £1,500 in a tax year, both limited to 10% of salary if less. The Partnership Shares attract matching shares. As the plan is an all-employee plan, the matching shares are not subject to performance conditions in accordance with legislation. One free matching share is awarded for each Partnership Share up to a maximum of £63 per month.

Dividends paid in respect of the shares in the Share Incentive Plan for UK-based employees are reinvested as Dividend Shares.

Share usage for employee share schemes

The Committee has agreed that, in respect of new issue or treasury shares, shares representing no more than 1% (and no more than 0.5% for the executive schemes) of the Company's issued share capital will be used in any one financial year for the grant of incentives under all of the Company's employee share schemes. The table opposite sets out the available dilution capacity for the Company's employee share schemes on this basis.

The Company currently intends to use new issue shares to satisfy future share awards under the executive long-term incentive plans up to the 0.5% annual dilution limit, and to use treasury shares to satisfy awards of free shares and matching shares under the all-employee Share Incentive Plan. For outstanding options it is intended that new issue shares will be utilised for the Executive Share Option Plan.

	Number of shares
Total issued share capital as at 31 December 2010	3,587m
All schemes:	
10% in any consecutive years	358.7m
Remaining headroom	212.8m
Executive schemes:	
5% in any consecutive ten years	179.4m
Remaining headroom	90.6m

Post-retirement benefits

UK pension benefits

UK executive directors are members of the BAE Systems Executive Pension Scheme (the ExPS) and members of the underlying employee pension plans. As such, they are subject to the same contribution rates payable by employees of the underlying plans, and the benefit changes introduced in 2006 for post-April 2006 service including the introduction of the Longevity Adjustment Factor, a reduction in the maximum level of pension increases and a change in the definition of Pensionable Pay.

The ExPS tops up the underlying employee plan to provide a target benefit for executive directors payable from normal retirement age of 1/30th of Final Pensionable Pay (FPP) for each year of ExPS pensionable service (subject to a maximum of two-thirds of FPP). FPP is defined as annual base salary averaged over the last 12 months prior to leaving service in respect of service accrued to 5 April 2006 and 36 months prior to leaving in respect of service from 6 April 2006. The ExPS also provides a lump sum death-in-service benefit equal to four times base salary at date of death, and a spouse's death-in-service pension equal to two-thirds of the prospective pension at normal retirement age. Children's allowances are also payable, usually up to the age of 18. Spouses' pensions and children's allowances are also payable upon death in retirement and death after leaving the Company's employment with a deferred pension. Once in payment, pensions are increased annually by the rise in the Retail Price Index subject to a maximum increase of 5% per year in respect of pre-6 April 2006 service and 2.5% per year in respect of service from 6 April 2006.

As a result of the 2006 age discrimination legislation, executive directors' default retirement age is 65 but they retain any previous rights they had to retire and draw their pensions without actuarial reduction for early payment at an earlier age.

Following the changes made to take account of the Pensions Simplification tax changes which came into effect from April 2006, UK executives reaching the Lifetime Allowance (LTA) were given a number of choices as previously reported. These were:

– remain in the pension scheme and pay any additional tax charge; or

– opt out of the pension scheme (and so earn no further pension benefits in respect of future service) and instead receive a taxable salary supplement. This supplement will be 30% of salary and 20% of salary for those senior executives with a two-thirds salary target after at least 20 years' and 30 years' service, respectively; or

– restrict scheme benefits to the value of the LTA with the remainder being provided directly from the Company as an unfunded promise. At retirement, the unfunded Company benefits can be either taken as pension or commuted in full for a taxable lump sum.

The Committee reviews these arrangements each year in the light of developing market practice, and believes they remain appropriate as they provide executives with competitive pension benefits and choices for dealing with the LTA which may better suit their needs whilst being broadly cost neutral to the Company, are in line with market practice and do not compensate executives for changes in taxation.

During the year, an additional review of UK executive pension arrangements has been undertaken in the light of the changes announced to the taxation of members of UK registered pension arrangements from 6 April 2011. The underlying principles for this review were that the aggregate level of benefits provided to members should continue to be cost neutral to the Company.

The review concluded that the new arrangements should be based on the Company's registered pension schemes and that, in appropriate circumstances, the Company will continue to have the option to offer an unfunded pension promise so as to mitigate the impact of the Lifetime Allowance (introduced in 2006) and the impact of the reduced Annual Allowance with effect from 6 April 2011. This new arrangement addresses tax-inefficiencies arising for existing employees as a consequence of the pension tax changes although members will be given the choice to remain in the current arrangement and pay the increased tax. The Committee has decided that in cases where the Company is to pay an unfunded promise, executives will be given the choice to commute some or all of the benefit for a taxable lump sum, or take it as pension.

