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Annual Report 1999

BAE SYSTEMS



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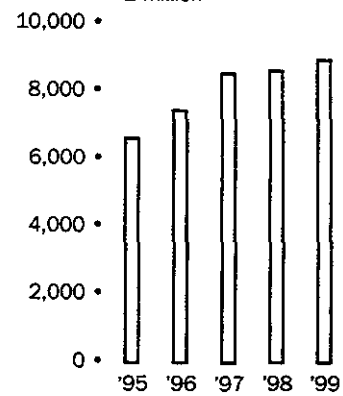
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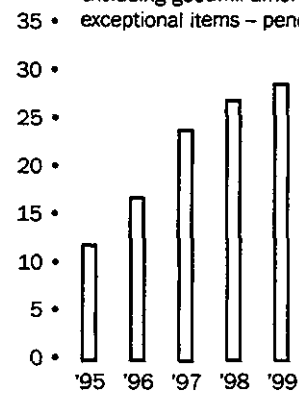
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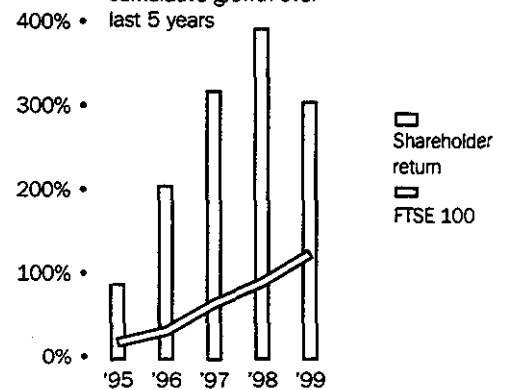
Sales over last 5 years
£ million



Diluted earnings per share
excluding goodwill amortisation and
exceptional items - pence



Shareholder return
cumulative growth over
last 5 years



FTSE 100 information: Datastream

Financial highlights

| | 1999 | 1998 | % |
|-------------------------------------|----------------|---------|--------|
| Sales* | £8.9bn | £8.6bn | +3.5% |
| Profit before interest** | £763m | £638m | +19.6% |
| Profit before tax** | £790m | £708m | +11.6% |
| Diluted earnings per share** | 28.8p | 27.1p | +6.3% |
| Dividend per share | 8.0p | 6.5p | +23.1% |
| Net (debt)/cash balance at year end | £(825)m | £196m | |
| Order book at year end*** | £36.6bn | £28.1bn | +30.2% |

Financial performance is explained further on pages 22 to 25

* Includes MES sales of £455m in 1999

** Excluding goodwill amortisation and exceptional items

*** Includes MES order book of £8.5bn in 1999

Chairman's statement



The world's aerospace and defence industry is undergoing great change. An industry that was, only a few years ago, nationally based and fragmented, is consolidating quickly and becoming global. The industry is driven by cost pressure together with the increasing technical complexity of customers' requirements. This is at a time when the demand for participants in the industry to work together effectively in delivering complex solutions has never been greater.

Good progress was made in 1999 in pursuing two key strands of value growth. First, we have continued to improve our operating performance through continuing productivity improvement as we delivered a strong order book. Importantly, we have significantly enhanced our prospects for future growth, and are well positioned to take advantage of emerging customer support opportunities.

Second, we have made an important step in addressing value through industrial consolidation following the merger with the former GEC Marconi Electronic Systems (MES) businesses.

We are now at the forefront of the world's aerospace and defence industry

This resulted in the transformation of British Aerospace to BAE SYSTEMS, and in one step establishes your company as the world's second largest defence company with unequalled global presence. It brings together two dynamic companies with a depth of technical capability to rival any competitor and establishes us as the future partner of choice.

Our industry is rapidly evolving to be one led by just a few major global prime contractors. Your Board's clear objective is to ensure that BAE SYSTEMS retains the leading position it now enjoys following the MES merger as further industry consolidation inevitably progresses.

The transformation to BAE SYSTEMS is an ideal opportunity to meld two strong businesses, both with highly effective management teams, into a single, agile organisation which is performance and customer focused, explicitly aligned to the evolving trading environment.

The lengthy regulatory process to clear the merger created a period of uncertainty, but was ultimately

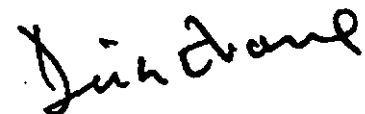
successful. We used the time needed for this clearance to undertake detailed integration planning so we were well placed to take immediate steps in combining the two businesses. Initial progress is very encouraging and we remain on track in meeting the objectives of the merger. I believe that following the merger your company is financially strong with an enviable market position.

We recognise that it is our people that make things happen. It is their technical prowess and their flair for innovation, coupled with effective behavioural skills, that will make the difference in the marketplace. Investing in personal development continues to be a top priority as we strive to be the Benchmark in all that we do.

I believe that we made great progress last year and I would like to take this opportunity to thank all the members of the BAE SYSTEMS team for their respective contributions. In particular I would like to thank Richard Lapthorne, who retired from the Board on 30 September 1999, for his major

contribution to the development of the company.

We do not underestimate the task ahead of us. However, with a highly experienced management team in place I have every confidence that we will deliver the performance that our customers and shareholders demand and deserve.



Sir Richard Evans
2 March 2000

Headline growth will be in the three critical areas of large commercial aircraft, defence support services and integrated systems

In determining the future direction for the business we are clearly focused on activities with the strongest growth and where technical capability and market position can add most value.

We have identified three particular areas of growth: large commercial aircraft, defence support services and complex integrated system programmes.

Large commercial aircraft

The market for large commercial aircraft is expanding as a result of good, sustainable, long term growth in passenger traffic together with the demand to replace ageing aircraft. Additionally, Airbus Industrie, in which BAE SYSTEMS is a 20% participant, has been highly successful in growing its market position.

The Airbus strategy to compete with a comprehensive product range across the aircraft market above 100 seats is working to good effect. 1999 was another year of strong order intake with production deliveries continuing to rise.

With its Airbus partners, BAE SYSTEMS is giving careful consideration to the launch of an A3XX family of aircraft ranging in size from 480 to 650 seats in three class configurations.

Engineering work on this programme is well advanced and the market is being tested to see when the launch conditions can be met. Discussions are well advanced with the UK Government to agree a suitable launch financing package which will underpin the UK

work and put us in a good position as we move towards a launch decision.

Defence support services

The defence market has different characteristics to those of the commercial aircraft market. Global defence spending has been marked by a significant downward adjustment following the end of the Cold War. The outlook in most markets now shows stability with modest growth in some regions. Within these spending projections there are however some significant changes in emphasis taking place.

Many defence departments are looking to industry to help reduce costs and free more of the available assets for allocation to their core security role. As a consequence, significant support activities are expected to become accessible to industry, from the armed forces, over coming years.

Whilst the balance of risk and reward will need to be carefully assessed, there is expected to emerge significant new business central to the core capabilities of BAE SYSTEMS.

As an example of the scale of the possible support market, BAE SYSTEMS currently undertakes approximately £2bn of support activity a year including some £500m in the UK but accesses only 7% of the support budget for the Royal Air Force. BAE SYSTEMS is now targeting business in all of its world markets to double our support business over the next three years.

BAE SYSTEMS worldwide workforce

| | |
|--------------|--------------------|
| | Sweden 3,000 |
| Canada 1,700 | UK 70,000 |
| | Germany 3,500 |
| | France 4,500 |
| US 16,700 | Italy 4,000 |
| | Saudi Arabia 5,400 |

as at 31 December 1999,
including joint ventures

A new customer support organisation has been formed targeting those opportunities that previously were largely retained within the armed forces. Early opportunities identified include training and support activities that are to be contracted out as the armed forces concentrate on their peace keeping and security roles.

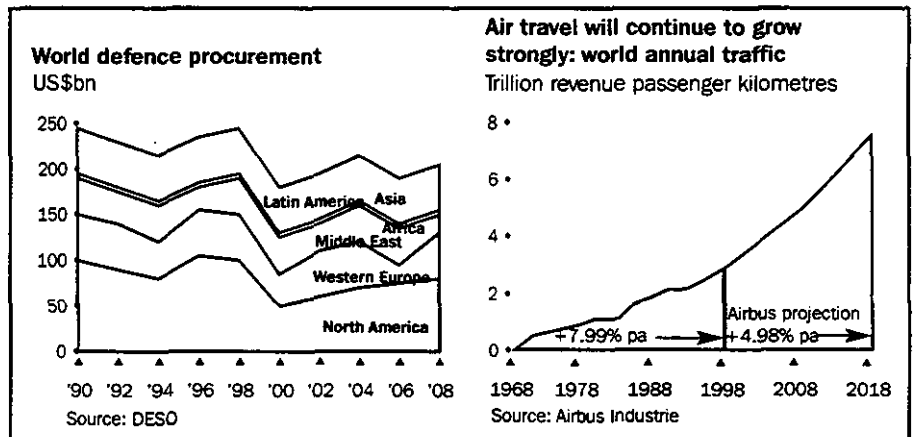
Integrated systems

The third principal area of targeted growth is in integrated systems. These systems are at the heart of most new equipment and equipment modernisation programmes.

Trends towards greater interoperability of the armed forces and the adoption of precision weapons are further drivers to growth in demand for electronic systems. As a consequence, the electronic systems content is rising as a proportion of total programme value. The complexity of these systems is leading to a need for greater integration of data resulting in large, integrated, 'System of Systems' solutions.

The technologies required to deliver such integrated solutions in airborne systems are complementary to those required in complex naval and land systems. In recognising these common skills, the company has been pursuing a strategy to migrate its established strong position in airborne systems into the naval and land system domains.

The merger with the former MES businesses is an important step in enhancing BAE SYSTEMS position as one of the world's leading providers of integrated air, land and naval system solutions.



Organisation

MES provides opportunities not only to enhance performance through synergies at the interface of the two companies but also through a much deeper change in the way both companies previously worked. This "unfreezing" of the two companies is at the heart of our new organisation, which has a clear customer focus. The new enlarged business has been designed to separate the responsibility of our major programmes from the management of facilities and operations.

Two Chief Operating Officers have been appointed with responsibilities for managing these respective aspects of the business. Mike Turner is responsible for the company's business operations, including commercial aircraft activities, avionics and partnerships. Steve Mogford, who joins the Board with effect from 1 April 2000, is responsible for

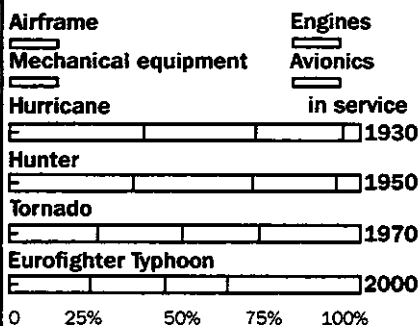
delivering the performance from the major programme prime contracts and customer support.

This new organisation enables excellent visibility of these major programmes at Board level whilst providing a much improved basis for maximising the efficiency of the supporting business operations.

This emphasis on major prime contract performance is a key differentiator for BAE SYSTEMS. The complexity of today's defence systems demands highly specialised skills including the management of both technical and financial programme risk. Such prime contracting skills are a particular BAE SYSTEMS strength.

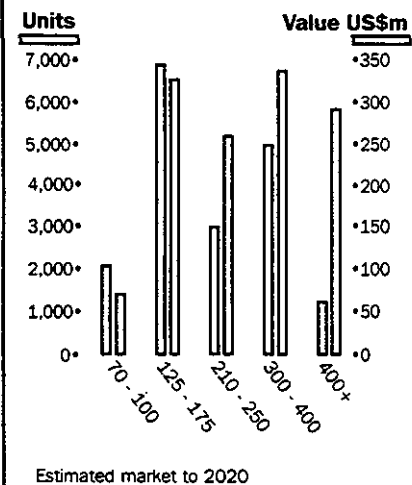
Best practice not past practice

Over recent years the avionics content of airborne systems has risen to a much higher proportion of programme value



Commercial jet market

Much of the value in the market for commercial jets lies in fewer numbers of larger aircraft



When the merger was announced it was estimated that significant synergies would result in annual cost savings totalling in excess of £275m within three full financial years of completion of the transaction. Since that time our validation work has confirmed these savings and indeed identified more.

These cost savings are drawn largely from rationalisation of facilities, procurement, programme management and elimination of costs of the interface of joint programme activities, marketing costs including duplicated overseas office locations and elimination of central costs. In addition it is estimated that substantial opportunities exist to win more business with the combined products and capabilities of the new enterprise.

The introduction of a new organisation has required the appointment of staff to either existing or new positions. These appointments are being made by drawing on the most suitable candidate. Inevitably such an approach will result in a reduction in staffing across the company, and this is a matter we aim to progress both quickly and in a sensitive manner.

Some of the benefits from these synergies will enhance the competitiveness of the business and flow as cost savings to customers. The estimated £275m of annual savings is after deducting such benefits. Given the long term nature of contracts, the high level of fixed price business together with the high volume of similarly priced export activity, such savings are expected to continue for some years.

Programme capability

The breadth and depth of BAE SYSTEMS programmes drives the world-class technical capabilities of our business. Through wide-ranging activities in the nine home markets of the business, the company is able to make most efficient use of available Research and Technology (R&T) funding to the benefit of both customers and shareholders.

These programmes represent a portfolio of activity in varying stages of maturity and profitability. The portfolio includes futuristic conceptual studies, often conducted on a 'cost plus' basis. Such studies may evolve into definition and development where profit recognition on fixed price activity is often deferred until confidence in system performance is achieved. There then follows the main production programme leading subsequently to long term support and later modification of legacy programmes. Such a portfolio contains a blend of activity with new business at the cutting edge of tomorrow's technology and business derived from programmes of up to 50 years from their inception.

Global positioning

BAE SYSTEMS is today the world's second largest defence company with a global customer base. The company has industry leading positions in many of its principal activities with high barriers to entry for aspirational newcomers.

The company is the world's second largest military aircraft business and the Matra BAe Dynamics (MBD) joint venture is similarly

BAE SYSTEMS has emerged to become the most global of the world's major aerospace and defence companies

placed in guided weapons. Airbus is now a major force in large commercial jets, and indeed its order intake exceeded that of its rival in 1999. Recent agreement to form an expanded joint venture with Alenia of Italy has also resulted in the establishment of a world ranking land and naval radar systems business.

The geographic expansion of the business base has been one of the most striking changes in the evolution of BAE SYSTEMS. The company has emerged from being a largely UK domestic producer to having home markets in nine countries. The company employs over 110,000 people including 18,400 in North America. The US is an important market with more sales last year from the now merged businesses to the US Department of Defense than to the UK's Ministry of Defence (MoD).

Consolidation

Significant value may be accessed through consolidation in the industry by achieving an improved competitive position. Such value lies in taking advantage of the opportunities to exploit new markets, reduce costs, share R&T and invest more efficiently. The merger with MES represents a major step in the consolidation of the industry and establishes BAE SYSTEMS as an attractive potential partner for subsequent steps.

Further moves may involve relationships with other companies in Europe and those in the US. This reflects the ongoing consolidation of the industry. BAE SYSTEMS is ideally placed

to play a significant part in the further steps of this process.

Support for the continuing globalisation of our business has already been apparent at a lower tier in the industry. BAE SYSTEMS has been welcomed as a defence equipment supplier in the industry's second tier in the US. BAE SYSTEMS will pursue a strategy to continue to build on this strong competitive position in North America.

With our participation in Airbus, Eurofighter and Tornado; with our 35% stake in Saab, and with our joint ventures in Germany, France and Italy, BAE SYSTEMS has a firm European base, and is well placed to participate in future European collaborative programmes. We do not compete with the emerging European Aeronautic Defence and Space Company (EADS). In almost all sectors where we have similar businesses we are partners; guided weapons, space, Airbus and Eurofighter.

Progress is being made in planning for the conversion of the Airbus partnership into a new Airbus Integrated Company (AIC), and to build on the established MBD joint venture.

MBD is to be enhanced and expanded through the agreement to integrate the guided weapons businesses of Aerospatiale Matra and Alenia Marconi Systems (AMS).

Discussions with Alenia have also been extended to consider the scope for partnership with BAE SYSTEMS in military aircraft activities.

The increasing emphasis on the integrated nature of systems is leading to new 'Sensor to Shooter' requirements. These involve complex, real time, data fusion technologies to link all elements from intelligence gathering and threat identification through to weapons targeting.

Fundamental to the philosophy of the company is its focus on major programmes with full visibility at Board level

| | |
|----------------------------|---|
| Astute | Astute is a £2bn prime contract for three new nuclear-powered submarines for the UK Royal Navy. The first boat is due for delivery in 2005. |
| Bowman | The Bowman programme is a BAE SYSTEMS joint venture with ITTI and Racal to design, manufacture and install a secure voice and data communications system for the British Army. The joint venture is the customer's preferred supplier and the programme is currently in its risk reduction phase with a view to winning a £2bn supply and support contract. |
| Eurofighter Typhoon | Development of Eurofighter Typhoon is progressing well to meet the requirements of four European nations for 620 aircraft, with deliveries commencing in 2001. Major assemblies for the first production aircraft of the initial batch of 148 aircraft were nearing completion at the end of 1999. |
| Gripen | In partnership with Saab, BAE SYSTEMS is participating in engineering and marketing of the Gripen combat aircraft for the export market. South Africa recently became the first export customer to order Gripen. |
| Hawk | Hawk is a range of advanced jet trainers and light combat aircraft. The aircraft continues to be highly successful in the export market having been selected for service in 17 countries to date. |
| Nimrod MRA4 | Nimrod is a replacement maritime patrol aircraft for the UK Royal Air Force. The £2.2bn programme involves the refurbishment of early aircraft, including substantial new airframe structure, and the integration of a sophisticated mission system undertaken in partnership with Boeing. |
| Tornado GR4 | BAE SYSTEMS is engaged in a major upgrade of the UK Royal Air Force's Tornado strike aircraft to the new GR4 standard. The programme involves the modification of 142 aircraft for completion by the end of 2002. |
| Type 45 | BAE SYSTEMS has been appointed prime contractor for the new Type 45 Destroyer. This £3bn programme is for 12 ships for service entry between 2007 and 2014, and replaces the UK Royal Navy's Type 42 vessels. |

Steve Mogford
Chief
Operating
Officer

Customer support

HAWK
fighter/trainer aircraft

Future Systems
Future Offensive Air
Systems (FOAS)

LANCER
battlefield
reconnaissance

EUROFIGHTER TYPHOON
frontline fighter aircraft

ASTUTE
nuclear powered submarine

NIMROD
reconnaissance aircraft

BOWMAN
battlefield command
system

GRIPEN
combat aircraft

HARRIER, TORNADO &
future US military
aircraft projects

Future aircraft
carrier (CVF)

Type 45 Destroyer

customer support. This approach, which draws heavily on a peer review philosophy, is already embedded in a number of our major programmes and is scheduled to be fully rolled out across the organisation during the course of the coming year. Our experience is that the peer reviews in LCM provide a highly effective means of identifying and sharing best practice across programmes.