Ian King, George Rose (who retires from the Company on 31 March 2011) and Peter Lynas already have an unfunded promise from the Company arising from the 2006 changes; for Ian King and Peter Lynas, this will be extended to cover the reduced Annual Allowance at no additional cost to the Company.

Ian King and **Peter Lynas** (Group Finance Director designate) are both members of the BAE Systems 2000 Pension Plan (the 2000 Plan), applicable to former employees of Marconi Electronic Systems (MES), and members of the ExPS with a normal retirement age of 62. The 2000 Plan provides a pension of 1/50th of Final Pensionable Earnings (FPE) for each year of pensionable service, payable from a normal retirement age of 65 and members pay contributions of 8% of Pensionable Earnings. FPE under the 2000 Plan is the best consecutive three-year average of base salary and bonus in the ten Plan Years prior to leaving, less an offset for State pensions. The Company decided in 2006 to limit pensionable bonuses in the 2000 Plan in the 2006/07 Plan Year to 20% of base salary and to 10% of base salary for the 2007/08 Plan Year and thereafter. However, there is a guarantee that the FPE figure for benefits in respect of service prior to 6 April 2007 will not be less than the FPE figure at 5 April 2007 to ensure that employees do not lose the benefit of contributions paid on past bonuses. Ian King and Peter Lynas joined the ExPS in 1999 following the BAe/MES merger. Therefore their individual total pensions are the sum of their 2000 Plan benefits plus the top up from the ExPS.

George Rose is a member of the BAE Systems Pension Scheme paying contributions of 9.29% of base salary, and is a member of the ExPS with a normal retirement age of 60. George Rose was affected by the previously applicable Inland Revenue earnings cap on approved pensions and has an unapproved (i.e. non-tax qualified) pension arrangement to top up his benefits from the approved schemes. This was designed so that the total pension from all sources would be broadly in line with the pension he would have received from the Group pension schemes had he not been subject to the earnings cap. The Pension Simplification tax changes allowed the flexibility to remove the earnings cap for George Rose in respect of service from April 2006, although some of his benefits will remain to be provided by means of an unfunded promise from the Company. No further contributions will be paid into his funded unapproved top up arrangement.

On leaving the Company, George Rose has been granted consent from the Company to early retirement and his pension benefits will therefore become payable from 1 April 2011, one year early. His pension is subject to the normal actuarial reduction for early payment that would be applied to any other member of the Executive Pension Scheme in these circumstances.

US pension benefits
Linda Hudson is a member of the 2006 Plan and a Non-Qualified Plan which provide a cash sum at retirement equal to a percentage of career average pay (salary plus bonus subject to a maximum bonus of 150% of salary). The cash accrual rate of the combined plans from 1 January 2010 is 14.1% of career average pay. Executive directors pay contributions at the same rates as other employees in the plan, being 1.5% of earnings. Linda Hudson also receives a company match on her contributions to her 401(k) plan up to a maximum contribution of 6% of salary, up to regulatory limits ($245,000 in 2010). From 1 January 2010, the company match was 85%.

Details of post-retirement benefits for each of the executive directors who served during 2010 are shown in Table D on page 119 and are calculated in accordance with the requirements of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

Other benefits
Other benefits provided to executive directors include a car allowance, the private use of a chauffeur-driven car and a cash allowance for medical examination.

On his appointment as Group Finance Director on 1 April 2011, Peter Lynas will be provided with Company support to establish a second home in London as the Committee believed this to be a more cost-effective option for the Company than requiring full relocation of his principal residence from outside London. This support is in accordance with Company policy, and consists of a lump sum of £22,200, together with a monthly allowance totalling £33,300 in year one declining on a uniform basis to £6,660 in year five (such monthly allowances over the five-year period totalling £99,900), and zero thereafter. Clawback provisions operate during the first two years of this arrangement whereby he would be required to repay these monies on a pro-rata basis should he leave the Company in certain circumstances, e.g. resignation or termination.

Executive directors' service contracts
It is the Committee's policy that executive directors should normally have service contracts that provide for the Company to give the individual 12 months' notice of termination. This policy has been chosen because it provides a reasonable balance between the need to retain the services of key individuals and the need to limit the liabilities of the Company in the event of the termination of a contract. The executive directors have service contracts with Group companies and details of these are shown below.

	Date of contract	Unexpired term	Notice period
Linda Hudson	26 October 2009 (amended 8 January 2010)	31 December 2011*	90 days either party
Ian King	27 June 2008	No fixed term	12 months either party
George Rose	16 November 1998 (amended 3 December 1999, 15 January 2004 and 17 October 2005)	No fixed term – ends 31 March 2011	12 months from the Company, 6 months from the individual
Peter Lynas	16 February 2011 (effective 1 April 2011)	No fixed term	12 months either party

* Subject to automatic renewal for one-year periods each year unless either party gives notice of non-renewal.

In the event of the termination of an executive director's contract it is the Committee's policy to seek to limit any payment made in lieu of notice to a payment equal to the amount of one year's base salary. The service contracts for two of the executive directors (Ian King and George Rose), and that for Peter Lynas which comes into effect on 1 April 2011, contain specific provisions to the effect that the Company has the right to pay a sum equivalent to 12-months' salary in lieu of notice.

Linda Hudson's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives notice of non-renewal. Separately, there is a 90-day termination provision. If the employment is (a) terminated by the Company (other than for cause as defined in the contract or in the event it is not extended following her 65th birthday) or (b) she resigns for a 'Good Reason' (as defined in her contract), she is entitled to a termination payment equal to (i) one year's base salary, (ii) a pro-rated bonus for the relevant financial year, and (iii) the continuation of 18-months' medical benefits, plus a further 18-months' subsidy of a portion of the premiums (or a cash payment in lieu of this benefit).

George Rose will retire from the Company, and as a director, with effect from 31 March 2011. No termination payments will be made. All outstanding long-term incentive awards and share options will vest in accordance with the rules of the respective share plans, i.e. subject to the attainment of the related performance conditions and pro-rating in accordance with the length of his service against the relevant performance period. He will not be required to defer one-third of his 2010 annual incentive, payable in 2011, into the SMP. He will receive a normal early retirement pension as described on page 111.

No executive director has provisions in his or her service contract that relate to a change of control of the Company (and neither does the Chairman nor the non-executive directors in their letters of appointment).

Policy on external board appointments
The long-standing policy of allowing executive directors to hold external non-BAE Systems-related non-executive directorships with the prior approval of the Committee will continue. The Committee considers that external directorships provide the Company's senior executives with valuable experience that is of benefit to BAE Systems. It is also considered appropriate for BAE Systems to contribute to the pool of non-executive expertise available for the benefit of the wider business community, thereby reciprocating the benefit that it in turn has received from other organisations which have permitted members of their senior management teams to serve on the BAE Systems Board. The Committee believes that it is reasonable for the individual executive director to retain any fees received from such appointments given the additional personal responsibility that this entails. Such fees retained by executive directors in 2010 were as follows: Ian King £43,333 in respect of his non-executive directorship of Rotork plc and George Rose £78,500 in respect of his non-executive directorship of National Grid plc.

Chairman's appointment, term and fees

Dick Olver was appointed Chairman on 1 July 2004. His appointment was for an initial fixed three-year term with effect from 17 May 2004 (the date that he was appointed to the Board as a non-executive director) and was subsequently extended in 2007 for a second term of three years to 16 May 2010. Following the approval of the Board under the chairmanship of Sir Peter Mason, Senior Independent Director, it was extended again in 2009 for a third term to 16 May 2013 unless terminated earlier in accordance with the Articles of Association or with either party giving the other not less than six months' prior written notice. The Chairman's appointment is documented in a letter of appointment which is not a contract of employment and he is required to devote no fewer than two days a week to his duties as Chairman. His appointment as Chairman will automatically terminate if he ceases to be a director of the Company. His fee, which was set by the Committee at £600,000 per annum for the duration of his second three-year term, was reviewed in 2010 and the Committee decided that his fee should remain unchanged at that time. His current fee will be subject to review in 2011.

Non-executive directors' appointment, term and fees

The non-executive directors do not have service contracts but do have letters of appointment detailing the basis of their appointment. The dates of their original appointment were as follows:

Non-executive director	Date of appointment	Expiry of current term*
Paul Anderson	08.10.2009	07.10.2012
Harriet Green	01.11.2010	31.10.2013
Michael Hartnall	10.06.2003	09.06.2012
Sir Peter Mason	22.01.2003	21.01.2012
Roberto Quarta	07.09.2005	06.09.2011
Nick Rose	08.02.2010	07.02.2013
Carl Symon	11.06.2008	10.06.2011
Ravi Uppal	02.04.2008	01.04.2011

* Subject to re-election at the AGM following their appointment and subsequently at intervals of no more than three years in accordance with the Company's Articles of Association.

The non-executive directors are normally appointed for two consecutive three-year terms subject to review after the end of the first three-year period and with any third term of three years being subject to rigorous review and taking into account the need progressively to refresh the Board. They do not have periods of notice and the Company has no obligation to pay compensation when their appointment terminates. Under the Company's Articles of Association, they are subject to re-election at the Annual General Meeting (AGM) following their appointment and subsequently at intervals of no more than three years. Having completed a three-year term of appointment, Andy Inglis retired from the Board on 9 July 2010 having originally been appointed to the Board on 13 June 2007. Phil Carroll, who had originally been appointed to the Board on 7 September 2005, also retired from the Board on 5 May 2010 on the expiry of his term. Ravi Uppal will retire from the Board at the end of his current term on 1 April 2011.