BAE SYSTEMS is one of only a few defence companies to possess the complete range of skills and capabilities to develop and produce the current generation of integrated defence solutions. Fewer still can match the company's programme involvement.

Many of these programmes are conducted in partnership with others. Each bring differing technologies and commercial maturities.

Assembly of the first Hawk aircraft for Australia has commenced

The primary source of value in the company lies in its major programmes. The management of risk to ensure timely and cost effective completion of complex programmes determines the long term performance of the company and is a core BAE SYSTEMS skill. Recognising this concentration of value, and differentiating BAE SYSTEMS from other large prime contractors, the company has recently deployed a radical new organisation structure.

The new organisation for BAE SYSTEMS brings particular management focus to major programmes (normally of more than £1bn in value) with each of these programmes reporting directly to a Chief Operating Officer.

At the heart of our programme management teams lies a depth and breadth of skills based on extensive experience in prime contracting drawn primarily from both the naval and airborne system roots of the company.

Linking this programmes organisation together are teams providing functional excellence for common processes. Life Cycle Management (LCM) is one such process which supports the consistent management of the project lifecycle. This is a comprehensive approach to project management from initial market analysis through bid preparation to product development, production and ultimately

Airborne systems

Near the start of its lifecycle is Future Offensive Air System (FOAS). FOAS comprises a series of UK studies to define concepts for a system to replace Tornado strike aircraft from 2017. The study contract epitomises the changes taking place in the procurement of defence equipment. Previously industry would bid to supply specific, defined, equipment against detailed specifications. Today, customers seek a capability to complete a security task with industry responsible for defining and delivering a solution.

FOAS identifies a requirement to deliver defence capability in the form of airborne deep strike. The studies include, but are not restricted to, conventional aircraft concepts. The FOAS requirement might, for instance, be met by uninhabited aircraft, cruise missiles or any combination of such products.

At the concept demonstration phase is the US-led Joint Strike Fighter (JSF) programme. JSF comprises two competing proposals to replace a range of current fighter aircraft. BAE SYSTEMS participates in both proposals. The likely requirement identifies some 3,000 aircraft replacements.

Boeing is a partner supplying the mission system to BAE SYSTEMS on the Nimrod MRA4 replacement maritime patrol aircraft. Nimrod comprises a £2.2bn programme to re-life existing Nimrod airframes and integrate a new, complex, suite of sensors and systems. This is a challenging programme, and the original plan for

engineering resources underestimated the requirement for the extensive new structure and airframe systems. This has led to an early reassessment of the in-service date and consequent contract re-negotiation with the UK MoD customer. The 1999 results reflect the cost implications of this reassessment.

The project management of Nimrod has been the subject of extensive review with the customer. The programme is now benefiting from an Integrated Project Team drawn from both customer and industry and it is spearheading the implementation of processes under the UK MoD's pioneering 'Smart Procurement' principles. Nimrod lessons learnt have been a key driver in establishing the design of BAE SYSTEMS new programme-led organisation.

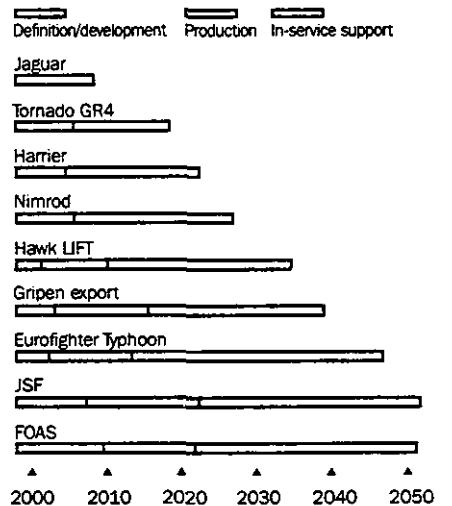
One of the company's largest programmes is Eurofighter Typhoon, a new fourth generation combat aircraft to arm the air forces of Germany, Italy, Spain and the UK, although significant export potential is already being identified. Development of this fixed price programme is proceeding well with profit recognition having commenced in 1999. Assembly of components for the first production aircraft has now commenced for first delivery at the end of 2001. Firm orders have been placed for the first batch of 148 of a formal, four nation, requirement for 620 aircraft.

Eurofighter Typhoon will be a key programme and source of revenue for decades. Production will be followed by continuing

Building on its capabilities in airborne systems integration BAE SYSTEMS has pioneered SPIRIT, a new approach to system development that allows complex design integration problems to be identified early in a product lifecycle.

The SPIRIT team (above) that won a silver Chairman's Award for Innovation are: Duncan Owen, Steve Tiley, Rob Brockie (nominator), Tony Jackson, Dave Short, John Lomax, Dave Borrill, Chris Nordberg, Mark Fish, Dave Bennett (Cassidy & Ashton), Paul Griffin, Tom Bridge, Richard Halstead (Cassidy & Ashton), Kevin Gerrity, Andy Tebay, Paddy Bourne, Michael Cross (Signal Communications). The team also included Andy Blake (not on photo).

Product range development
military aircraft



Pamela Vriesenga operating the Tactical Strike Co-ordination Manager (TSCM) in the US. The TSCM is an integrated, strategic planning tool that provides commanders of airborne forces with the capability to perform battle space visualisation, autorouting, airspace deconfliction and strike plan effectiveness assessments

upgrade and modification work to keep pace with technical advances.

The UK work share of the collaborative programme is 37.5% and BAE SYSTEMS has a significant share of the programme. With the BAE SYSTEMS supplied avionics and equipment content the company's value added contribution rises to some 45% of the system, excluding engines. This reflects the evolution of combat aircraft equipment and avionics content which has progressively increased, generation on generation. Future upgrades will largely centre on such equipment, raising still further the through-life BAE SYSTEMS value on the Eurofighter Typhoon programme. Similarly the company is supplying advanced avionics and equipment such as Head Up Displays to other programmes including the F-16, F-18 and the new F-22 and JSF combat aircraft in the US.

The Hawk advanced jet trainer and light combat aircraft continues to expand its customer base. Current production activity centres on aircraft for Australia and the NATO flying training programme in Canada. A recent notable success was the selection by South Africa of Hawk as part of a larger defence package including Gripen aircraft in partnership with Saab. Contracts leading to 24 Hawk and 28 Gripen aircraft are expected to become effective during the current year.

Tornado is at a different point in the maturity cycle. Whereas Eurofighter Typhoon is just entering the production phase and Hawk production continues, Tornado new-build has been completed. The company is now engaged in a programme to develop and update 142 aircraft to the GR4 standard.

Tornado aircraft are at the centre of the Al Yamamah programme in Saudi Arabia.

Following completion of Tornado deliveries and equipment the programme is now focused on support service activities involving some 5,400 people including 2,000 Saudi nationals.

BAE SYSTEMS derives continuing revenue from a large number of legacy programmes. For instance the Canberra aircraft entered service in 1948 and examples are still in service today. Capturing a larger share of the market to support such long term programmes together with those of tomorrow, represents a significant growth opportunity for the company.

Naval systems

The merger with MES fulfils the company's strategy of migrating its airborne system integration skills to embrace complementary prime contracting capability in naval systems. It marries MES surface and submarine shipbuilding and naval prime contracting activity with BAe's combat management, guided weapon and sensor activities.

The combination brings together strong capabilities to compete for emerging new requirements such as the UK's next generation aircraft carrier (CV(F)). As with the FOAS requirement, the UK MoD will be seeking a complete solution to their requirement for naval force projection. This will include the naval platform, the airborne segment with a Future Carrier Borne Aircraft (FCBA) and, importantly, the systems that integrate them. This 'System of Systems' approach is expected to become an increasing feature of defence procurement.

Another major UK naval programme is the £3bn Type 45 anti-air warfare destroyer to replace the Royal Navy's Type 42 vessels. BAE SYSTEMS has been appointed prime contractor by the UK MoD and a first-of-class

contract is anticipated this year, leading to service entry for this class of 12 ships between 2007 and 2014.

The Type 45 main weapons system, Principal Anti-Air Missile System (PAAMS), has been selected with contracts awarded to MBD last year. PAAMS will integrate with the highly advanced new Sampson multi-mode electronic scanning radar developed by BAE SYSTEMS.

Good progress continues to be made in the development of the £2bn Astute class nuclear-powered submarine programme. The provision of the three Astute boats is the first of the major naval programmes in the UK to involve industry fully in the prime contracting activity. As such, it represents an important opportunity to manage risk and with it capture greater value than previously possible.

Naval deliveries in 1999 included the two F2000 frigates for the Malaysian Navy and the last of the four Vanguard class Trident submarines, HMS VENGEANCE. The final batch of the Duke class Type 23 frigates is nearing completion with HMS KENT having been accepted by the Royal Navy in January 2000 and the last vessel in the batch to be

The Devonshire Dock Hall, Barrow - BAE SYSTEMS capabilities in naval systems extend from complete ship prime contracting and system integration to ship design and build

Product range development
major naval programmes



 Definition/development
 Production
 In-service support

Invincible - aircraft carriers

Swiftsure & Trafalgar - SSNs

Trident - SSBNs

Type 22,23,42 - frigates/destroyers

Astute - SSNs

Type 45 - destroyers

CV(F) - aircraft carriers

▲ 2000 ▲ 2010 ▲ 2020 ▲ 2030 ▲ 2040 ▲ 2050

CV(F) aircraft carrier

launched later in the year. Apart from the Astute programme, the company is also working on three sophisticated patrol vessels for the Royal Brunei Navy and two large Landing Platform Docks and two Auxilliary Oilers for the UK MoD.

We are the prime contractor to the UK MoD to supply and support the Royal Navy Torpedo programmes worth some £500m. The company continues to deliver on development and production contracts as part of that role.

The company acquired the Govan yard in December 1999 and the second of the Auxilliary Oilers is now being constructed there. The future of the yard is dependent on a PFI contract for the supply and operation of

six Roll-on, Roll-off ferries, the tenders for which are under review with the UK MoD.

In the new Smart Procurement and developing Computer Aided Logistics Support (CALs) environments, the concept of through-life costs is receiving increasing attention from the customer. The support and training activities for today's complex systems are integral to the naval programmes and are expected to grow. The company is well placed to provide the full range of support services with a strong in-house capability complemented by joint ventures for naval training and the operation of the Portsmouth Naval Dockyard. These activities will be an important focus of the company's new Customer Support organisation.

We will ensure BAE SYSTEMS is seamless with a clear identity and common unified processes

Mike Turner, Chief Operating Officer

| | |
|---|---|
| <p>Airbus - current programmes</p> | <p>BAE SYSTEMS is a 20% partner in Airbus Industrie and designs and manufactures the wings for all Airbus aircraft. Strong demand resulted in 294 aircraft deliveries last year, when the 2,000th Airbus aircraft was delivered. Importantly, Airbus enjoys a 58% share of the single aisle market.</p> |
| <p>Airbus - future programmes</p> | <p>Airbus continues to expand its family of airliners. Development of smaller and larger extensions (including the A3XX) to the range are currently underway. The 105 seat A318 will enter service in the last quarter of 2002 and, above 375 seats, the A340-500 and 600 airliners will enter service in 2002.</p> |
| <p>Avionics</p> | <p>A wide range of avionics, from integrated radar-based weapon systems to individual displays and sensors, is produced by BAE SYSTEMS. The company supplies avionics on many of the world's most advanced combat aircraft including Eurofighter Typhoon and the F-16, F-18 and the new F-22 and JSF programmes in the US.</p> |
| <p>North America</p> | <p>BAE SYSTEMS is a significant supplier of aerospace and defence systems to the US Department of Defense and major American aerospace companies. The company has a strong position in advanced aerospace products and intelligent electronic systems ranging from communications and data link technology, electronic warfare systems, aeronautical products, imagery exploitation, systems engineering and technical support.</p> |
| <p>Operations</p> | <p>Good progress has been made in the year. The manufacturing, aerostructure and shipyard operations have been grouped together to optimise the value from the company's centre of excellence policy. This will facilitate the drive to reduce costs and further increase productivity through the sharing of best practice.</p> |
| <p>Regional Aircraft</p> | <p>BAE SYSTEMS produces the 70-100 seat RJ regional jetliner and provides a wide range of lifecycle support services, such as maintenance and training, to a fleet of over 1,500 jet and turboprop airliners world-wide.</p> |

**Mike
Turner**
Chief
Operating
Officer

OPERATIONS

INTEGRATION

INTERNATIONAL
PARTNERSHIPS

AVIONICS

REGIONAL AIRCRAFT

NORTH AMERICA

AIRBUS

AVIATION SERVICES

BAE SYSTEMS is a substantial constituent of the defence industrial base in North America with proforma annual sales of over \$2.5bn and 18,400 people at numerous locations. BAE SYSTEMS in North America is the leader in many fields of advanced technologies such as real-time distribution of data from intelligence and target identification to weapons delivery. The North American activities have established strong positions in airborne systems and equipment including advanced flight controls.

Significant consolidation has taken place amongst the prime contractors within the US defence market with industry and governments now considering the next moves that would lead to a more global industry base. Consolidation amongst the second tier, equipment and systems, suppliers is less advanced. BAE SYSTEMS has been welcomed as a competitive member of the industry in the US and opportunities exist to grow substantially its business in this market.

One of the company's longest established partnerships is its 20% participation in Airbus, which is proving highly successful in the marketplace. It has grown its market position against strong established competition from a zero base a few decades ago to outsell the remaining competition in 1999.

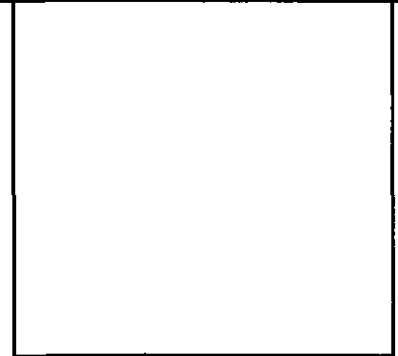
The past few years have seen Airbus achieve order intake significantly above its production output.

The rising demand for Airbus aircraft, and in particular the single aisle airliners, is being reflected in increasing production output. Deliveries of single aisle wing-sets are being increased and are now expected to reach 24 aircraft sets per month in 2001.

This unprecedented level of production activity places strain on the entire supply chain. New resource planning systems and processes aimed at streamlining management of the supply chain have recently been introduced. Some initial difficulties have been experienced in implementing these new systems resulting in short term disruption to production. However with programmes returning to schedule significant benefits from these new systems are now anticipated.

Despite continuing rising deliveries to 294 aircraft in 1999 (229 in 1998) Airbus Industrie had a backlog of 1,445 aircraft valued at \$100.1bn at year end. This order book represents approximately half the airlines' committed orders. The outlook is for Airbus to achieve parity in a market served principally by just two manufacturers.

To achieve this market success Airbus has pursued a consistent product strategy to offer competitive airliners across the market. The family of aircraft concept has enabled a high degree of commonality to be offered in all aspects of the aircraft operation from flight and cabin crew training to maintenance and spares.

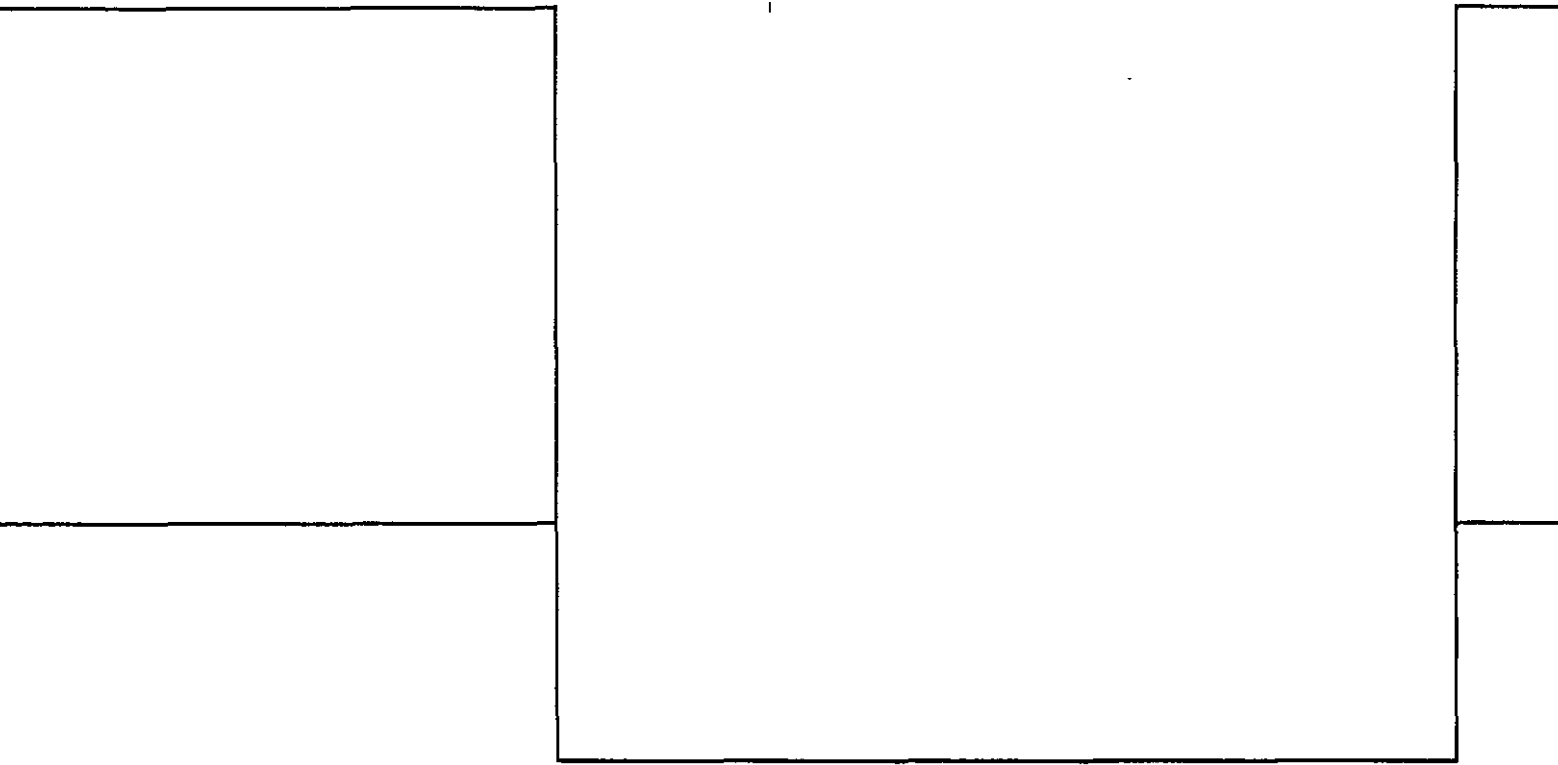


Daryl Goode

The above Tactical Exploitation Group (TEG) system uses high data rate digital inputs from multiple reconnaissance sources. This provides ground force commanders with real-time tactical screening and image processing and near real-time interpretation and analysis.