In compliance with the new UK Corporate Governance Code, all members of the Board will submit themselves for re-election on an annual basis from the 2011 AGM onwards.

Non-executive directors are proposed by the Nominations Committee and are appointed by the Board on the basis of their experience to provide independent judgement on issues of strategy, performance, resources and standards of conduct.

Following publication of the new UK Corporate Governance Code in 2010, the time commitment expectations for non-executive directors were reviewed and, with their agreement, their Letters of Appointment were amended to reflect that they need to commit approximately two days for each of the Board meetings scheduled during the year, to cover attendance and preparation for the meeting. Additional time commitments will include attending scheduled Board committee meetings, strategy review meetings and ad hoc meetings of the Board (or sub-committees of the Board) that may be called from time to time. The non-executive directors are aware that it is not possible to be specific as to exact time commitments as this will vary according to the nature of the matters that the Board is required to deal with at any point in time. Newly appointed non-executive directors will also have to dedicate additional time to induction activities. The level of their fees is set by the Non-Executive Directors' Fees Committee to reflect this time commitment and responsibility, and after reviewing practice in other comparable companies. Having undertaken its review in January 2011, the Committee decided that the non-executive directors' fees for 2011 will be as follows:

	2010 fee	**2011 fee**
Base fee	£66,000	**£75,000**
Additional fee for chairing committees:		
Audit Committee	£20,000	**£20,000**
Corporate Responsibility Committee	£20,000	**£20,000**
Remuneration Committee	£20,000	**£20,000**
Additional fee for Senior Independent Director	£20,000	**£20,000**
Travel allowance (per meeting)*	£4,000	**£4,000**

* The travel allowance of £4,000 per meeting is paid on each occasion that a non-executive director's attendance at a Board meeting necessitates air travel of more than five hours (one-way) to the meeting location, subject to a maximum of six travel allowances per year.

The table below summarises the fee structure for 2010 and 2011:

Non-executive director	2010 fee*	**2011 fee***
Chairman Audit Committee	£86,000	**£95,000**
Chairman Corporate Responsibility Committee	£86,000	**£95,000**
Chairman Remuneration Committee	£86,000	**£95,000**
Senior Independent Director	£86,000	**£95,000**
Other non-executive directors	£66,000	**£75,000**

* Excludes the travel allowance of £4,000 per meeting referred to above.

On behalf of the Board

Dick Olver Chairman

16 February 2011

Tabular information on directors' shareholdings, share-based incentives, emoluments and pensions

TABLE A: DIRECTORS' INTERESTS

	As at 1 January 2010*				**As at 31 December 2010**			
	Ordinary shares	Executive Share Option Plan	Share Matching Plan	Performance Share Plan	**Ordinary shares**	**Executive Share Option Plan**	**Share Matching Plan**	**Performance Share Plan**
P M Anderson	–	–	–	–	**10,000**	**–**	**–**	**–**
H Green[1]	–	–	–	–	**–**	**–**	**–**	**–**
M J Hartnall	20,000	–	–	–	**20,000**	**–**	**–**	**–**
L P Hudson	224,957	133,740	99,908	390,549	**253,390**	**133,740**	**196,291**	**685,355**
I G King	678,327	1,132,008	527,437	1,325,953	**873,422**	**1,132,008**	**912,728**	**1,712,771**
Sir Peter Mason	25,283	–	–	–	**25,283**	**–**	**–**	**–**
R L Olver	40,000	–	–	–	**40,000**	**–**	**–**	**–**
R Quarta	–	–	–	–	**–**	**–**	**–**	**–**
G W Rose	806,114	369,554	227,699	951,739	**859,694**	**369,554**	**357,099**	**1,132,368**
N C Rose[2]	–	–	–	–	**55,000**	**–**	**–**	**–**
C G Symon	10,000	–	–	–	**10,000**	**–**	**–**	**–**
R K Uppal	–	–	–	–	**–**	**–**	**–**	**–**

* or upon appointment.
1 Appointed as a director on 1 November 2010.
2 Appointed as a director on 8 February 2010.

The table above gives details of the interests in ordinary shares in BAE Systems plc held by directors and their connected persons for those individuals who were directors of the Company as at 31 December 2010. There have been no changes in the interests of the current directors listed in the table above between 31 December 2010 and 16 February 2011 with the exception of the interests in the ordinary shares of Ian King and George Rose who have acquired an additional 107 and 106 ordinary shares, respectively, since 31 December 2010 under the partnership and matching shares elements of the Share Incentive Plan so that their beneficial shareholdings at the date of this report stood at 873,529 and 859,800, respectively.

The Company's register of directors' interests (which is open to inspection) contains full details of directors' share interests.

Information subject to audit
The Auditors are required to report on the information contained in Tables B, C and D on pages 115 to 119.

TABLE B: SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – IAN KING

Share options	1 January 2010	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2010	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP^{TSR}	49,313	–	49,313	–	–	nil	24.03.05	24.03.10	3.81	24.03.10[1,2]	24.03.12
PSP^{TSR}	53,200	–	26,599	–	26,601	nil	12.04.06	13.04.10	3.72	12.04.10[1,3]	12.04.13
PSP^{TSR}	115,973	–	–	115,973	–	nil	30.03.07	30.03.10	–	30.03.10[4]	30.03.14
PSP^{TSR}	122,039	–	–	–	122,039	nil	26.03.08	–	–	26.03.11[5]	26.03.15
PSP^{EPS}	122,039	–	–	–	122,039	nil	07.05.08	–	–	26.03.11[1]	26.03.15
PSP^{TSR}	103,467	–	–	–	103,467	nil	08.09.08	–	–	08.09.11[6]	08.09.15
PSP^{EPS}	103,467	–	–	–	103,467	nil	08.09.08	–	–	08.09.11[6]	08.09.15
PSP^{TSR}	328,227	–	–	–	328,227	nil	24.03.09	–	–	24.03.12[6]	24.03.16
PSP^{EPS}	328,228	–	–	–	328,228	nil	24.03.09	–	–	24.03.12[6]	24.03.16
PSP^{TSR}	–	289,351	–	–	289,351	nil	23.03.10	–	–	23.03.13[6]	23.03.17
PSP^{EPS}	–	289,352	–	–	289,352	nil	23.03.10	–	–	23.03.13[6]	23.03.17
	1,325,953	**578,703**	**75,912**	**115,973**	**1,712,771**						
ExSOP	318,314	–	–	–	318,314	1.72	30.09.03	–	–	30.09.06[1]	30.09.13
ExSOP	272,388	–	–	–	272,388	2.01	30.03.04	–	–	30.03.07[1]	30.03.14
ExSOP	221,903	–	–	–	221,903	2.64	24.03.05	–	–	24.03.08[1]	24.03.15
ExSOP	145,443	–	–	–	145,443	4.28	12.04.06	–	–	12.04.09[1]	12.04.16
ExSOP	173,960	–	–	–	173,960	4.57	30.03.07	–	–	30.03.10[1]	30.03.17
	1,132,008	**–**	**–**	**–**	**1,132,008**						

LTIPs	1 January 2010	Granted during the year	Vested during the year	Lapsed during the year	31 December 2010	Market price at date of award £	Date of award	Date of vesting	Market price on vesting £
SMP	46,410	–	46,410	–	–	4.57	22.03.07	22.03.10[1]	3.87
SMP	109,411	–	–	–	109,411	4.86	26.03.08	26.03.11[1]	–
SMP	371,616	–	–	–	371,616	3.43	24.03.09	24.03.12[6]	–
SMP	–	431,701	–	–	431,701	3.80	23.03.10	23.03.13[6]	–
	527,437	**431,701**	**46,410**	**–**	**912,728**				

Ian King's SMP award that vested on 22 March 2010 attracted reinvested dividends which equated on vesting to an additional 4,912 shares. The market price on vesting was £3.87.

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 115 and 116.
1 Subject to a performance condition that has been met.
2 'Date exercisable' refers to the date on which the portion of the option exercised during the year became exercisable.
3 As (2) above. The option over shares remaining at the year end is exercisable on the fifth anniversary of grant.
4 The award lapsed during the financial year under review having not met the performance condition.
5 The outstanding award lapsed after the end of the financial year having not met the performance condition.
6 Subject to a performance condition that is yet to be tested.

PERFORMANCE SHARE PLAN (PSP)

A full description of the PSP is set out on pages 108 and 109. PSP awards granted since 2008 attract dividends prior to vesting.

PSP^{TSR} – nil vesting if the Company's TSR at the end of the three-year performance period is outside the top 50% of TSRs achieved by a sectoral comparator group; 25% vesting if TSR is at median (50%); and 100% vesting if TSR is in the top 20%, with vesting on a straight-line basis between these two points.

PSP^{EPS} – proportion of the award exercisable is determined by the rate of annual actual EPS growth over the three-year performance period, with nil vesting at annual actual EPS growth of 5% or less, 100% vesting at 11% growth, and vesting on a straight-line basis between these two points.

Awards that satisfy the performance conditions at the end of year three are exercisable in three tranches at the end of years three, four and five.