Progress has been made on other land systems this year with two major contracts for the AS90 Braveheart self-propelled howitzer. Firstly, a UK development contract was awarded to increase the range of the system including the adoption of a modular charge system. Secondly, the system has been selected by Poland as the focal point of their commitment to NATO standard artillery.

Work continues on the development programme of the Ultra Lightweight Howitzer for the US marines and the US army which the UK and Italian armies have both now also joined. Looking forward, major opportunities are being actively pursued for both self-propelled and towed artillery in the world market to increase the orderbook.



Computer image of the A3XX interior, showing the wide, dual lane stairs, designed for rapid boarding and departure

Consistent with this strategy Airbus launched the A318, a new 105 seat derivative of the highly successful A320 single aisle airliner to enter service in the last quarter 2002. Engineering work continues on the A340-500 and 600 variants of the long-range A340 aircraft. These new additions will enter service from 2002 and will be Airbus' largest aircraft to date.

Consideration is being given to the launch of the A3XX. This would be a new range of very large aircraft seating between 480 and 650 passengers in a three class configuration. Engineering work is well advanced with high

confidence in the technical maturity. Airlines are being approached to establish market interest. Sources of finance are also being investigated before consideration of a formal launch by the partners. Discussions are well advanced with the UK Government to agree a suitable launch finance package which will underpin the UK work and put us in a good position as we move towards a launch decision.

Airbus has formed a military aircraft division to manage the proposed A400M tactical military transport aircraft programme. The A400M is being proposed to meet the requirements to replace a number of ageing military airlifters in Europe.

The Regional Aircraft business has produced mixed results. The Asset Management organisation has continued to make excellent progress in placing turboprop and

jet airliners on leases with rates continuing to strengthen. By year end the proportion of idle aircraft had been reduced to 8%, which is below the industry average. 23 new RJ aircraft were delivered, an increase of three on 1998. Order intake was seven aircraft and at the year end order backlog represented 11 aircraft. Improving the order book for the RJ programme in the coming year in an increasingly competitive market will be key in assessing the long term future of this programme.

BAE SYSTEMS has established two aircraft support activities. Avrotec is engaged in maintenance and support of the BAe 146 and RJ aircraft and Aviation Services has established a successful business involved in freighter conversion of early Airbus aircraft and in heavy maintenance. Aviation Services completed 12 freighter conversions in 1999 taking the total to 28 since the first delivery in 1997.

The Airbus A340

During 1999 the 300th A330/A340 long-range aircraft was delivered into service

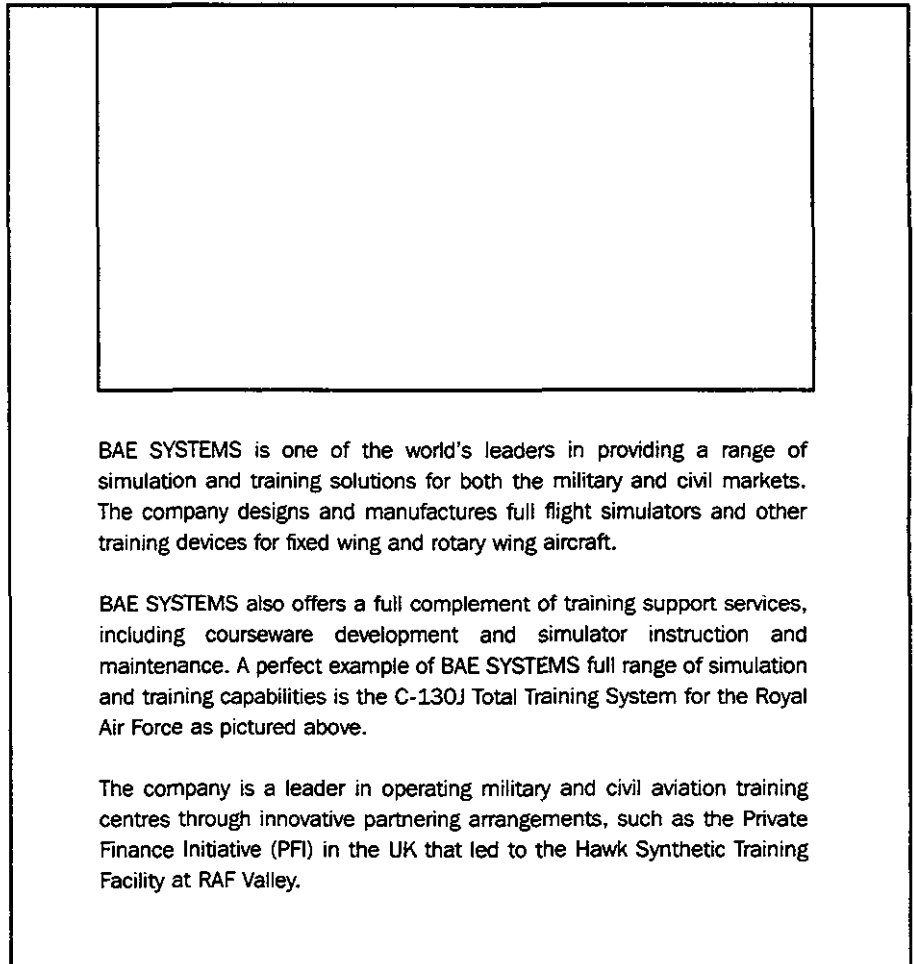
Gregg Dematos, Blad Argintaru, Rob Pietsch and Mike Lokuta (front centre) with Gemin-Eye, a helmet mounted display developed by Flight Simulation and Training (formerly Reflectone), in partnership with the US Army. Gemin-Eye provides a full colour, wide, field-of-view, visual scene to simulator pilots. Gemin-Eye won a Chairman's Award for Innovation in 1999

BAE SYSTEMS is one of the world's leaders in avionics and airborne systems. These include air intercept radar such as the Blue Vixen for Sea Harrier and ECR 90 for Eurofighter Typhoon. More than 11,000 Head Up Displays (HUDs) have been supplied on over 50 aircraft types and are being specified for the US F-22 fighter.

Following the success of the company's HUDs on military aircraft, a new market is now opening to migrate this technology to HUD applications on commercial aircraft.

An important growth area of defence electronics is the secure communication of data between disparate assets. The company is a major supplier of the latest NATO standard Data Link system, Link 16. Such technologies provide the backbone of data distribution in the emerging 'System of Systems' concepts for battlespace management.

The company is a leading supplier of electro-optics and defensive systems such as the directional infrared counter-measures. It is a pioneer of airborne Identify Friend or Foe (IFF) systems relying on complex data encryption techniques.



Artist's impression of the conventionally armed cruise missile, Storm Shadow, which is being developed by Matra BAe Dynamics to provide the Royal Air Force's Tornado and Eurofighter Typhoon aircraft with the capability to strike hardened targets

Avionics and equipment represent a rising proportion of the value of military aircraft and BAE SYSTEMS has a high proportion of the total value add of the production system. Future system upgrades will be largely concentrated in avionics equipment and its integration resulting in still higher through-life value.

We made an important breakthrough last year with Royal Ordnance. The award of a partnership contract covering multi-year ammunition requirements for the UK MoD has provided an important base of work for the future. The agreement relates to around £1bn of business over a 10 year period. In addition, a major contract for Challenger tank ammunition was won last year taking the order book to some £750m. With this good order position, and following the rationalisation announced last year, prospects for the business are now better than for many years.

The new organisation also gives particular focus to the management of joint venture activities. With a substantial volume of business now undertaken in partnership with others these activities are being given priority through the appointment of a Group Managing Director responsible for managing BAE SYSTEMS partner relationships.

The AMS joint venture with Alenia of Italy is now established as a leading naval and land system business. It supplies a range of naval

and land based radars and command systems for defence applications as well as sophisticated radars and integrated management systems for commercial air traffic control.

The AMS joint venture's missile business, which includes the successful UK Brimstone programme, is planned to be merged with the MBD operations in the coming months.

Recent successes in MBD have resulted in the guided weapons joint venture growing its order book to £4.6bn. A number of MBD programmes are maturing from development to production including the ASRAAM short range air-to-air missile and the Storm Shadow/Apache EG family of conventionally armed cruise missiles (pictured above).

Contracts for stand-off missiles have been won in the Middle East and Italy. MBD is planned to be further strengthened by the future integration of the Aerospatiale Matra and AMS missile businesses.

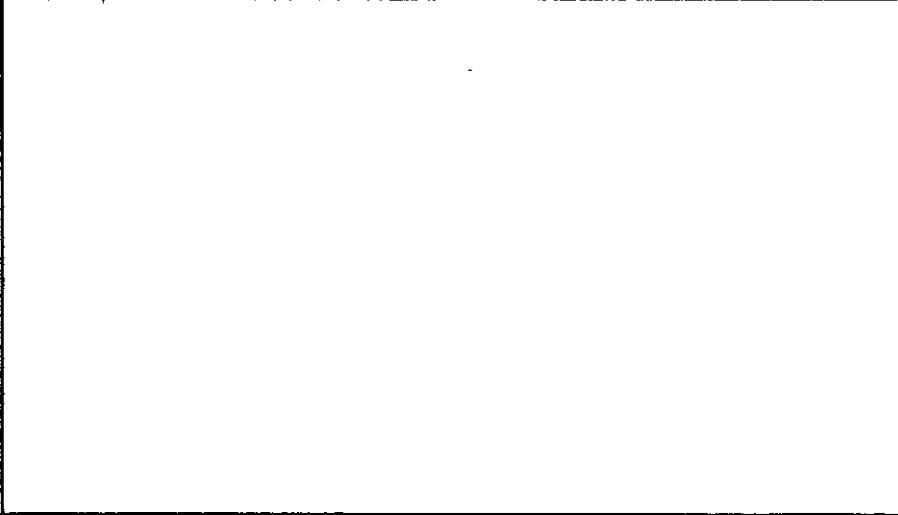
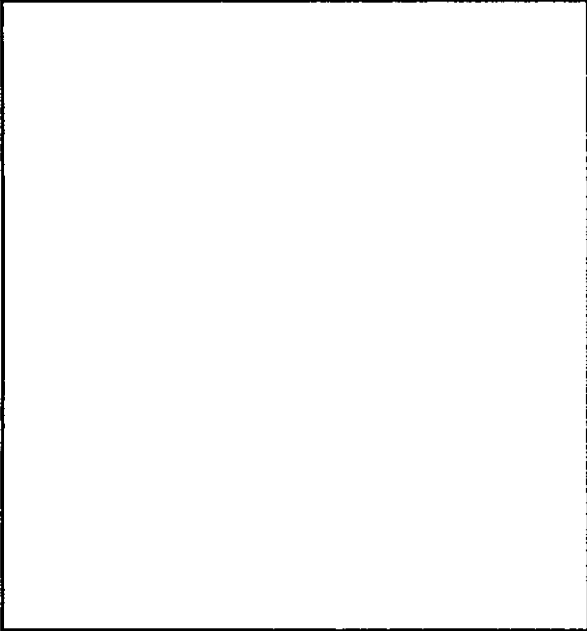
The UK MoD has been conducting a competition to select a Beyond Visual Range Air-to-Air Missile (BVRAAM) to arm Eurofighter Typhoon. MBD has proposed Meteor, an advanced, ram-jet powered, missile. Meteor would be the most advanced missile in its class, capable of countering the threat posed by emerging new air-to-air missile technologies.

BAE SYSTEMS is a 35% shareholder in Saab AB and a partner in that company's Gripen combat aircraft programme. Saab is currently in the process of acquiring another Swedish aerospace business, Celsius. This acquisition will significantly enhance Saab's strategic presence and has the endorsement of BAE SYSTEMS. Completion of the acquisition is planned for March 2000.

The STN Atlas naval and land systems joint venture in Germany has performed below expectations during 1999 and actions are now being taken to implement recovery.

In military aircraft, BAE SYSTEMS is partnered with Boeing on the T-45 Goshawk, Harrier and Nimrod programmes. The company is teamed with Lockheed Martin and Northrop Grumman on one of two competing JSF concepts and has a significant systems involvement in the other, Boeing led, contender. A joint venture with Dassault is engaged in technology acquisition for future combat aircraft.

Collaborations of this kind are key to competing in global defence markets and increasingly are the only way extensive research and development programmes will be able to be undertaken in accessing multi-national budgets and working in partnership towards joint solutions.



Graham Procter and Ian Morgan working on one of our five axis Advanced Contour Machine (ACM) tools which are part of a major investment in leading edge manufacturing systems in support of Eurofighter Typhoon production

Operational excellence

Separating major programmes from management of facilities and operations aids the elimination of duplication and gives the management team clear accountability for the delivery of continuing cost reduction and world-class manufacturing processes. The approach facilitates the establishment of centres of excellence to ensure efficient identification and adoption of best practice.

The breaking down of business unit boundaries from past divisional structures, and consequent elimination of duplicated administration and manufacturing cost structures is an important element in the "unfreezing" of BAE SYSTEMS.

Our manufacturing strategy has been established to concentrate the company's in-house manufacturing activity on defined core capabilities through the development of centres of excellence. This has been complemented by the development of low cost sources of supply for low value-added components both within the UK and abroad. This uses the partnering values which characterise our supply chain practices.

In our Regional Aircraft business a continued focus on bill of material cost reduction, coupled with build-cycle time compression and the use of a world-class integrated enterprise planning system have allowed significant gains to be made in both the cost of production of the RJ aircraft and the ability to deliver to customers' timescales.

Our strategy is to be a leader in championing many environmental issues such as the virtual elimination of Poly Chlorinated

Biphenyls (PCBs) from production processes and the recycling of used materials.


The company's achievements in this area have been recognised in the UK through a UK Business in the Environment commendation as a significant improver in the field of environmental performance and management, and in the US through the Environmental Responsibility Leader Recognition programme.

To facilitate the implementation of centres of excellence and maximise the benefit from manufacturing synergies, aerostructures and shipbuilding facilities are managed within a common operations organisation.

Our Broad Oak facility in Portsmouth was a winner in the 1999 *Management Today* Best Factory Awards. This recognised the achievement of productivity increases of 25% in two years; delivery performances to world-class standards; re-work levels cut from 11% to 3% and work-in-progress reduced by 30%.

The merger of MES and BAe was allowed to proceed subject to certain undertakings. Those undertakings concerned *inter alia* the maintenance of appropriate measures to ensure that competitors' access to the avionics businesses and the shipyards is not compromised.

The separation of shipyard management from the management of certain major naval programmes has also aided compliance with these regulatory undertakings.



BAE SYSTEMS invests millions in many educational programmes across the world. These programmes cover a wide range of activities, but importantly include the promotion of engineering, science and technology. Pictured above is Richard Holt, a manufacturing engineer from our Brough operations bringing design and technology to life with children from Chiltern Primary School in Hull (United Kingdom).

BAE SYSTEMS is committed to benefiting the communities in which the company operates. As a member of Business in the Community's 'PerCent Club' BAE SYSTEMS is working to achieve a donation of 1% of pre-tax profits to community, education and environmental projects.

In 1999, the company's employee fund raising scheme, Charity Challenge, has also raised over £1m for our partnership charity, the Leukaemia Research Fund, and other national and local charities.

In addition, good environmental practices led to the company being recognised during 1999 as the second best engineering company in the index of Corporate Environmental Engagement Survey of FTSE 100 companies. Over the next year we will be working to ensure that all our sites are on target to achieve the ISO 14001 standard for environmental management.

BAE SYSTEMS 1999 Community Report contains information on safety, health and environment, education, charitable and heritage work. A copy can be obtained from the company.

“Operationally, the company’s focus has been on raising productivity, reducing costs and speeding up throughput. Inventories and cycle times have dropped substantially...”

Aviation Week & Space Technology, May 1999

Recognising success

The Chairman’s Awards - Gold winners

Tony Vines (pictured)

Created the first C130-H Simulator to achieve FAA Level C Certification. Although not a software writer, Tony managed, without assistance, to design, develop and prove the simulator upgrade necessary for the certification. Now 98% of flight training on C130s can be conducted on the simulator offering considerable marketing opportunities.

Simon Cant, Alan Minishull, Charles Stoddard

The team developed a simple strap system which removed the need for manual handling of Airbus stringers thus reducing man-hours and creating a safer working environment.

Steve Wilson, Peter May

All aircraft use bushes in their structure to protect components. These bushes are chemically processed and coated with cadmium, a process previously done manually. Steve and Peter have developed a process whereby bushes are cadmium plated on a jig with an internal spring to conduct electricity. This innovation is reducing bottlenecks, reducing solvent emissions and saving money.

Eric Cheer

Eric devised radical design changes to improve VHF/UHF receiver architecture and produce a successful prototype of the miniature receiver, which retains our position as world leader in this field. As well as its small size, it has an ultra low current consumption, stealth attributes and offers scope for enhancement.

Peter Clapperton, Ernie Attwell

Introduced an environmental education partnership between BAE SYSTEMS and a local primary school in Llanhilleth (United Kingdom). This innovatively links the world of industry with the world of education and promotes an interest in engineering from an early age.

The success of an organisation can be demonstrated by the way in which its achievements, and importantly those of its people, are recognised by the external community. 1999 proved to be an important year in recognising such success. It was the year that the company was recognised as the world’s “Best Managed Large Aerospace Company” in Aviation Week’s prestigious Global Accolade awards.

This reflects wholly on the commitment and quality of the people we employ and the development opportunities that are both open to them and seized by them. There can be few better measures of the good progress that the BAE SYSTEMS team is making than as reflected in our Chairman’s Award for Innovation, now in its fourth year. This programme encourages and rewards innovation across the company and in 1999 attracted over 1,250 entries, almost a threefold increase on 1996.

As described on the insert on this page, last year there were five outstanding entries that won the

Rachael Becconsail, winner of the "Young Female Engineer of the Year" award

distinction of a Gold award. In addition a significant number of Silver and Bronze awards were attained by teams across the business. All of these successes have a direct and often immediate impact on the excellence of delivery to our customers and in growing shareholder value.

At the heart of BAE SYSTEMS capability is a committed workforce of over 110,000 people including some 24,000 engineers. The company's performance depends on the ability to attract and retain people of the highest quality.

The progress that we have made in this area in recent years is reflected in the company being recognised as the "Employer of Choice in Engineering", based on The Times newspaper's annual graduate careers survey.

The company places great emphasis on the personal development of all its people and has a policy to invest in lifelong learning and development. This investment is underpinned by the Virtual University which aligns the Learning, Best Practice, and Research and Technology programmes across the company. This is achieved through strategic partnerships with Universities and through our on-line network of Learning Centres across the world.

In 1999, recognition has come from around the world. In the US we achieved two Hammer awards recognising our contribution in improving dramatically the way

government works. FOAS was named runner-up for the coveted Chief of Defence Procurement's Annual Award for Business Excellence.

An important event last year was our Military Aircraft business winning the UK Business Excellence Award. This award is the conclusion of a long assessment based on the EFQM Business Excellence model which has been used since 1994, over which period the business' score has doubled. The assessors were particularly impressed by the way in which such a large manufacturer had developed an excellence culture that fosters creativity and innovation.

The company has again been awarded a Queen's Award for Export Achievement in the UK. Our Airbus wing manufacturing business was cited for an increase in export deliveries of more than 90% over the period 1996 to 1998, and the substantial contribution these exports make to the UK economy.

This is a summary of just some of the highlights of the year in celebrating the success and creativity of our people. Further honours and awards are shown in the insert on this page. Space does not permit including all such key achievements across our business. However, the significant growth in attaining these top accolades is clear, and demonstrates the hunger amongst BAE SYSTEMS people to be the Benchmark for our industry.

Recent achievements

- Management Today award - Aerospace category of the award for BRITAIN'S MOST ADMIRABLE COMPANIES.
- UK Quality Awards for Business Excellence for the large private sector organisation category.
- Boeing Gold Supplier status for our site in Greenlawn, US.
- US Navy's Certificate of Merit and Centurion award - for "commitment, outstanding loyalty and dedication to the Navy and the country".
- Air Finance Investor & Operators recognition - Airbus was rated top manufacturer of both single aisle and wide-bodied aircraft, in terms of operational success, residual value and value for money.
- Millennium Excellence National Training Award - in the large company category, recognising our use of people development programmes as an effective tool for business improvement.
- Numerous site-based Investors in People awards - which recognises commitment to developing people.
- Seven of our products achieved Millennium Product Status - the second largest total for any UK company.
- Two James S. Cogswell Awards - for Outstanding US Industrial Security Achievement.
- Investor Relations Award - we were runners up in the 1999 Grand Prix for Best Overall Investor Relations programme.
- Winner and runner up in the "Young Female Engineer of the Year" award from the Institute of Incorporated Engineers (IIE).

We have completed the MES merger with a strong balance sheet, and with every expectation of being ungeared in 2000

George Rose, Group Finance Director

Financial strength

1999 has once again seen the company deliver a set of results in line with our plans.

Profit before interest, excluding goodwill amortisation and exceptional items, increased to £763m (1998 £638m) on sales of £8.9bn. Before taking into account the contribution from MES, this represents a 15.2% increase on 1998. MES contributed a £28m profit before interest, excluding goodwill amortisation and exceptional items, and £455m sales, which represented a single month's trading.

Profit before tax, excluding goodwill amortisation and exceptional items, advanced 11.6% to £790m. The lower level of MES contribution for the short trading month of December was the principal reason for holding back the corresponding increase in diluted earnings per share to 6.3%.

Going forward, the future workload for the enlarged group is underpinned by a strong order book which stood at £36.6bn at the year end (1998 £28.1bn), with MES contributing £8.5bn to this.

The merger with MES, which was announced on 19 January 1999, represents an important step in addressing value creation through industrial consolidation. At that time it was estimated that significant synergy benefits would result in annual cost savings totalling in excess of £275m within three full financial years of completion of the merger. Subsequent verification work has confirmed these savings and identified further opportunities.

Based on the confidence that the directors have in the company's outlook following the merger the dividend per share for the year has been increased to 8.0p (1998 6.5p), representing an increase of 23.1% which is covered 3.6 times on a diluted basis. This increase reflects the company's intention to base its dividend policy on 3.25 times cover (before goodwill amortisation and exceptional items) on a full year basis.

In the past year BAE SYSTEMS shares have underperformed the UK FTSE 100 Index, reflecting the lower valuations attributed to engineering stocks. However, over the last five years to 31 December 1999 the cumulative annual performance of BAE SYSTEMS shares has consistently outperformed the FTSE 100. In real terms, the percentage increase from 1 January 1995 to 31 December 1999 was in excess of 300% for BAE SYSTEMS shares, against a FTSE 100 increase of 126% over the same period.

Shareholders' funds have increased significantly to £7.4bn (1998: £2.0bn). This is mainly attributable to the goodwill arising on the merger with MES.

The group ended the year with net indebtedness of £825m, which included the benefit of the future disposal of its investment in Orange plc. The significant majority of the group's net indebtedness would have been offset by cash payments on defence contracts had they been received prior to the year end rather than, as was the case, in the early months of 2000.

table 1: Summarised performance

| | Proforma results year to 31 December 1999 £m | Year to 31 December 1999 £m | Year to 31 December 1998 £m |
|-------------------------|---|--------------------------------|--------------------------------|
| Sales | 12,389 | 8,929 | 8,611 |
| Profit before interest* | 1,115 | 763 | 638 |
| Operating cash flow | 639 | 324 | (839) |

*excluding goodwill amortisation and exceptional items

table 2: Segmental analysis

| | Sales | | | Profit/(loss) | | |
|---|---|--------------------------------|--------------------------------|---|--------------------------------|--------------------------------|
| | Proforma results year to 31 December 1999 £m | Year to 31 December 1999 £m | Year to 31 December 1998 £m | Proforma results year to 31 December 1999 £m | Year to 31 December 1999 £m | Year to 31 December 1998 £m |
| Defence | 5,837 | 5,837 | 6,353 | 760 | 760 | 638 |
| Commercial Aerospace | 2,970 | 2,970 | 2,523 | (10) | (10) | 12 |
| MES businesses | 3,915 | 455 | | 380 | 28 | - |
| Other businesses and head office | 35 | 35 | 47 | (15) | (15) | (12) |
| | 12,757 | 9,297 | 8,923 | 1,115 | 763 | 638 |
| Less: intra group | (368) | (368) | (312) | | | |
| Net interest excluding exceptional items | | | | | 27 | 70 |
| Goodwill amortisation, including joint ventures | | | | | (63) | (23) |
| Exceptional items | | | | | (268) | 288 |
| | 12,389 | 8,929 | 8,611 | | 459 | 973 |

The future disposal of the Orange investment is consistent with the company's strategy of disposing of its non-core assets, and which it has realised through the issue of the Exchangeable Bonds in July 1999. Further details of the transaction are provided below and in note 17 to the accounts. The positive cash impact from this action (£686m) together with the cash generated by the former BAe businesses (£373m), and MES during the one month of ownership (£33m), have gone some way to offset the outflows associated with the MES merger which totalled £1,884m.

Operating performance

The tables above provide unaudited pro forma results for the enlarged group on an annualised basis, with MES contributing sales of £3.9bn and operating profit of £380m. This pro forma profit for 1999 included one off non-recurring charges of £60m relating to two programmes. The first related to difficulties at

Matra Marconi Space following the cancellation of a satellite due to have been delivered in 1999. The second concerned the additional costs incurred to deliver the last of the Malaysian frigates. These same factors also affected MES 1999 cash flow. Tables 3 and 4 (overleaf) analyse both profit and operating cash flows for 1999, as reported, by sector and highlights the impact of certain key movements including rationalisation charges, aircraft finance, lease management and launch aid. Detailed operational reviews are provided in the operating review contained in these accounts, with key performance measures summarised as follows.

Defence

Performance in the Defence businesses was again good. Productivity further improved with a higher profit recognition as key programmes mature. Operating margin increased to 13.0% (10.0% in 1998) on lower sales. Defence

Profit before interest £ millions

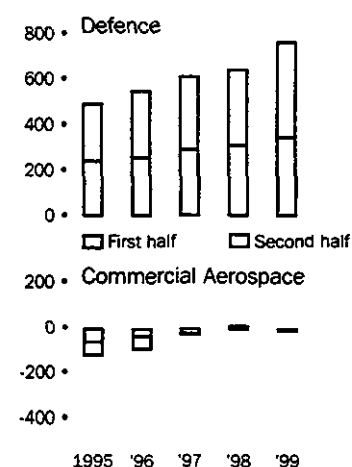


table 3 Underlying operating performance

| | Profit before interest 1998 £m | Movements | | | Profit before interest 1999 £m |
|--------------------------------------|--|-----------------------|---------------------|---------------|--|
| | | Rationalisation £m | Launch aid £m | Trading £m | |
| Defence | 638 | 19 | - | 103 | 760 |
| Commercial Aerospace | 12 | - | (35) | 13 | (10) |
| MES | - | - | - | 28 | 28 |
| Other | (12) | - | - | (3) | (15) |
| | 638 | 19 | (35) | 141 | 763 |
| Actual Profit and Loss charge | | | | | |
| Launch finance | (141) | | | | (176) |
| Rationalisation | (32) | | | | (13) |

sales benefited from higher activity in defence systems and key military aircraft programmes including Eurofighter Typhoon. These increases were offset by lower sales as the established Al Yamamah programme in the Kingdom of Saudi Arabia moves from hardware and construction phases towards a stable base of underlying customer support activity. The reduced sales for the year have also been affected by the renegotiated programme for Nimrod, where delays in the programme have occurred following a reassessment of the engineering resource and technical requirements. The 1999 results reflect the cost implications of this reassessment.

As a result of the ongoing drive for operational improvements, coupled with reducing workload on the Harrier programme, in June the company announced a Defence sector rationalisation. The programme encompasses the closure of the Dunsfold site together with a voluntary redundancy programme across a number of other sites across the sector. Pre-tax exceptional costs of the programme are estimated at £250m over a two year period, with £198m charged in 1999.

The results for the year include the benefit from the company's stake in Saab AB. This joint venture partner is currently in the process of acquiring another Swedish aerospace business, Celsius. This acquisition will significantly enhance Saab's strategic presence, and the anticipated benefits from this move will be reflected in the company's share of future results.

Commercial Aerospace

The Commercial Aerospace activities produced sales of £3.0bn (1998 £2.5bn) with an order book at the year end of £13.1bn compared to £12.0bn at the end of 1998 primarily through increased Airbus activity. The Commercial results for the year included our share of the result attributable to Airbus Industrie (AI) being a loss after interest of £42m (1998 loss: £25m). This was offset by profit improvements in the regional aircraft business together with continued good trading on Airbus wing-sets. Launch aid repayments charged to the profit and loss account during 1999 amounted to £176m (1998 £141m) of which £74m were on single aisle programmes.

Airbus continues to expand its family of airliners, and development of smaller and larger extensions to the range are currently underway. Development of an A3XX family of airliners seating 480 to 650 passengers continues. Discussions are well underway to establish possible sources of launch finance including the UK Government. Development expenditure of £13 million has been charged in 1999, principally relating to the A3XX.

Airlines placed net orders for 430 new Airbus airliners during 1999. Net of cancellations the order book for Airbus airliners stood at 1,445 aircraft valued at \$100.1 billion at the year end (1998: \$92.7 billion). Our regional jet business, Avro, delivered 23 RJ aircraft during 1999, with orders outstanding at year end for 11 aircraft.

Future reporting

The sectors against which the company has in the past reported its results are no longer appropriate as a basis going forward. We will be reporting performance in the same way we manage the business, by the seven sectors:

- North America
- Avionics
- Operations
- Commercial Aerospace
- Major Programmes
- Customer Support
- International Partnerships

This sector split separates the programmes management from that of the operational facilities and reflects the new company organisation as described in the Operational Review. It places a focus on customer support as a separate business stream and gives greater emphasis to the way joint ventures are managed. Importantly it also enables commercial separation of both the Avionics and North American businesses from other activities, facilitating compliance with the regulatory undertakings.

Taxation

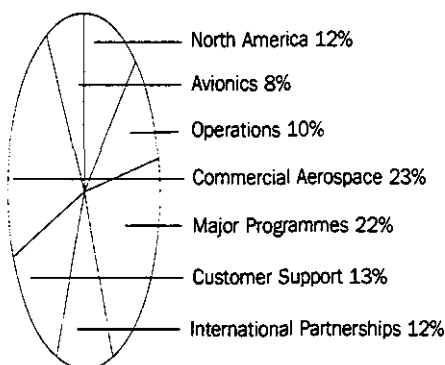
The tax charge on ordinary activities before goodwill amortisation and exceptional items was £188m. This represents a 24% tax charge against pre-exceptional profits. With a significant proportion of the group's revenues in future years being generated in higher tax jurisdictions, including the US, the planning rate is currently expected to increase towards a rate in excess of 30% from 2000 onwards.

table 4 Cash flow analysis

| | Customer stage payments £m | Aircraft finance £m | Lease management £m | Rationalisation £m | Launch finance £m | Trading cash flow £m | Operating cash flow £m |
|-------------------|-------------------------------|------------------------|------------------------|-----------------------|----------------------|-------------------------|---------------------------|
| Defence | (73) | - | - | (66) | - | 549 | 410 |
| Airbus | - | 127 | - | (1) | (172) | 32 | (14) |
| Regional Aircraft | (5) | - | (90) | (32) | - | 3 | (124) |
| MES | 34 | - | - | - | - | 3 | 37 |
| Other | - | - | - | - | - | 15 | 15 |
| | (44) | 127 | (90) | (99) | (172) | 602 | 324 |

BAE SYSTEMS -

new sector sales analysis



Year 2000

The work undertaken to mitigate risks posed by the Year 2000 problem ensured a successful transition into the year 2000. Only minor issues have been reported to date, and the roll-over was smooth and trouble free across the whole of BAE SYSTEMS, including the newly merged MES business.

External costs associated with addressing the Year 2000 date change continue to be estimated at £90m for the BAe programme, with a further £6m estimated as arising in respect of the MES programme from the date of the merger.

Treasury and financial risk management

Treasury policy issues are disclosed in the Directors' Report, with commentary on interest rate and currency management, including financial details of treasury instruments, provided principally in note 30 to the accounts.

Treasury activity during the year

The merger with MES, and the associated funding requirements, resulted in increased activity in the capital and banking markets during 1999. A summary of the major transactions is set out below:

(a) August 1999: an additional Revolving Credit Facility for £2bn was entered into for a five year term.

(b) October 1999: a £500m undrawn 12 month loan facility was entered into providing the group with bridging finance for liquidity requirements.

(c) November 1999: Total consideration for MES was £6.5bn, which principally represents the issue of 1.17bn ordinary shares, Capital Amortising Loan Stock of £369m together with assumed debt of £1.4bn.

(d) December 1999: a \$3 billion Commercial Paper programme was launched in the US, providing the group access to a highly liquid, cost effective short term source of funding. This was used to refinance the MES intercompany debt repaid on completion of the merger. At the year end there was \$1.5bn outstanding on this programme at an average maturity of 36 days and weighted average rates of 6.0%.

The only financial covenant in respect of the above facilities and capital instruments relates to interest cover.

At the year end, 61% of debt (being loans and overdrafts) was fixed at interest rates ranging from 3.75% to 11.875%. All investments and cash deposits are at floating rates.

Exchangeable Bonds

In July 1999, £686 million was raised through the issue of seven year bonds exchangeable into the company's investment in the ordinary shares of Orange plc (the Exchange Property). From August 1999, the bondholders have had the right to exchange the bonds for the Exchange Property which, at the year end, represented the company's investment in Orange plc and Mannesmann AG. At the option of the company the bonds may be settled in cash based on the prevailing market value of the Exchange Property. However, consistent with the company's strategy of disposing of its non-core assets, the company does not intend to settle any amounts due to bondholders in cash. The substance of the transaction has therefore been to affect the future disposal of the Exchange Property at the issue price of the bonds, with the issue proceeds reflected as cash in the year end net debt position.

The bonds carry a coupon of 3.75% and were issued at a premium of 29.4% to the then prevailing market price of the Exchange Property.

Currency exposure

The group's principal currency exposure is the US\$/£ Sterling exchange rate arising from the group's manufacturing and sales activities relating to commercial aircraft. US\$ cover exists for 38% of the group's anticipated exposure to 2004 at a rate lower than the five year planning rate. The group has an additional 14% of cover over the period to 2004, which is contingent on the path of the US\$/£ Sterling exchange rate during the period.