EXECUTIVE SHARE OPTION PLAN (EXSOP)

No options have been granted under this Plan since 2007 and it is intended only to be used in future in exceptional circumstances. Options granted under this Plan are normally exercisable between the third and tenth anniversary of grant. The maximum duration of an option is ten years.

(i) **2005-2007 grants** – 33.33% of each option grant is exercisable if the Company achieves on average real EPS growth pa of 3% but less than 4% over the three-year performance period; 66.67% for real EPS growth pa of 4% but less than 5%; and 100% for real EPS growth of 5% or more.

(ii) **2004 grant** – as in (i) but performance is retested at the end of year five against the full period from grant.

(iii) **2003 grant** – as in (i) but performance is retested at the end of years four and five against the full period from grant.

TABLE B: SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – GEORGE ROSE

Share options	1 January 2010	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2010	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP TSR	63,133	–	63,133	–	–	nil	24.03.05	24.03.10	3.81	24.03.10[1,2]	24.03.12
PSP TSR	67,942	–	33,970	–	33,972	nil	12.04.06	20.04.10	3.77	12.04.10[1,3]	12.04.13
PSP TSR	122,538	–	–	122,538	–	nil	30.03.07	30.03.10	–	30.03.10[4]	30.03.14
PSP TSR	122,039	–	–	–	122,039	nil	26.03.08	–	–	26.03.11[5]	26.03.15
PSP EPS	122,039	–	–	–	122,039	nil	07.05.08	–	–	26.03.11[1]	26.03.15
PSP TSR	227,024	–	–	–	227,024	nil	24.03.09	–	–	24.03.12[6]	24.03.16
PSP EPS	227,024	–	–	–	227,024	nil	24.03.09	–	–	24.03.12[6]	24.03.16
PSP TSR	–	200,135	–	–	200,135	nil	23.03.10	–	–	23.03.13[6]	23.03.17
PSP EPS	–	200,135	–	–	200,135	nil	23.03.10	–	–	23.03.13[6]	23.03.17
	951,739	**400,270**	**97,103**	**122,538**	**1,132,368**						
ExSOP	185,747	–	–	–	185,747	4.28	12.04.06	–	–	12.04.09[1]	12.04.16
ExSOP	183,807	–	–	–	183,807	4.57	30.03.07	–	–	30.03.10[1]	30.03.17
	369,554	**–**	**–**	**–**	**369,554**						

LTIPs	1 January 2010	Granted during the year	Vested during the year	Lapsed during the year	31 December 2010	Market price at date of award £	Date of award	Date of vesting	Market price on vesting £
SMP	52,286	–	–	–	52,286	4.86	26.03.08	26.03.11[1]	–
SMP	175,413	–	–	–	175,413	3.43	24.03.09	24.03.12[6]	–
SMP	–	129,400	–	–	129,400	3.80	23.03.10	23.03.13[6]	–
	227,699	**129,400**	**–**	**–**	**357,099**				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 115 and 116.
1 Subject to a performance condition that has been met.
2 'Date exercisable' refers to the date on which the portion of the option exercised during the year became exercisable.
3 As (2) above. The option over shares remaining at the year end is exercisable on the fifth anniversary of grant.
4 The award lapsed during the financial year under review having not met the performance condition.
5 The outstanding award lapsed after the end of the financial year having not met the performance condition.
6 Subject to a performance condition that is yet to be tested.

SHARE MATCHING PLAN (SMP) – MATCHING SHARES

A full description of the SMP, under which awards are subject to a three-year performance period, is set out on page 109. SMP awards attract dividends prior to vesting.

2009 and 2010 awards – nil match for actual EPS growth of less than 5% pa increasing uniformly to a 2:1 match at 11% pa growth.

2008 award – nil match for actual EPS growth of 5% pa or less, increasing uniformly to a 1:1 match for 8% pa growth.

2007 award – nil vesting for real EPS growth pa of less than 3% over the three-year performance period, with one-third of the matched award vesting on average real EPS growth pa of 3% but less than 4%, two-thirds vesting with a growth rate of 4% but less than 5%, and full vesting at growth of 5% or over.

SHARE PRICE INFORMATION

The mid-market price for the Company's ordinary shares at 31 December 2010 was 330.0p (2009 359.5p). The range during the year was 294.7p to 388.8p.

AGGREGATE AMOUNT OF GAINS MADE BY DIRECTORS

The aggregate amount of gains made by directors from the exercise of share options in 2010, as calculated at the date of exercise, was £655,392 (2009 £1,268,104). The net aggregate value of assets received by directors in 2010 from Long-Term Incentive Plans, as calculated at the date of vesting, was £198,770 (2009 £247,044).

RATIONALE FOR KEY PERFORMANCE MEASURES FOR PSP, EXSOP AND SMP

EPS – importance to major investors as a key indicator of long-term financial performance and value creation.