Board of Directors

Executive directors

Sir Richard Evans CBE (1987)

Chairman

Assumed his current position on 1 May 1998. He joined the company in 1969 and has held a number of senior positions in the group. He is a non-executive director of United Utilities plc. Age 57

John Weston CBE (1994)

Chief Executive Officer

Appointed Chief Executive on 1 May 1998 having held a number of senior positions since joining the company in 1970. He is a member of the CBI Council, the SBAC Council, the Advisory Board to the Royal College of Defence Studies and the Council of the Royal United Services Institute. Age 48

Peter Gershon CBE (1999)

Appointed a member of the Board on 29 November 1999 following the merger with the MES business. Prior to the merger he was a director of The General Electric Company, p.l.c. He will retire from the Board on 31 March 2000. Age 53

Michael Lester (1999)

Group Legal Director

Appointed a member of the Board on 29 November 1999 following the merger with the MES business. Prior to the merger he was a director and Vice Chairman of The General Electric Company, p.l.c. He is a non-executive director of Premier Farnell plc. Age 59

Sir Charles Masefield (1999)

Group Marketing Director

Appointed a member of the Board on 29 November 1999 following the merger with the MES business. Prior to the merger he was a director of The General Electric Company, p.l.c. Age 60

George Rose (1998)

Group Finance Director

Appointed Group Finance Director on 1 April 1998 having joined the company in 1992. He previously held senior positions in the Rover Group and Leyland DAF. He is a non-executive director of Saab AB and a member of the Financial Reporting Review Panel. Age 47

Mike Turner CBE (1994)

Chief Operating Officer

A member of the Board since 1994 and a member of the Airbus Industrie GIE Supervisory Board. He is a non-executive director of Babcock International Group Plc. Age 51

Non-executive directors

Sir Robin Biggam (1994) * †

Chairman of the Independent Television Commission and the Fairey Group plc. Also a non-executive director of British Energy Plc. Chairman of the Nominations and Compensation Committee. Age 61

Keith Brown (1989) * †

A former managing director of Morgan Stanley Dean Witter and a former board member of London Transport. Chairman of the Audit Committee. Age 57

Dr Ulrich Cartellieri (1999)

Appointed a non-executive director on 1 December 1999.

Dr Cartellieri is a member of the Supervisory Board of Deutsche Bank AG and he is also a director of Robert Bosch GmbH, Henkel KGaA and Deputy Chairman of DEG, the Federal Government owned German Investment and Development Company. Age 62

Sir Ronald Hampel (1989) * †

Chairman of United News & Media Plc, former chairman of ICI plc and a non-executive director of Aluminium Company of America. Age 67

Lord Hesketh KBE (1994) * †

A non-executive deputy chairman of Babcock International Group Plc. A former Government Chief Whip in the House of Lords and a Privy Councillor. Age 49

* member of the Nomination and Compensation Committee

† member of the Audit Committee

Dates in brackets show the year of the individuals' appointment to the Board of British Aerospace plc.

Directors' report

The directors of British Aerospace plc (trading as BAE SYSTEMS) present their report, together with the accounts, for the year ended 31 December 1999.

Principal activities

On 29 November 1999 the company completed its merger with the Marconi Electronic Systems (MES) business which was formerly part of The General Electric Company, p.l.c. (GEC). The MES business is an international business with leading positions in avionics, electro-optics, naval and underwater systems, naval prime contracting and shipbuilding (surface ships and submarines) and defence systems together with joint ventures in radar and defence systems, missile systems, ground and naval systems, air traffic control, sonar and space. Further details of the structure of the company following the merger and the principal activities of the company are detailed in the operating and financial review on pages 4 to 21.

Research and Technology

Research and Technology has been primarily targeted at key enabling technologies, such as sensor system development, leading to reduced costs and cycle times. There has been a growth in emphasis on developing higher tier capabilities at the system engineering and integration level.

Following the merger with MES, the company is developing a fully integrated cross-sector technology plan to gain maximum leverage in the telecommunications and IT sectors and to exploit synergies between land, naval and air systems and platforms.

Office of Fair Trading undertakings

In order to meet issues raised in respect of competition in the defence industry and national security, following the merger of BAe and MES, BAE SYSTEMS has agreed in principle to give undertakings to the Secretary of State for Trade and Industry which seek to remedy or prevent adverse

effects of the merger. It is expected that the terms of the undertakings will be finalised shortly.

The undertakings will contain measures which address, *inter alia*:

- competition concerns arising where BAe and MES are members of competing teams bidding for contracts which are presently out to tender;
- competition concerns arising from vertical integration of BAe's prime contracting capability for fixed wing combat aircraft and MES avionics business;
- competition concerns arising from the strengthened prime contracting capability of the merged business in naval shipbuilding;
- national security issues; and
- the appointment of an independent Compliance Officer to oversee compliance with the undertakings.

The responsibility for ensuring compliance with the undertakings will ultimately be that of the directors.

Information regarding the contact details for the Compliance Officer may be obtained through the Company Secretary, at the company's registered office.

Treasury policy

The group's treasury activities are directed by the Treasury Review Management Committee (TRMC). Two executive directors are members of the TRMC, including the Group Finance Director who is the chairman. The TRMC also has representatives with legal and taxation expertise.

The group operates a centralised 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. An overriding policy is that trading in

financial instruments for the purpose of profit generation is prohibited, with all financial instruments being used for risk management purposes. Other key policies are:

- (i) to maintain a balance between continuity of funding and flexibility through the use of borrowings with a range of maturities, currencies and fixed/floating rates of interest reflecting the group risk profile;
- (ii) to maintain adequate undrawn committed borrowing facilities;
- (iii) to mitigate the exposure to interest rate fluctuations on borrowings and deposits by utilising interest rate swaps, interest rate options and forward rate agreements; and
- (iv) to hedge economically both contracted and anticipated foreign currency cash flows over a five year period, having first matched receipts and payments.

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

- to manage the group's core funding and liquidity;
- to manage exposure to interest rate movements;
- to manage exposure to foreign currency movements; and
- to control and monitor bank credit risk and credit capacity utilisation.

With respect to the last point, the department transacts with an extensive range of counter-party banks and financial institutions, and adopts a systematic approach to the control and monitoring of counter party credit risk. A credit limit is allocated to each counter party with reference to their relevant credit rating. For internal credit risk purposes, all transactions are marked to market and the resultant exposure is allocated against the credit limit.

A Compliance Manager monitors compliance against the principal policies and guidelines (including the utilisation of credit) and is

Directors' report

required formally to report any exceptions found to the TRMC. Further disclosure on financial instruments is set out on page 25 of the operating and financial review and in note 30 to the accounts.

Supplier payment policy

It is group policy that each business unit is in compliance with local best practice in the country of operation in respect of supplier payment policies. Agreed payment schedules are maintained provided that the supplier complies with all relevant terms and conditions. Group policy is that changes to the agreed payment schedule are made with the prior agreement of the supplier.

In the UK it is group policy to support the CBI Prompt Payment Code regarding the payment of suppliers.

The average number of days credit provided during 1999 by suppliers was 40 (1998 34 days). The company does not have any trade creditors.

Employment

The group has a programme in place to assist employees to achieve their full potential and to develop the skills necessary to meet the current and future expectations of our customers. The programme focuses on both personal and technological development within the group.

All employment policies include a commitment to equal opportunities regardless of sex, race, colour, nationality, ethnic origin or disability, subject only to considerations of national security. The company's policy is to provide, wherever possible, employment opportunities for disabled people and to ensure that disabled people joining the company and employees who become disabled whilst in our employment benefit from training and career development opportunities.

The company has put into place a number of ways of providing employees with information on the performance of the company and other matters that affect them. The effectiveness of the communication process is assessed regularly with the aim of continually improving these so as to provide employees with the information they want by the most effective means.

Employees are actively encouraged to become shareholders in the company by way of a SAYE Share Option Scheme and a Profit Sharing Scheme. Currently, over 28,000 employees participate in the SAYE Share Option Scheme and over 34,000 in the Profit Sharing Scheme. Following the merger, these schemes will be made available to employees across the company.

QUEST

The group has established a Qualifying Employee Share Ownership Trust (QUEST) for the purposes inter alia of the SAYE Share Option Scheme (1993). This is detailed further in notes 12 and 23 to the accounts.

Honours

The following individuals were honoured in the 1999 Birthday Honours and the 2000 New Year Honours lists:

CBE

Peter Gershon
Mike Turner

OBE

Patrick Carroll
Robin Southwell
Jerry Wooding

MBE

George Brown
David Cross
Philip Dye
Thomas Hamill
Caroline Morrison
Laurie Prince
Michael Walker

Safety, health and environment

The company is committed to high standards of health and safety at work and encourages active concern for the environment. There are clearly structured procedures and initiatives in place that recognise the contribution employees can make in these areas. An environmental policy is in place, and at the time of the merger we were in the third year of a five year improvement plan. Following the merger this policy will be applied across the enlarged group.

Year 2000

The work undertaken to mitigate risks posed by the Year 2000 problem ensured a successful transition into the year 2000.

Only minor issues have been reported to date and the roll-over was smooth and trouble free across the whole of the BAE SYSTEMS business, including the newly merged MES business.

Monitoring continues to ensure that any Year 2000 issues identified in the future are effectively mitigated. The contingency plans developed in the latter part of 1999 will remain in force for as long as is considered necessary, and until at least the end of this year.

The company continues to estimate that external Year 2000 costs excluding enhancements will amount to £90m for the BAe business, and that a further £6m from the date of the merger is estimated in respect of the MES business.

Share capital

As at 2 March 2000 the company had not been advised of any significant interests in the issued ordinary share capital of the company.

On 29 November 1999 the company allotted 1,167,811,580 new ordinary shares to be issued to former GEC shareholders as part of the consideration for the MES business (see note 23).

Directors' report

The number of ordinary shares shown in the Register of Members as at 31 December 1999 as foreign-held pursuant to Article 43 of the company's Articles of Association was 833,625,025 (28.6%). Article 43 contains provisions that restrict the aggregate number of foreign-held shares at any one time to 49.5% of the issued ordinary share capital. The Articles also contain an individual shareholding restriction, which restricts any one foreign shareholder or group of related foreign shareholders to a holding of no greater than 15% of the issued ordinary share capital.

A resolution will be put to shareholders at this year's Annual General Meeting to give a general authority to make market purchases of the company's shares up to a maximum of 10% of the share capital of the company. Further details of the resolution will be included in the Notice of the Annual General Meeting that will be sent to shareholders at the end of March.

Results and dividends

The profit after taxation and minority interest was £324m (1998 £692m). The directors propose a final dividend of 5.0p per ordinary share, amounting to £149m, which, together with the interim dividend, amounts to a total annual dividend of 8.0p per ordinary share (1998 6.5p), at a total cost of £202m (1998 £114m). After deducting £21m, which represents the total for the preference share dividend, the total retained profit for the year is £101m (1998 £557m).

Charitable donations

During 1999 the amount donated for charitable purposes in the UK was £1,150,969 (1998 £1,113,000).

It is the company's policy not to make contributions for political purposes.

Directors

The names of the current directors are listed on page 26.

Richard Laphorne retired as a director and Vice-Chairman of the company on 30 September 1999.

Peter Gershon, Michael Lester and Sir Charles Masefield were all appointed directors of the company on 29 November 1999, following the completion of the merger with the MES business. Dr Ulrich Cartellieri was appointed a director of the company on 1 December 1999.

On 11 February 2000 the company announced that Peter Gershon would be retiring from the Board on 31 March 2000 to take up a Government appointment. Steve Mogford will join the Board on 1 April 2000.

In accordance with Article 85 of the company's Articles of Association Sir Richard Evans, Sir Ronald Hampel and Mike Turner will retire by rotation at the Annual General Meeting, and all being eligible, will offer themselves for re-election. In accordance with Article 91, Dr Ulrich Cartellieri, Michael Lester, Sir Charles Masefield and Steve Mogford will offer themselves for election.

Details of unexpired periods of service contracts for the above mentioned directors are shown in the Remuneration report on page 36.

Beneficial and non-beneficial interests, including family interests, in the share capital of the company, for those persons who were directors at the end of the financial year are detailed on page 36. There have been no changes in the beneficial or non-beneficial interests in the share capital of the company in the period from the year end to 2 March 2000. The Board is not aware of any contract of significance (other than service contracts or as disclosed in the Remuneration report or in note 5 to the accounts) in relation to the company or its subsidiaries in which any director has, or has had, any material interest. During the year

the company has purchased for a number of directors and officers of group companies insurance against certain liabilities in relation to the group.

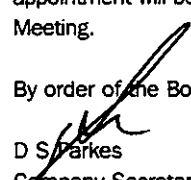
Annual General Meeting

At the forthcoming Annual General Meeting resolutions will be proposed to change the name of the company to BAE SYSTEMS plc, to authorise the company to purchase its own shares, to amend provisions in the Articles of Association concerning the retirement by rotation of directors and to renew the directors' authorities to allot shares. Details of these resolutions appear in the Notice of the Annual General Meeting.

Auditors

KPMG Audit Plc, the auditors for the company, have indicated their willingness to continue in office and a resolution proposing their re-appointment will be put to the Annual General Meeting.

By order of the Board


D S Parkes
Company Secretary
2 March 2000

Corporate governance

Over the last few years a number of guidelines and codes have been published making recommendations on the standards of corporate governance that are believed to be best practice for UK companies. This culminated with the publication of the Combined Code which provides principles of good governance and a code of best practice.

This statement on corporate governance, together with the Remuneration report, describes the way in which the principles and practices detailed in the Combined Code are applied within the company.

The Board

A board of directors with a wide range of experience and competencies heads the company. There are presently seven executive and five non-executive directors. The Board considers all of the non-executive directors to be independent as they are independent of the company's executive management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Sir Robin Biggam has been nominated as the senior independent director.

The Board is scheduled to meet six times each year with additional meetings called as required (eight meetings were held in 1999). All directors receive regular information on the company's operational and financial performance and the Board as a whole reviews regularly the group's business plan, future strategy, engineering and technology, management resources and risk management. The Board has agreed a schedule of matters that are reserved to it for decision.

The directors have adopted a number of policies and procedures to help them operate effectively. These cover, amongst other things, access to independent professional advice, training, the provision of information and the role of the Company Secretary.

Separate individuals have been appointed to the positions of Chairman and Chief Executive Officer; this ensures that there is a clear division of responsibilities between the two positions. The Chairman is responsible for the effective working of the Board and ensuring that all directors are properly informed of matters affecting the company. The Chief Executive Officer is responsible for all operational matters.

Directors are initially appointed by the Board. Following such appointment, the director is required to retire and seek re-election at the next Annual General Meeting. All directors, with the exception of the UK Government appointed director, retire by rotation such that approximately one-third of the Board seeks reappointment each year. Under the company's Articles of Association the UK Government has the right to appoint one director, presently Keith Brown, who is specifically excluded from the re-election provisions of the Articles. These provisions can only be changed with the authority of the UK Government.

Board committees

The Board has two committees:

Audit Committee

The Audit Committee meets twice a year and its terms of reference cover reviewing the findings of the audit work undertaken by the company's auditors and the internal audit function, review of the company's accounts prior to submission to the Board and considering the appointment of the auditors and the payment of their fees. Executive directors are invited to attend meetings of the Audit Committee, however for part of every meeting the committee also meets with the auditors without executive directors being present.

Nominations and Compensation Committee

The Nominations and Compensation Committee is responsible for all matters relating to the engagement and remuneration of executive directors (see 'Remuneration report'). It is also responsible for nominating, for the Board's consideration, suitable individuals for appointment to the Board.

Relations with shareholders

BAE SYSTEMS has a comprehensive investor relations programme through which the company maintains a regular dialogue with major shareholders. The Chief Executive Officer and Group Finance Director lead the programme, although the Chairman of the Nominations and Compensation Committee deals with major shareholders when there is a need for a dialogue on matters concerning the remuneration of the executive directors.

The Chief Executive Officer reports to shareholders at the company's Annual General Meeting on the performance of the company and the Board is present to answer questions asked by shareholders.

Compliance with the Combined Code

The company complied with the provisions of the Combined Code at the year end except that, as reported above, the director appointed by the UK Government is not required to submit himself for re-election.

In order to achieve compliance in respect of directors' service contract notice periods, changes were effected during the year as set out in the Remuneration report on page 36.

Basis of preparation of the accounts

After making enquiries, the directors have a reasonable expectation that the group has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.

Corporate governance

Management of business risk

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 responsibility for controlling risk rests with management, which is supported by the group risk and internal audit functions. These controls enable the group to operate a policy of partial self-insurance.

Internal control

The overall responsibility for the systems of internal control within BAE SYSTEMS rests with the directors of the company. The responsibility for establishing and operating detailed control procedures lies with the Managing Director of each operating business.

Having reviewed the issues arising from the integration of the BAe and MES businesses, together with the principles and practices detailed in the Combined Code, the directors have developed a new 'Operational Framework' which sets out the modus operandi for the enlarged group. This Framework is currently being implemented. Performance against the requirements of the Operational Framework will be closely monitored during the coming year as part of the implementation process.

The Operational Framework sets out the group's new organisational structure, together with the attendant delegated authorities. It sets out management's responsibility in identifying, evaluating and managing risk, with clear procedures for the regular reporting of operational risk and performance (including financial) throughout the year. Reporting is structured to ensure that key issues are escalated through local management to the Senior Management Team and ultimately to the Board as appropriate. It establishes a common framework across the company for operational and financial controls, as well as setting out key principles in terms of behaviour and ethics.

The company has taken the opportunity in producing the Operational Framework to draw upon best practice from within the two former businesses and roll out such processes across the new organisation. Lifecycle Management (LCM) is, as highlighted on page 9 of the Operating and Financial Review, a key project management process that has been successfully developed within the business. Through the Operational Framework LCM will now be rolled out across the group during 2000.

As in the past, the internal audit team will independently review the risk identification procedures and control processes implemented by management and it provides a degree of assurance as to the operation and validity of the systems of internal control through a programme of cyclical reviews. The Audit Committee, to which it reports on a regular basis, monitors its performance.

The Audit Committee reviews the corporate governance assurance procedures, together with the strategy of both the internal and external auditors, assessing their findings and monitoring actions taken. The Audit Committee is also required to review this statement on internal controls.

As the Operational Framework is not yet in place, the directors have taken advantage of The London Stock Exchange's transitional rules and have, as in previous years, completed a formal review only of the effectiveness of BAE SYSTEMS internal financial controls.

In order to assist the Board in this review a formal self assessment by the Managing Directors of each operating business has been undertaken to confirm compliance against the internal financial control policies and procedures of the respective BAe and MES businesses. Such policies and procedures which, in line with any system of internal control, provide only reasonable and not

absolute assurance against material misstatement or loss, support the company's commitment to competency, integrity and ethical values.

The responsibility for internal control procedures within joint ventures and other collaborations rests, on the whole, with the senior management of those operations. BAE SYSTEMS normally monitors its investments and exerts influence through Board representation.

Statement of Directors' responsibilities

Company law requires the directors to prepare accounts for each financial year that give a true and fair view of the state of affairs of the company and the group and of the profit or loss for that period. In preparing those accounts, the directors are required to:

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

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the accounts comply with the Companies Act 1985. They have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

Remuneration report

The Board of directors has delegated to the Nominations and Compensation Committee (the Committee) responsibility for remuneration policy and specific packages for individual executive directors and other senior management of the company. All members of the Committee are non-executive directors and it is chaired by Sir Robin Biggam; the Chairman and the Chief Executive Officer attend committee meetings except where their individual positions and remuneration are discussed.

The Committee also has responsibility for nominations; when acting in this role the Chairman is also a member of the Committee.

Remuneration policy

After the announcement of the proposed merger, the Committee reviewed its policy on directors' and senior management remuneration. Following this review the Committee agreed that it should retain a policy of setting basic salaries at median competitive levels and to reward upper quartile performance with potential upper quartile remuneration. Also the Committee agreed the need to structure remuneration packages to both incentivise and reward executives whilst maintaining a balance between long and short-term performance. However, as a result of the exceptional circumstances of the merger, including the appointment of three former directors of GEC, it was agreed that basic salaries for a number of executive directors should be set outside the agreed policy but that over time the Committee would seek to ensure that all basic salaries did fall back in-line with the policy.

It has been agreed that with prior agreement executive directors should continue to be allowed to hold external non-BAE SYSTEMS related non-executive directorships and the director may retain any fees received for such appointments.

The Committee recognised that former GEC directors transferring to the merged company would initially have no share options as the company was unable to convert former GEC options into options over shares in the newly merged company. To provide a long-term incentive, options over shares were granted to the three transferring executive directors at the date of appointment. The number of options granted was calculated using the option price of £4.21 together with two times basic salary. These options were granted under the Executive Share Option Scheme and may be exercised between the third and tenth anniversaries of the date of grant, conditional upon the growth in the company's pre-exceptional earnings per share for any three year period exceeding the sum of the increase in the RPI for the period and a real growth requirement of 9%.

An additional scheme, the Share Investment Plan (1999) was put into place for Mr Gershon as disclosed in the Listing Particulars sent to shareholders in October last year. When Mr Gershon leaves the company on 31 March 2000 his interest in this scheme will lapse together with his Executive Share Options.

The Committee has taken the view that the merger also provides the former BAE executive directors with an exceptional challenge in integrating the new company and delivering on-going operational cost savings. As a result, these directors, with the exception of the Chairman, have been given an exceptional grant of options over shares under the Executive Share Option Scheme. The number of options granted was calculated using the option price of £4.21 together with two times basic salary. These options are exercisable between the third and tenth anniversaries of the date of grant conditional upon the achievement of merger cost savings as validated by the company's auditors. If annual cost savings exceed £400m by 31 December 2002 the options

Directors' remuneration

| | Executive directors | | | | | | | | Non-executive directors | | | | |
|-------------------------------|---------------------|---------------|---------------|------------|-------------------------|------------|------------|------------|-------------------------|-----------|---------------------|-------------------|--------------|
| | Sir Richard Evans | P O Gershon** | R D Laphorne* | M Lester** | Sir Charles Masefield** | G W Rose | M J Turner | J P Weston | Sir Robin Biggam | K C Brown | Dr U Cartellieri*** | Sir Ronald Hampel | Lord Hesketh |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| 1999 | | | | | | | | | | | | | |
| Basic salary | 520 | 37 | 243 | 39 | 35 | 301 | 302 | 429 | — | — | — | — | — |
| Fees | — | — | — | — | — | — | — | — | 35 | 35 | 2 | 30 | 30 |
| Benefits | 10 | 1 | 11 | 1 | 1 | 17 | 17 | 19 | — | — | — | — | — |
| Bonus | 175 | — | — | — | — | 122 | 130 | 146 | — | — | — | — | — |
| Total | 705 | 38 | 254 | 40 | 36 | 440 | 449 | 594 | 35 | 35 | 2 | 30 | 30 |
| Company pension contributions | 65 | 2 | 30 | 2 | 3 | 11 | 37 | 53 | — | — | — | — | — |
| 1998 | | | | | | | | | | | | | |
| Basic salary | 501 | n/a | 293 | n/a | n/a | 196 | 285 | 346 | — | — | n/a | — | — |
| Fees | — | n/a | — | n/a | n/a | — | — | — | 35 | 33 | n/a | 27 | 28 |
| Benefits | 9 | n/a | 13 | n/a | n/a | 11 | 12 | 14 | — | — | n/a | — | — |
| Bonus | 175 | n/a | 99 | n/a | n/a | 91 | 100 | 131 | — | — | n/a | — | — |
| Total | 685 | n/a | 405 | n/a | n/a | 298 | 397 | 491 | 35 | 33 | n/a | 27 | 28 |
| Company pension contributions | 62 | n/a | 10 | n/a | n/a | 8 | 35 | 43 | — | — | n/a | — | — |

* Retired 30 September 1999

** Appointed 29 November 1999

*** Appointed 1 December 1999

The emoluments of the directors and the Chairman during the year are shown above.

The remuneration of the highest paid director, Sir Richard Evans, including company pension contributions, was £769,526 (1998 £747,371 (£1,406,628 including gains on option exercises)).

The main benefits received by the directors consist of company cars, petrol and private medical insurance.

Mr Bauman who retired in 1998 received total emoluments of £16,666 in that year (1999 nil).

Former directors - a payment of £528,658 was paid to Mr R L Kirk in 1999 in respect of share options. Mr S Gillibrand undertook consultancy work for the company for which he received £21,789 of which £12,284 was remuneration (1998 £122,961 of which £78,252 was remuneration).

will be exercisable in full. If the savings are between £275m and £400m, the options will be exercisable on a sliding scale between zero and 100%.

The Board believes that the company's remuneration policy is compliant with the Combined Code which has sought to establish best practice in this area for UK companies. The Committee will continue to consult with principal shareholders when it is considering changes to the structure of the company's executive director remuneration policy.

Remuneration

Remuneration for executive directors typically consists of basic salary, a bonus based on annual performance, executive share options, participation in the long term incentive plan and retirement benefits. The following provides more detail of these elements.

Basic salary and benefits

Executive directors' salaries are reviewed each year by the Committee and adjusted to

reflect performance and the competitiveness of salaries relative to the market. Information on the market for comparable management positions is obtained from independent sources and is provided to the Committee so that it can form a view as to where to position basic salaries and benefits relative to comparable companies. All reviews of salaries and benefits for executive directors are made having taken full account of the performance of the company as a whole and the pay and conditions of group employees in particular. It is the company's stated aim to create an environment with fair reward policies, which recognise and reward individual performance against business objectives; this applies equally to all employees.

The Committee has reviewed regularly the split between basic salary and performance related elements of remuneration in order properly to incentivise executive directors and believes that a significant proportion of remuneration should be based on schemes that encourage them to perform at the highest level. In addition, through the use of

share based incentive schemes, it seeks to align the interests of executive directors with those of other shareholders.

Bonus Scheme

The executive directors and other senior executives participate in a Bonus Scheme that rewards those individuals if targets agreed by the Committee for Earnings Per Share and cash performance are met.

In 1999 the Bonus Scheme was structured such that the bonus payable was equal to 10% of basic salary for the achievement of budgeted Earnings Per Share targets and 20% for the achievement of more stretching Earnings Per Share targets. Likewise a bonus of 10% was payable for achievement of budgeted cash levels and 20% for achieving a more stretching target. A maximum of 10% of basic salary was payable on performance against non-financial measures. Pro rata payments were payable for achievements between these targets.

As was the case in previous years, individuals who participated in the Bonus Scheme were

Restricted Share Plan

| | Shares purchased and held in trust during the year | | Additional shares purchased during the year to be available after three years | |
|-------------------|--|--------|---|-------|
| | 1999 | 1998 | 1999 | 1998 |
| Sir Richard Evans | 26,044 | — | 21,768 | — |
| G W Rose | 13,524 | — | 11,304 | — |
| M J Turner | 14,860 | 3,020 | 12,421 | 1,008 |
| J P Weston | 19,506 | 13,300 | 16,304 | 4,444 |

given the option of taking the bonus partly or wholly in shares through the Restricted Share Plan. If an election is made to take shares through the plan, they are to be held in trust for a period of three years after which the company will give the individual additional shares to the value of 50% of the gross value of the bonus payment dedicated to the plan.

The above table details shares held on behalf of executive directors following elections using bonus payments made in 1999.

The Committee has retained the right to vary the bonus should there be exceptional events that affect the bonus targets. Non-executive directors do not participate in the bonus scheme.

Long Term Incentive Schemes

Through the Performance Share Plan, conditional awards of shares are made to executive directors. The maximum value of such awards in any one year is equal to the basic salary paid to a director, who at the end of the performance period receives a proportion of the award conditional on the performance of the company. Performance is measured relative to the other constituent members of the FTSE 100 over a three year period as follows:

- **Total Shareholder Return (TSR)**

This is the principal measure and, against a sliding scale, 100% of the conditional shares are awarded to directors if the company's TSR is in the top 20% of TSRs achieved by FTSE 100 companies, with 10% vesting if the TSR is in the top 50%. Intermediate positions will be calculated on a straight line pro rata basis. No awards will be made if the company's TSR performance is outside the top 50%. Awards will be made in three equal installments at the end of years three, four and five; and

- **Earnings Per Share (EPS)**

EPS is used as a second measure and requires the average value of EPS

excluding exceptional items over the performance period to be no less than the average value for the three years prior to the performance period.

Both sets of performance criteria must be met in order for an award to be made under the Schemes.

Both of the above measures may be adjusted for exceptional items as appropriate at the discretion of the Committee.

Details of the Performance Share Plan options exercised by executive directors during 1999 are shown on page 35.

Prior to the introduction of the Performance Share Plan, executive directors were regularly granted share options through the Executive Share Option Scheme. Directors were granted options to the value of four times the level of their basic salary in any ten year period.

Executive share options granted in 1994 and 1995 can only be exercised if growth in the pre-exceptional EPS for any three year period exceeds the sum of the increase in RPI for that period and a real growth requirement of 7.5%. Options cannot be exercised within three years of the date of grant.

Details of directors' interests in the Executive and SAYE Share Option Schemes and options and conditional awards made under the Performance Share Plan are shown on page 35.

The Committee is of the opinion that to give a full statement of directors' share options would result in a statement of excessive length. It has therefore adopted the alternative recommendation proposed by paragraph A3 of the Urgent Issues Task Force Abstract 10.

The profit before dealing costs inherent in unexercised options capable of being exercised at a surplus and granted under the

Executive Share Option Scheme, SAYE Share Option Scheme and the Performance Share Plan at 31 December 1999 is shown below:

Profit on unexercised options

| | 1999 £'000 | 1998 £'000 |
|-------------------|---------------|---------------|
| Sir Richard Evans | 1,864 | 1,837 |
| G W Rose | 1,040 | 1,185 |
| M J Turner | 1,345 | 1,588 |
| J P Weston | 4,031 | 4,921 |

At 31 December 1999 directors held the following options at prices greater than the market value of the shares.

| | Option Price | No. of options |
|-----------------------|--------------|----------------|
| P O Gershon | 4.21 | 212,921 |
| M Lester | 4.21 | 223,800 |
| Sir Charles Masefield | 4.21 | 198,099 |
| G W Rose | 4.21 | 199,524 |
| M J Turner | 4.21 | 212,921 |
| J P Weston | 4.21 | 237,529 |

The figures have been calculated by reference to a mid-market price for the company's ordinary shares at 30 December 1999 of 410p (1998 509.5p). The range during 1999 was 519p to 343p.

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 100% of basic salary. As a minimum standard this must be achieved as quickly as possible from shares vested from the annual bonus, exercised through the Executive Share Option Scheme or Performance Share Plan, by using 50% of the shares that vest or 50% of the options which are exercised on each occasion. Thereafter, executive directors will be expected to increase their personal shareholding gradually, on each occasion using 25% of the shares that vest or 25%

Directors' share options

| | 1 January 1999** | Granted during the year | Exercised during the year | Lapsed during the year | 31 December 1999 | Weighted average exercise price £ | Range of exercise prices £ | Market price on day of exercise £ | Date from which exercisable | Expiry date |
|--------------------------------------|---------------------|-------------------------------|---------------------------------|------------------------------|---------------------|---|----------------------------------|--|-----------------------------------|-------------|
| Executive Share Option Scheme | | | | | | | | | | |
| Sir Richard Evans | 58,060 | — | — | — | 58,060 | 1.86 | 1.86 | — | 05.10.98 | 06.10.05 |
| P O Gershon** | — | 212,921 | — | — | 212,921 | 4.21 | 4.21 | — | 20.12.02 | 21.12.09 |
| R D Laphome | 247,616 | — | — | — | 247,616 | 1.86 | 1.86 | — | 05.10.98 | 01.10.00 |
| M Lester** | — | 223,800 | — | — | 223,800 | 4.21 | 4.21 | — | 20.12.02 | 21.12.09 |
| Sir Charles Masefield** | — | 198,099 | — | — | 198,099 | 4.21 | 4.21 | — | 20.12.02 | 21.12.09 |
| G W Rose | 236,093 | 199,524 | — | — | 435,617 | 3.05 | 1.22 - 4.21 | — | 16.03.98 | 21.12.09 |
| M J Turner | 184,996 | 212,921 | — | — | 397,917 | 3.12 | 1.86 - 4.21 | — | 05.10.98 | 21.12.09 |
| J P Weston | 1,004,316 | 237,529 | — | 14,100 | 1,227,745 | 1.76 | 0.76 - 4.21 | — | 10.04.93 | 21.12.09 |
| SAYE Share Option Scheme | | | | | | | | | | |
| Sir Richard Evans | 9,504 | — | — | — | 9,504 | 1.81 | 0.89 - 2.70 | — | 01.01.00 | 01.01.03 |
| G W Rose | 8,108 | — | — | — | 8,108 | 1.73 | 0.89 - 2.70 | — | 01.01.00 | 01.12.00 |
| M J Turner | 9,127 | — | — | — | 9,127 | 1.88 | 0.89 - 2.90 | — | 01.01.00 | 01.07.04 |
| J P Weston | 7,928 | — | — | — | 7,928 | 1.75 | 0.89 - 2.90 | — | 01.01.00 | 01.07.04 |
| Performance Share Plan | | | | | | | | | | |
| Sir Richard Evans | 317,516 | 100,194 | — | — | 417,710 | — | — | — | 02.05.99 | 02.03.06 |
| R D Laphome | 225,932 | 56,631 | 91,760 | *78,708 | 112,095 | — | — | 3.55 | 02.05.99 | 01.07.02 |
| G W Rose | 87,000 | 57,281 | 12,113 | — | 132,168 | — | — | 4.75 | 02.05.99 | 02.03.06 |
| M J Turner | 188,484 | 57,281 | 23,520 | — | 222,245 | — | — | 4.75 | 02.05.99 | 02.03.06 |
| J P Weston | 188,484 | 82,524 | — | — | 271,008 | — | — | — | 02.05.99 | 02.03.06 |

*Forfeited on retirement from the company

**at date of appointment

Option prices are set at the average of the middle market quotes for the three days preceding the date of their grant and, where they have been subject to adjustment, are shown rounded to the nearest penny.

Options exercised

| | Date of exercise | Number of options exercised | Number of shares sold following exercise | Realised gain on shares sold £* | Unrealised gain on retained shares £ |
|-------------------------------|---------------------|-----------------------------------|---|---|--|
| Performance Share Plan | | | | | |
| G W Rose | 02.05.99 | 12,113 | — | — | 57,537 |
| M J Turner | 02.05.99 | 23,520 | 23,520 | 111,720 | — |

*Shares were sold immediately on exercise of options. Gain before dealing costs.

On 2 November 1999, after he had retired as a director of the company, Mr Laphome exercised 91,760 options held in the Performance Share Plan realising a gain of £325,748 before dealing costs.

of the options exercised each year, until a personal shareholding equal to 200% of annual salary is achieved and maintained. These limits are reviewed periodically.

Post retirement benefits

The executive directors are members of group pension schemes and have a normal retirement age of 60, with the exception of Mr Lester and Sir Charles Masefield who have a normal retirement age of 62.

Of the executive directors, Mr Rose and Mr Gershon are affected by the Inland

Revenue earnings cap on approved pensions and have unapproved pensions to top up their benefits from the approved schemes.

Both Mr Gershon's and Mr Rose's unapproved arrangements are partly funded and partly unfunded. The company's pension contribution to the funded unapproved arrangements for Mr Rose in 1999 were £217,001. No payments were made in respect of Mr Gershon. The accrued benefits shown on page 36 include the benefits from the approved and unapproved arrangements.

Mr Laphome retired during the year. Under the terms of his contract no early retirement penalty was applied. He was affected by the Inland Revenue earnings cap and has unapproved pension arrangements to top up his benefits from the approved scheme. His unapproved arrangements were unfunded and the benefits since retirement will be paid by the company with £19,463 paid in 1999.

Details of pensions earned by the directors are shown on page 36.