TSR (and secondary financial measure) – importance to major investors as an indication of both earnings and capital growth relative to major companies in the same sector, and to ensure that awards only vest if there has been a clear improvement in the Company's performance over the relevant period.

TABLE B: SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – LINDA HUDSON

Share options	1 January 2010	Granted during the year	Exercised or released during the year	Lapsed during the year	31 December 2010	Exercise price £	Date of grant	Date of exercise, release or lapse	Market price on release £	Date from which exercisable	Expiry date
PSP[TSR]	89,160	–	–	89,160	–	–	30.03.07	30.03.10	–	30.03.10[1]	30.03.14
PSP[TSR]	45,881	–	–	–	45,881	–	26.03.08	–	–	26.03.11[2]	26.03.15
PSP[EPS]	45,882	–	–	–	45,882	–	26.03.08	–	–	26.03.11[3]	26.03.15
PSP[TSR]	104,813	–	–	–	104,813	–	24.03.09	–	–	24.03.12[4]	24.03.16
PSP[EPS]	104,813	–	–	–	104,813	–	24.03.09	–	–	24.03.12[4]	24.03.16
PSP[TSR]	–	191,983	–	–	191,983	–	23.03.10	–	–	23.03.13[4]	23.03.17
PSP[EPS]	–	191,983	–	–	191,983	–	23.03.10	–	–	23.03.13[4]	23.03.17
	390,549	**383,966**	**–**	**89,160**	**685,355**						
ExSOP	133,740	–	–	–	133,740	4.57	30.03.07	–	–	30.03.10[3]	30.03.17
	133,740	**–**	**–**	**–**	**133,740**						

LTIPs	1 January 2010	Granted during the year	Vested during the year	Lapsed during the year	31 December 2010	Market price at date of award £	Date of award	Date of vesting	Market price on vesting £
SMP	99,908	–	–	–	99,908	3.43	24.03.09	24.03.12[4]	–
SMP	–	96,383	–	–	96,383	3.80	23.03.10	23.03.13[4]	–
	99,908	**96,383**	**–**	**–**	**196,291**				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 115 and 116.
1 The award lapsed during the financial year under review having not met the performance condition.
2 The outstanding award lapsed after the end of the financial year having not met the performance condition.
3 Subject to a performance condition that has been met.
4 Subject to a performance condition that is yet to be tested.

Note: Awards granted to Linda Hudson (a US national) under the PSP are technically characterised as long-term incentives rather than options as, subject to the attainment of the performance condition, they are delivered automatically on the third, fourth and fifth anniversary of grant without the need to exercise an option. They are shown in the top portion of the table for ease of comparison.

TABLE C: DIRECTORS' REMUNERATION

	2010						2009					
	Base salary £'000	**Fees £'000**	**Bonus £'000**	**Benefits £'000**	**Other pay £'000**	**Total £'000**	Base salary £'000	Fees £'000	Bonus £'000	Benefits £'000	Other pay £'000	Total £'000
Chairman												
R L Olver	**–**	**600**	**–**	**13**	**–**	**613**	–	600	–	63	–	663
Executive directors												
W P Havenstein[1]	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	294	–	–	11	–	305
L P Hudson[2]	**583**	**–**	**1,168**	**22**	**–**	**1,773**	105	–	189	9	–	303
I G King	**900**	**–**	**1,437**	**26**	**–**	**2,363**	900	–	1,680	70	–	2,650
G W Rose	**623**	**–**	**645**	**28**	**–**	**1,296**	623	–	755	74	–	1,452
M J Turner[3]	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	–	–	–	–	591	591
Non-executive directors												
P M Anderson[2]	**–**	**76**	**–**	**–**	**20**	**96**	–	15	–	–	4	19
P J Carroll[4]	**–**	**23**	**–**	**–**	**8**	**31**	–	66	–	–	24	90
H Green[5]	**–**	**11**	**–**	**–**	**–**	**11**	n/a	n/a	n/a	n/a	n/a	n/a
M J Hartnall	**–**	**86**	**–**	**–**	**8**	**94**	–	86	–	–	4	90
A G Inglis[4]	**–**	**45**	**–**	**–**	**–**	**45**	–	86	–	–	4	90
Sir Peter Mason	**–**	**86**	**–**	**–**	**8**	**94**	–	86	–	–	4	90
R Quarta	**–**	**66**	**–**	**–**	**4**	**70**	–	66	–	–	4	70
N C Rose[5]	**–**	**59**	**–**	**–**	**4**	**63**	n/a	n/a	n/a	n/a	n/a	n/a
Sir Nigel Rudd[1]	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	–	81	–	–	4	85
C G Symon	**–**	**86**	**–**	**–**	**20**	**106**	–	71	–	–	24	95
R K Uppal	**–**	**66**	**–**	**–**	**20**	**86**	–	66	–	–	24	90
	2,106	**1,204**	**3,250**	**89**	**92**	**6,741**	1,922	1,223	2,624	227	687	6,683

1 Resigned or retired in 2009.
2 Appointed in 2009.
3 Retired in 2008.
4 Retired in 2010.
5 Appointed in 2010.

All emoluments and compensation paid to the directors during the year are shown above. Where the individual was appointed during the year the amount is shown from appointment.