Directors' Interests

| | At 1 January 1999* | | | | | | At 31 December 1999 | | | | | |
|------------------------|--------------------|---------------|-------------------------|----------|---|-------------------------------|---------------------|---------------|-------------------------|----------|---|-------------------------------|
| | Shares | Share Options | Restricted Share Plan** | Warrants | Conditional Awards of shares under the Performance Share Plan | Capital Amortising Loan Stock | Shares | Share Options | Restricted Share Plan** | Warrants | Conditional Awards of shares under the Performance Share Plan | Capital Amortising Loan Stock |
| Sir Robin Biggam | 888 | — | — | — | — | — | 888 | — | — | — | — | — |
| K C Brown | 8,884 | — | — | 88 | — | — | 8,884 | — | — | 88 | — | — |
| Dr U Cartellieri* | — | — | — | — | — | — | — | — | — | — | — | — |
| Sir Richard Evans | 212,914 | 67,564 | 9,220 | 1,503 | 317,516 | — | 246,521 | 67,564 | 26,884 | 1,503 | 417,710 | — |
| P O Gershon*† | 347,079 | — | — | 13 | — | 109,620 | 497,079 | 212,921 | — | 13 | — | 109,620 |
| Sir Ronald Hampel | 3,108 | — | — | 31 | — | — | 3,108 | — | — | 31 | — | — |
| Lord Hesketh | 6,000 | — | — | — | — | — | 6,000 | — | — | — | — | — |
| M Lester* | 456,428 | — | — | — | — | 144,157 | 456,428 | 223,800 | — | — | — | 144,157 |
| Sir Charles Masefield* | 22,402 | — | — | — | — | 1,354 | 22,537 | 198,099 | — | — | — | 1,354 |
| G W Rose | 70,485 | 244,201 | — | — | 87,000 | — | 96,499 | 443,725 | 11,304 | — | 132,168 | — |
| M J Turner | 150,061 | 194,123 | 2,616 | — | 188,484 | — | 167,502 | 407,044 | 15,037 | — | 222,245 | — |
| J P Weston | 74,412 | 1,012,244 | 18,476 | 170 | 188,484 | — | 128,843 | 1,235,673 | 26,376 | 170 | 271,008 | — |

* At date of appointment

** Matching shares only

† Mr Gershon also has a potential beneficial interest in 308,847 shares under the Share Investment Plan 1999

Mr Gershon and Mr Lester have contingent interests over a maximum of 2,532 ordinary shares and 799 CALS and 2,550 ordinary shares and 805 CALS respectively. These are held in a trust established for participants in the GEC Savings-Related Share Option Scheme.

Post Retirement Benefits

| | Age | Directors' contributions in the year £ | Amount of additional pension accrued in 1999 payable at normal retirement age £ | Accrued pension payable at normal retirement age £ |
|-----------------------|-----|--|---|--|
| Sir Richard Evans | 57 | 25,904 | 20,966 | 321,550 |
| P O Gershon | 53 | 1,170 | 1,658 | 170,412 |
| R D Lapthorne | 56 | *7,257 | 33,601 | **99,033 |
| M Lester | 59 | 1,198 | 2,009 | 267,908 |
| Sir Charles Masefield | 60 | 1,845 | 14,837 | 190,888 |
| G W Rose | 47 | 4,493 | 23,366 | 79,798 |
| M J Turner | 51 | 14,995 | 15,629 | 170,776 |
| J P Weston | 48 | 21,335 | 43,728 | 195,575 |

* For the period to retirement for Mr Lapthorne

** At date of retirement for Mr Lapthorne

- The amount of additional pension in 1999 excludes any increase for inflation.
- On death before retirement, a lump sum is payable equal to 4 times basic salary plus the director's own contributions. A survivor's pension (if applicable) would also be payable equal to two thirds of the pension that the director would have accrued had he stayed in service until normal retirement age. If the director has an eligible child or children, a further pension would be payable.
- On death after retirement, the pension benefits are paid in the same proportions as described above, based on the pension payable at the date of death. A lump sum will be paid if the director dies within 5 years of retirement equal to the pension payments that would have been made during the remainder of the 5 year period if the director had not died.
- The executive directors do not have a right to an early retirement pension.
- Pensions in payment increase by the lower of 5% per annum and the change in the RPI.
- There are no discretionary benefits.

Service contracts

All the executive directors with the exception of Mr Gershon have contracts requiring both the company and the individual to give not less than 12 months' notice of termination. Mr Gershon has a contract that initially requires either party to give a minimum of 24 months' notice of termination, this would have reduced to 12 months with effect from the beginning of next year if he had remained a director of the company.

It is the Board's policy that non-executive directors do not have service contracts. They are proposed by the Committee and appointed by the Board on the basis of their experience to provide independent judgement on issues of strategy, performance, resources and standards of conduct. Fees payable to non-executive directors are recommended to the Board by the Committee chairman after discussion with the executive directors. The level of

non-executive director's fees is set after reviewing practice in other comparable companies.

As at 31 December 1999 the directors of the company and their families had the beneficial interests in the company's securities as shown above.

There have been no changes in the interests of the directors between 31 December 1999 and 2 March 2000.

By order of the Board

Sir Richard Evans
Chairman
2 March 2000

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Report of the auditors on the accounts



Auditors' report to the members of British Aerospace plc

We have audited the accounts on pages 39 to 68.

Respective responsibilities of directors and auditors

The directors are responsible for preparing the Annual Report. As described on page 32 this includes responsibility for preparing the accounts in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of The London Stock Exchange, and by our profession's ethical guidance.

We report to you our opinion as to whether the accounts give a true and fair view and are properly prepared in accordance with the Companies Act. We also report to you if, in our opinion, the directors' report is not consistent with the accounts, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law or the Listing Rules regarding directors' remuneration and transactions with the group is not disclosed.

We review whether the statement on pages 30 and 31 reflects the company's compliance with the seven provisions of the Combined Code specified for our review by the Stock Exchange, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report, including the corporate governance statement, and consider whether it is consistent with the audited accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the accounts.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting

policies are appropriate to the group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts.

Opinion

In our opinion the accounts give a true and fair view of the state of affairs of the company and the group as at 31 December 1999 and of the profit of the group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

CPAG Audit Plc
KPMG Audit Plc

Chartered Accountants
Registered Auditor

London

2 March 2000

Consolidated profit and loss account

for the year ended 31 December

| | Notes | Continuing operations | | Total 1999 £m | Total 1998 £m |
|--|-------|-----------------------|----------------------------|---------------------|---------------------|
| | | Ongoing 1999 £m | Acquisitions 1999 £m | | |
| Sales | 2 | 8,474 | 455 | 8,929 | 8,611 |
| Less: adjustment for share of joint venture sales | 2 | (1,761) | (125) | (1,886) | (1,569) |
| Turnover | 2 | 6,713 | 330 | 7,043 | 7,042 |
| Operating costs | 3 | | | | |
| Excluding goodwill amortisation and exceptional items | | (5,950) | (324) | (6,274) | (6,376) |
| Goodwill amortisation | | (17) | (26) | (43) | (12) |
| Exceptional items | 6 | (210) | — | (210) | (51) |
| | | (6,177) | (350) | (6,527) | (6,439) |
| Operating profit/(loss) | | 536 | (20) | 516 | 603 |
| Share of operating (loss)/profit of joint ventures | 2 | | | | |
| Share of operating (loss)/profit before goodwill amortisation | | (28) | 22 | (6) | (28) |
| Goodwill amortisation | | (18) | (2) | (20) | (11) |
| | | (46) | 20 | (26) | (39) |
| Non-operating exceptional items | 6 | | | | |
| Loss on sale and closure of operations | | — | — | — | (22) |
| Profit on disposal of fixed asset investments | | — | — | — | 401 |
| | | — | — | — | 379 |
| Profit before interest | 2 | | | | |
| Excluding goodwill amortisation and exceptional items | | 735 | 28 | 763 | 638 |
| Goodwill amortisation and exceptional items | | (245) | (28) | (273) | 305 |
| | | 490 | — | 490 | 943 |
| Interest | 4 | | | | |
| Net interest arising on activities excluding exceptional items | | 15 | (12) | 3 | 45 |
| Share of net interest of joint ventures | | 23 | 1 | 24 | 25 |
| Exceptional interest charges | 6 | (58) | — | (58) | (40) |
| | | (20) | (11) | (31) | 30 |
| Profit/(loss) before tax on ordinary activities | 2 | | | | |
| Excluding goodwill amortisation and exceptional items | | 773 | 17 | 790 | 708 |
| Goodwill amortisation and exceptional items | | (303) | (28) | (331) | 265 |
| | | 470 | (11) | 459 | 973 |
| Tax | 7 | | | | |
| Tax on profit excluding exceptional items | | | | (188) | (172) |
| Tax on exceptional items | | | | 57 | (108) |
| | | | | (131) | (280) |
| Profit after tax on ordinary activities | | | | 328 | 693 |
| Equity minority interests | 26 | | | (4) | (1) |
| Profit for the financial year | | | | 324 | 692 |
| Dividends | 8 | | | | |
| Equity: ordinary shares | | | | (202) | (114) |
| Non-equity: preference shares | | | | (21) | (21) |
| | | | | (223) | (135) |
| Retained profit | 24 | | | 101 | 557 |
| Basic earnings per share | 9 | | | | |
| Including goodwill amortisation and exceptional items | | | | 16.2p | 38.4p |
| Excluding goodwill amortisation and exceptional items | | | | 30.8p | 29.4p |
| Diluted earnings per share | 9 | | | | |
| Including goodwill amortisation and exceptional items | | | | 15.6p | 35.1p |
| Excluding goodwill amortisation and exceptional items | | | | 28.8p | 27.1p |

Balance sheets

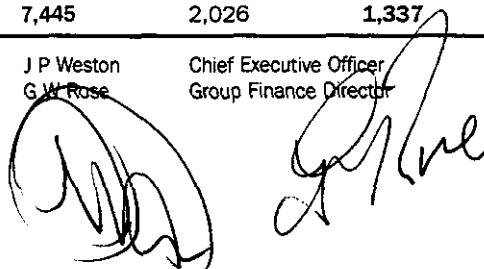
as at 31 December

| | Notes | Group | | Company | |
|---|---------|------------|------------|------------|------------|
| | | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Fixed assets | | | | | |
| Intangible assets | 10 | 6,365 | 322 | — | — |
| Tangible assets | 11 | 2,167 | 1,604 | 35 | 37 |
| Investments | 12 | | | | |
| Share of gross assets of joint ventures | | 5,208 | 3,384 | | |
| Share of gross liabilities of joint ventures | | (4,573) | (2,927) | | |
| Share of joint ventures | | 635 | 457 | | |
| Others | | 25 | 139 | 3,575 | 2,171 |
| | | 660 | 596 | | |
| | | 9,192 | 2,522 | 3,610 | 2,208 |
| Current assets | | | | | |
| Stocks | 13 | 1,559 | 1,442 | 8 | 14 |
| Debtors due within one year | 14 | 3,647 | 3,201 | 4,636 | 2,077 |
| Debtors due after one year | 14 | 512 | 511 | 189 | 213 |
| Investments | 15 & 28 | 1,713 | 1,066 | 1,084 | 635 |
| Cash at bank and in hand | 28 | 811 | 308 | 355 | 8 |
| | | 8,242 | 6,528 | 6,272 | 2,947 |
| Current liabilities | | | | | |
| Loans and overdrafts | 16 & 28 | (2,025) | (264) | (886) | (123) |
| Creditors | 18 | (4,871) | (4,069) | (7,083) | (3,377) |
| | | (6,896) | (4,333) | (7,969) | (3,500) |
| Net current assets/(liabilities) | | 1,346 | 2,195 | (1,697) | (553) |
| Total assets less current liabilities | | 10,538 | 4,717 | 1,913 | 1,655 |
| Liabilities falling due after one year | | | | | |
| Loans | 16 & 28 | (1,155) | (898) | (536) | (250) |
| Creditors | 18 | (542) | (701) | (2) | (1) |
| | | (1,697) | (1,599) | (538) | (251) |
| Provisions for liabilities and charges | 19 | (1,396) | (1,092) | (38) | — |
| | 2 | 7,445 | 2,026 | 1,337 | 1,404 |
| Capital and reserves | | | | | |
| Called up share capital | 23 | 140 | 111 | 140 | 111 |
| Shares to be issued | 24 | 255 | — | 2 | — |
| Share premium account | 24 | 212 | 110 | 212 | 110 |
| Statutory reserve | 25 | 202 | 202 | 202 | 202 |
| Other reserves | 24 | 5,212 | 324 | 216 | 216 |
| Profit and loss account | 24 | 1,339 | 1,273 | 565 | 765 |
| Shareholders' funds | | | | | |
| Equity: ordinary shares | | 7,091 | 1,750 | 1,068 | 1,134 |
| Non-equity: preference shares | 23 | 269 | 270 | 269 | 270 |
| | | 7,360 | 2,020 | 1,337 | 1,404 |
| Equity minority interests | 26 | 85 | 6 | — | — |
| | | 7,445 | 2,026 | 1,337 | 1,404 |

Approved by the Board on 2 March 2000 and signed on its behalf by:

J P Weston
G W Rose

Chief Executive Officer
Group Finance Director



Consolidated cash flow

| for the year ended 31 December | Notes | 1999 £m | 1998 £m |
|--|-------|------------|--------------|
| Net cash inflow/(outflow) from operating activities | | | |
| Operating profit | | 516 | 603 |
| Depreciation, amortisation and impairment | | 254 | 150 |
| Profit on disposal of fixed assets | | (4) | (19) |
| Movement in provisions for liabilities and charges <i>excluding deferred tax</i> | | (116) | (93) |
| Decrease/(increase) in working capital: | | | |
| Stocks | | 100 | 62 |
| Debtors | | 122 | (1,647) |
| Creditors | | (409) | 469 |
| Customer stage payments | | (44) | (31) |
| | | 419 | (506) |

Cash flow statement

| | | | |
|---|----|----------------|--------------|
| Net cash inflow/(outflow) from operating activities | | 419 | (506) |
| Dividends from joint ventures | | 30 | 5 |
| Returns on investments and servicing of finance | 29 | (62) | 94 |
| Taxation | 29 | (81) | (136) |
| Capital expenditure and financial investment | 29 | (132) | 419 |
| Acquisitions and disposals | | | |
| Acquisitions - MES | 29 | (1,357) | — |
| Acquisitions - other | | (18) | (612) |
| Disposal of subsidiary undertakings and joint ventures | 12 | 42 | 201 |
| Equity dividends paid | | (100) | (60) |
| Net cash outflow before financing and management of liquid resources | | (1,259) | (595) |
| Management of liquid resources | 29 | 234 | 785 |
| Financing | 29 | 1,686 | (127) |
| Net increase in cash available on demand | | 661 | 63 |

Reconciliation of net cash flow to net movement in net funds

| | | | |
|--|----|----------------|--------------|
| Net increase in cash available on demand | | 661 | 63 |
| Net decrease in liquid resources | | (234) | (785) |
| (Increase)/decrease in other loans included within net funds | | (957) | 145 |
| Change in net funds from cash flows | | (530) | (577) |
| Investments, loans and finance leases assumed on acquisition of MES | | (435) | — |
| Other non cash movements | 28 | 27 | 1 |
| Net decrease in net funds | | (938) | (576) |
| Net funds at 1 January | | 212 | 788 |
| Net (debt)/funds at 31 December | 28 | (726) | 212 |
| Reconciliation to movement in net cash/(debt) as defined by the group | | | |
| Net decrease in net funds | | (938) | (576) |
| (Increase)/decrease in cash on customers' account | | (83) | 11 |
| Net decrease for the year | 28 | (1,021) | (565) |

Other group statements

Statement of total recognised gains and losses

for the year ended 31 December

| | 1999 £m | 1998 £m |
|---|------------|-------------|
| Profit for the financial year | | |
| Group, excluding joint ventures | 339 | 711 |
| Joint ventures | (15) | (19) |
| Total profit for the financial year | 324 | 692 |
| <i>Currency translation on foreign currency net investments, including joint ventures</i> | (9) | (7) |
| <i>Revaluation of current asset investment</i> | 563 | — |
| <i>Revaluation of land and buildings</i> | (10) | — |
| <i>Deferred tax on revalued assets</i> | — | (37) |
| Other recognised gains and losses relating to the year (net) | 544 | (44) |
| Total recognised gains and losses relating to the year | 868 | 648 |
| Prior year adjustment | — | (284) |
| Total recognised gains and losses | 868 | 364 |

Note of historical cost profits and losses

for the year ended 31 December

| | 1999 £m | 1998 £m |
|---|------------|--------------|
| Reported profit before tax on ordinary activities | 459 | 973 |
| Difference between historical cost and revalued amount: | | |
| Depreciation on land and buildings | 2 | 2 |
| Partial sale of investment in Orange plc | — | 403 |
| Historical cost profit before tax on ordinary activities | 461 | 1,378 |
| Historical cost profit for the year retained after tax, minority interests and dividends | 103 | 962 |

Reconciliation of movements in shareholders' funds

for the year ended 31 December

| | 1999 £m | 1998 £m |
|--|--------------|--------------|
| Profit for the financial year | 324 | 692 |
| Dividends | (223) | (135) |
| Other recognised gains and losses relating to the year (net) | 101 | 557 |
| New share capital subscribed | 29 | — |
| Merger reserve arising on the issuance of shares relating to the MES acquisition | 4,336 | — |
| Shares to be issued in relation to the MES acquisition | 255 | — |
| Issuance of shares to the QUEST | 7 | — |
| Exercise of share options, warrants and dividend scrip issue | 68 | 51 |
| Write back of goodwill on disposal of the Arlington Securities business | — | 4 |
| Net increase in shareholders' funds | 5,340 | 568 |
| Opening shareholders' funds | 2,020 | 1,452 |
| Closing shareholders' funds | 7,360 | 2,020 |

Notes to the accounts

1 Accounting policies

Basis of preparation

The accounts are drawn up in accordance with applicable accounting standards under the historical cost convention as modified by the revaluation of certain land and buildings and the treatment adopted in respect of the revaluation of certain current asset investments (note 17). Financial Reporting Standard 16 - Current Taxation has been adopted for the first time in these accounts. Its adoption has had no material impact upon reported results, and comparative figures have not needed restatement in consequence. Financial Reporting Standard 15 - Tangible Fixed Assets has not been adopted in these accounts, but will be adopted in 2000, once a full assessment of its impact on the enlarged group has been completed.

Basis of consolidation

The accounts of the group consolidate the results of the company and its subsidiary undertakings, and include its share of its joint ventures' results on the gross equity method, all of which are made up to 31 December.