The benefits received by the UK-based executive directors include, where appropriate, the provision of a car allowance and the private use of a chauffeur-driven car. The benefits received by the Chairman, Dick Olver, include the private use of a chauffeur-driven car.

The benefits received by the US-based executive director include a cash allowance for a car, medical examination, dental benefits, and insured life and disability benefits. In addition, the benefits received by Linda Hudson also include $1,955 (£1,265) in respect of private use of a company aeroplane (2009 $8,455).

The other pay received by the non-executive directors represents the travel allowance of £4,000 per meeting as set out on page 113.

Sir Richard Evans retired as a director and Chairman on 30 June 2004. He remained employed in a part-time customer relationship role and ceased to be an employee on 29 February 2008. He subsequently became a member of the Company's Home Market Advisory Board for Saudi Arabia of which he ceased to be a member on 28 February 2010 upon the expiry of his contract. His consultancy fees in 2010 for the period of time he spent in the role of a member of the Home Market Advisory Board were £47,000 (2009 £246,954).

A payment of £7,884 was made to Mike Turner in January 2010, due in relation to the tax payable in respect of his private use of a chauffeur-driven car in the 2008/09 tax year, the amount of which was agreed with HM Revenue and Customs. There were no other payments to former directors during the year other than the Company pension payments to Sir Richard Lapthorne and Sir Peter Gershon referred to on page 119.

TABLE D: POST-RETIREMENT BENEFITS

	Age	NRA*	Accrued benefit at 1 January 2010[1] £ pa	Accrued benefit at 31 December 2010[1] £ pa	Change in accrued pension after allowing for inflation £ pa	Transfer value at 1 January 2010[2] £	Transfer value at 31 December 2010 £	Director's contributions £	Increase in value less director's contributions £
L P Hudson[3]	60	65	347,088	514,438	167,350	242,180	389,262	2,379	144,703
I G King[4]	54	62	509,944	585,228	75,284	6,780,197	8,174,403	79,200	1,315,006
G W Rose[5]	58	60	366,564	388,568	22,004	6,840,222	7,374,857	57,663	476,972

* Normal Retirement Age

1 Accrued benefits may be reduced if they are taken before the normal retirement age of the scheme. In addition, a longevity adjustment factor applies to UK pension accrued after 5 April 2006.

2 Transfer values have been calculated in accordance with GN11 issued by the actuarial profession. For UK-based directors the assumptions are the same as those used in the calculation of cash equivalents from the schemes. For US-based directors the assumptions are the same as those used for accounting disclosures. The increase in transfer value arising from the change in assumptions is: Linda Hudson: £5,113; Ian King: £166,128; George Rose: £(104,428).

3 Linda Hudson is a member of a US retirement plan which provides a cash sum at retirement equal to a percentage of career average pay. The accrued benefit shown above is a cash lump sum amount payable at normal retirement age. This benefit comprises £61,457 from a contributory Qualified Plan and £452,981 from Non-Qualified Plans. In addition, Linda Hudson participates in a Section 401(k) defined contribution arrangement set up for US employees in which the Company will match employee contributions up to a limit. In 2010, the Company paid contributions of £8,087 into this 401(k) arrangement. Linda Hudson is paid in US dollars. Of the change in the accrued benefit and the transfer value £15,932 and £12,055, respectively, is due to currency movements.

4 Ian King has an unfunded unapproved retirement arrangement for benefits in excess of the Lifetime Allowance. The pension and transfer value figures shown are in respect of his total benefit.

5 George Rose has a funded unapproved retirement arrangement for pensionable service before 6 April 2006. No Company contributions have been made to this arrangement during the year. In addition, George Rose has an unfunded unapproved retirement arrangement for pensionable service before 6 April 2006 and for benefits in excess of the Lifetime Allowance. The pension and transfer value figures shown are in respect of his total benefit.

Sir Peter Gershon and Sir Richard Lapthorne, both former directors, have unfunded pension arrangements. In 2010, the Company paid Sir Peter Gershon a pension of £109,280 (2009 £109,230) and Sir Richard Lapthorne a pension of £102,382 (2009 £100,058) in respect of these arrangements.

BAE SYSTEMS

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