The acquisition method of accounting has been adopted. Under this method, the results of businesses acquired or disposed of in the year are included in the consolidated profit and loss account from the date of acquisition, or up to the date of disposal. Goodwill arising on consolidation and on acquisition of joint venture interests is capitalised in respect of all acquisitions from 1 January 1998 and amortised on a straight line basis through the profit and loss account over its estimated useful economic life, based upon assessments of the durability of markets, product ranges and projected future profitability of the businesses concerned. Prior to 1998, goodwill was either capitalised and amortised through the profit and loss account or was written off directly to reserves depending upon the circumstances of each acquisition. To date all goodwill capitalised has been assessed as having a 20 year estimated useful economic life.

Impairment reviews are undertaken at the end of the first full financial year following each acquisition and also if events or changes in circumstance indicate that such a review is necessary.

On the subsequent disposal or termination of a previously acquired business, the profit and loss on disposal or termination is calculated including the gross amount of any related goodwill previously written off directly to reserves or the net amount of goodwill remaining unamortised, as appropriate.

Company accounts

In the company's accounts, all fixed asset investments (including subsidiary undertakings and joint ventures) are stated at cost (or valuation in respect of certain listed investments) less provisions for permanent diminutions. Dividends received and receivable are credited to the company's profit and loss account to the extent that they represent a realised profit for the company. In accordance with Section 230(4) of the Companies Act 1985 the company is exempt from the requirement to present its own profit and loss account. The amount of the profit for the financial year of the company is disclosed in note 24 to these accounts.

Revenue recognition

Sales comprise the net value of deliveries made, work completed or services rendered during the year and include the group's share of sales of joint ventures. Sales are recognised when title passes or a separately identifiable phase of a contract or development has been completed. Turnover represents sales made by the company and its subsidiary undertakings, excluding the group's share of sales of joint ventures.

Profit is recognised at the time of sale. In the case of contracts with extended delivery programmes, it is arrived at by reference to the estimated overall profitability of the contract and appropriate provision is made for any losses in the year in which they are first foreseen.

Foreign currencies

Transactions in overseas currencies are translated at the exchange rate ruling at the date of the transaction or, where forward cover contracts have been arranged, at the contracted rates. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date or at a contracted rate if applicable and any exchange differences arising are taken to the profit and loss account.

For consolidation purposes the assets and liabilities of overseas subsidiary undertakings and joint ventures are translated at the closing exchange rates. Profit and loss accounts of such undertakings are consolidated at the average rates of exchange during the year. Exchange differences arising on these translations are taken to reserves.

Aircraft financing

The group is exposed to actual and contingent liabilities arising from commercial aircraft financing, both from financing arranged directly by the group and from that arranged by third parties where the group has provided guarantees or has other recourse obligations. Provision for these risks is made on a systematic basis, having regard to the ability to re-lease or re-sell the underlying aircraft.

Tangible fixed assets

Depreciation is provided, on a straight line basis, to write off the cost or valuation of tangible fixed assets over their estimated useful economic lives using the following rates:

| | |
|--|--|
| Buildings | — 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 |
| Other equipment | — 10 to 15 years, or the project life if shorter |

No depreciation is provided on freehold land and assets in the course of construction.

Impairment reviews are undertaken if there are indications that the carrying values may not be recoverable.

Leases

Assets obtained under finance leases are included in tangible fixed assets at cost and are depreciated over their useful economic lives, or the term of their lease, whichever is shorter. Future instalments under such leases, net of finance charges, are included within loans. Rental payments are apportioned between the finance element, which is charged as interest to the profit and loss account, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant rate of charge on the outstanding obligation.

Rental payments under operating leases are charged to the profit and loss account on a straight line basis in arriving at operating profit.

Notes to the accounts

1 Accounting policies continued

Assets held for leasing out under operating leases are included in tangible fixed assets at cost less depreciation. Rental income from aircraft operating leases is recognised in sales as the receipts fall due.

Stocks

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

Long term contracts – The amount of profit attributable to the stage of completion of a long term contract is arrived at by reference to the estimated overall profitability of the contract. Appropriate provisions are made for any losses in the year in which they are first foreseen. Work in progress relating to long term contracts is stated at cost less provisions for anticipated losses.

Development properties – The net realisable value is based on advice received from independent valuers and assumes the grant of relevant planning consent but excludes any development profit.

Cash received on customers' account and customer stage payments

Amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery are credited, as progress payments, against any expenditure incurred upon stocks or work in progress for the particular contract. Any unexpended balance is held in creditors as customer stage payments or, if the amounts are subject to advance payment guarantees, as cash received on customers' account.

Financial instruments

The group uses derivative financial instruments to hedge its exposures to fluctuations in interest and foreign exchange rates. Instruments accounted for as hedges are designated as a hedge at the inception of contracts. Receipts and payments on interest rate instruments are recognised on an accruals basis, over the life of the instrument. Gains and losses on foreign currency hedges are recognised on maturity of the underlying transaction, other than translational hedges of foreign currency investments which are taken to reserves. Gains and losses arising from retiming of foreign exchange transactional cover are deferred to match the maturity of the underlying exposure. Gains or losses arising on hedging instruments which are cancelled due to the termination of underlying exposure are taken to the profit and loss account immediately. Finance costs associated with debt issuances are charged to the profit and loss account over the life of the instruments.

Short term debtors and creditors that meet the definition of a financial asset or liability respectively have been excluded from FRS 13 analysis where permitted by that Standard.

Research and development

Group funded revenue expenditure on research and development is written off as incurred and charged to the profit and loss account, except where substantially supported under contract.

Launch costs

The costs of launching an aircraft project fall into two principal categories: design, development and education; and jigs and tools.

Design, development and education – In the case where the project is fully funded by the group, the expenditure is charged to the profit and loss account as incurred. In the case where the project has specific external funding, the relevant expenditure is carried forward within stocks and amortised by reference to an assessment of sales.

Jigs and tools – Expenditure on jigs and tools is capitalised into fixed assets and depreciated over its useful life.

Externally funded launch aid

Externally funded launch aid has been provided to the group for various Airbus projects from both HM Government and certain financial institutions. In all cases repayments are made by way of levies on aircraft sales, with any outstanding amounts included in creditors.

Tax

The charge for taxation is based on the profit for the year and takes account of taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes. Provision for deferred tax is made using the liability method to the extent that the net deferred tax asset or liability is likely to crystallise in the foreseeable future.

Pensions and other post retirement benefits

The expected cost of providing pensions and other post retirement benefits, as calculated periodically by independent actuaries, is charged to the profit and loss account so as to spread the cost over the expected average remaining service lives of current employees. The group operates several pension schemes providing benefits based on final pensionable pay. The assets of the schemes are held separately from those of the group.

Notes to the accounts

2 Segmental analysis

| | Sales | | Turnover | | Profit/(loss) before interest excluding exceptional items | | | | Profit/(loss) before interest | |
|---------------------------------------|--------------|--------------|--------------|--------------|--|------------|--------------------------------|------------|----------------------------------|------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m | Excluding joint ventures | | Including joint ventures | | 1999 £m | 1998 £m |
| | | | | | 1999 £m | 1998 £m | 1999 £m | 1998 £m | | |
| Defence | 5,837 | 6,353 | 5,067 | 5,455 | 743 | 625 | 760 | 638 | 562 | 638 |
| Commercial Aerospace | 2,970 | 2,523 | 1,980 | 1,852 | 35 | 53 | (10) | 12 | (10) | (39) |
| MES businesses | 455 | — | 330 | — | 6 | — | 28 | — | 28 | — |
| Other businesses and head office | 35 | 47 | 34 | 47 | (15) | (12) | (15) | (12) | (27) | 367 |
| | 9,297 | 8,923 | 7,411 | 7,354 | 769 | 666 | 763 | 638 | 553 | 966 |
| Less: intra group | (368) | (312) | (368) | (312) | — | — | — | — | — | — |
| Goodwill amortisation: Defence sector | — | — | — | — | (17) | (12) | (35) | (23) | (35) | (23) |
| Goodwill amortisation: MES | — | — | — | — | (26) | — | (28) | — | (28) | — |
| | 8,929 | 8,611 | 7,043 | 7,042 | 726 | 654 | 700 | 615 | 490 | 943 |

| | Profit/(loss) before tax on ordinary activities excluding exceptional items | | | | Profit/(loss) before tax on ordinary activities | | Assets employed | | | |
|----------------------------------|--|------------|--------------------------------|------------|---|------------|--------------------------------|--------------|--------------------------------|--------------|
| | Excluding joint ventures | | Including joint ventures | | 1999 £m | 1998 £m | Excluding joint ventures | | Including joint ventures | |
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m | | | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Defence | 747 | 646 | 736 | 650 | 538 | 650 | 2,875 | 2,959 | 3,238 | 3,369 |
| Commercial Aerospace | (62) | (14) | 2 | (32) | (34) | (123) | (1,934) | (2,027) | (2,074) | (1,988) |
| MES businesses | (20) | — | 1 | — | 1 | — | 6,132 | — | 6,530 | — |
| Other businesses and head office | 61 | 22 | (15) | 22 | (49) | 401 | 562 | 441 | 576 | 449 |
| | 726 | 654 | 724 | 640 | 456 | 928 | 7,635 | 1,373 | 8,270 | 1,830 |
| Unallocated interest | 3 | 45 | 3 | 45 | 3 | 45 | — | — | — | — |
| Unallocated cash | — | — | — | — | — | — | (825) | 196 | (825) | 196 |
| | 729 | 699 | 727 | 685 | 459 | 973 | 6,810 | 1,569 | 7,445 | 2,026 |

Notes to the accounts

2 Segmental analysis continued

Sales are stated after the inclusion of £4,048 million (1998 £3,439 million) in respect of the group's joint venture sales and after the elimination of sales made to the joint ventures of £2,162 million (1998 £1,870 million), of which £935 million (1998 £782 million) arises in Defence, £1,220 million (1998 £1,088 million) arises in Commercial Aerospace, and £7 million arises in MES.

Turnover, profit before interest and assets employed (excluding joint ventures) largely originated from the United Kingdom during 1999 and 1998. Following the merger with MES a significant amount in future years will also originate from the US.

Rental income in 1999 from aircraft operating leases included within turnover is £80 million (1998 £85 million).

Intra group sales largely arise in Defence and originate from the United Kingdom.

Segmental profit before tax includes interest charged or credited by head office to the sectors on internal accounts. Assets employed include dividends declared by businesses.

Where appropriate, overhead costs relating to head office are allocated to business sectors.

Exceptional items allocated to 'other businesses and head office' include MES integration and finance costs in 1999 and the disposal of investments in 1998. The Defence rationalisation exceptional charge has been allocated to that sector. As in prior years, the interest adjustment made to the exceptional net present value provisions has been allocated to Commercial Aerospace. In 1998 the costs associated with the Financial Risk Insurance Programme were also allocated to Commercial Aerospace.

The distribution of external sales which includes the group's share of its joint ventures and turnover by geographical market comprised:

| | Sales | | Turnover | |
|---------------------------|--------------|--------------|--------------|--------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| United Kingdom | 1,471 | 954 | 1,250 | 793 |
| Rest of Europe | 2,522 | 1,984 | 2,416 | 2,151 |
| Middle East | 2,461 | 3,286 | 2,225 | 3,209 |
| USA and Canada | 1,522 | 1,139 | 711 | 543 |
| Far East | 354 | 641 | 56 | 72 |
| Australasia and Pacific | 443 | 484 | 345 | 239 |
| Central and South America | 92 | 100 | 27 | 25 |
| Africa | 64 | 23 | 13 | 10 |
| | 8,929 | 8,611 | 7,043 | 7,042 |

3 Operating costs

| | Ongoing 1999 £m | Acquired 1999 £m | Total 1999 £m | 1998 £m |
|--|-----------------------|------------------------|---------------------|--------------|
| Raw materials and other bought in stock | 3,688 | 75 | 3,763 | 4,302 |
| Change in stocks of finished goods and work in progress | (224) | 61 | (163) | 5 |
| Staff costs (note 5) | 1,549 | 103 | 1,652 | 1,327 |
| Depreciation, amortisation and impairment | 218 | 36 | 254 | 150 |
| Net provisions created (excluding pensions and deferred tax) | 174 | 1 | 175 | 85 |
| Other external charges | 858 | 76 | 934 | 678 |
| Other operating income | (86) | (2) | (88) | (108) |
| | 6,177 | 350 | 6,527 | 6,439 |

Included within the above analysis are the following expenses:

| | 1999 £m | 1998 £m |
|---|------------|------------|
| Operating lease charges – within other external charges | | |
| Plant and machinery | 4 | 10 |
| Other, including aircraft | 135 | 102 |
| Exceptional items (note 6): | | |
| Change in stocks of finished goods and work in progress | 4 | — |
| Staff costs | 51 | — |
| Depreciation, amortisation and impairment | 22 | — |
| Net provisions created | 117 | — |
| Other external charges | 16 | 51 |

Research and development expenditure was £871 million (1998 £621 million) of which £178 million (1998 £191 million) related to joint ventures.

The remuneration of the group's principal auditors for the year ended 31 December 1999 for statutory audit work was £2,989,000 (1998 £1,726,000), including £512,000 (1998 £457,000) in relation to the Company. In addition £9,046,000 (1998 £7,766,000) was paid in the United Kingdom to the principal auditors and their associates in respect of non-audit work, principally in relation to corporate transactions and tax advisory and compliance work; £597,000 (1998 £386,000) was paid overseas.

Notes to the accounts

4 Interest

| | 1999 £m | 1998 £m |
|---|-------------|------------|
| Interest receivable and similar income | 107 | 176 |
| Interest payable and similar charges: | | |
| On bank loans and overdrafts | (25) | (36) |
| On finance leases | (2) | (2) |
| Others | (77) | (93) |
| Net interest arising on activities excluding exceptional items and joint ventures | 3 | 45 |
| Share of net interest of joint ventures | 24 | 25 |
| Exceptional finance charges relating to the MES acquisition (note 6) | (22) | — |
| Adjustment to exceptional net present value provisions (note 6) | (36) | (40) |
| | <u>(31)</u> | <u>30</u> |

The interest arising on the funding arranged for the MES acquisition of £12 million has been allocated to the MES results reported within acquisitions.

5 Employees and directors

The weekly average and year end numbers of employees were as follows:

| | Weekly average | | At year end | |
|---|------------------------|------------------------|------------------------|------------------------|
| | 1999 Number '000 | 1998 Number '000 | 1999 Number '000 | 1998 Number '000 |
| Defence | 37.1 | 36.7 | 36.1 | 38.0 |
| Commercial Aerospace | 9.7 | 9.3 | 9.8 | 9.5 |
| MES businesses | 3.1 | — | 36.9 | — |
| Other businesses and head office | 0.6 | 0.5 | 0.6 | 0.4 |
| Group employees excluding joint venture employees | <u>50.5</u> | <u>46.5</u> | <u>83.4</u> | <u>47.9</u> |

The aggregate payroll costs of group employees excluding joint venture employees were:

| | 1999 £m | 1998 £m |
|-------------------------------|--------------|--------------|
| Wages and salaries | 1,405 | 1,143 |
| Social security costs | 116 | 93 |
| Other pension costs (note 27) | 131 | 91 |
| | <u>1,652</u> | <u>1,327</u> |

Included within the above 1999 amounts are £92 million wages and salaries, £8 million social security costs, and £3 million other pension costs relating to acquired businesses.

Total directors' emoluments, including company pension contributions, were £2,893,691 (1998 £2,574,314).

No amounts were paid this year or last year to past directors relating to pensions other than those disclosed in the Remuneration report.

Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 32 to 36.

Transactions

At 31 December 1999 there was an aggregate balance of £71,477 (1998 £695,601) outstanding on house purchase loans made to, or arranged for three officers (1998 10 officers) to assist with their relocation at the company's request.

Notes to the accounts

6 Exceptional items

| | 1999 £m | 1998 £m |
|---|--------------|-------------|
| Exceptional loss included within operating profit | | |
| Defence sector rationalisation | (198) | — |
| MES integration costs | (12) | — |
| Financial Risk Insurance Programme costs | — | (51) |
| | (210) | (51) |
| Exceptional (loss)/profit not included within operating profit | | |
| Partial sale of investment in Orange plc | — | 368 |
| Sale of investment in Orion Network Services Inc | — | 33 |
| | — | 401 |
| Sale of the Arlington Securities business | — | (22) |
| | — | 379 |
| Exceptional (loss)/profit included within profit before interest | (210) | 328 |
| Exceptional interest | | |
| Finance charges relating to the MES acquisition | (22) | — |
| Adjustment to exceptional net present value provisions | (36) | (40) |
| | (58) | (40) |
| Net exceptional (loss)/profit included within profit before tax | (268) | 288 |

Defence sector rationalisation

On 24 June 1999 the group announced a rationalisation of Defence sector activities including the closure of the Dunsfold site together with redundancy programmes across a number of business units.

The total cost of this rationalisation is estimated at £250 million before a tax credit of £60 million, of which £198 million before a tax credit of £43 million has been charged at 31 December 1999. The balance is expected to be charged in 2000. A net cash outflow of £53 million arose in 1999 in respect of these costs.

MES integration and finance costs

The group acquired MES on 29 November 1999 and is now in the process of integrating this business within the enlarged organisation. Costs of £12 million before a tax credit of £2 million have been charged at 31 December 1999. Integration costs are expected to continue in the next three financial years. A net cash outflow of £5 million arose in 1999 in respect of these costs.

Finance charges arising as a result of the acquisition relate to certain loan and overdraft facilities that were required to be renegotiated as a direct consequence. The cost resulting from these renegotiations amounted to £22 million before a tax credit of £1 million. A net cash outflow of £22 million arose in 1999 in respect of these costs.

Adjustment to exceptional net present value provisions

Adjustments have been included to maintain the net present value of certain Commercial Aerospace sector recourse provisions which were established as exceptional items on a net present value basis in prior years. The taxation effect of these adjustments is £11 million (1998 £nil). These adjustments have no cash flow effect.

7 Tax

| | 1999 £m | 1998 £m |
|---|--------------|--------------|
| Current year UK corporation tax at 30.25% (1998 31%) | (181) | (139) |
| Prior year UK corporation tax credit/(charge) | 114 | (146) |
| Deferred tax (charge)/credit | (104) | 27 |
| Advance corporation tax | — | 94 |
| Overseas tax | (4) | (3) |
| Joint ventures | (13) | (5) |
| Tax on the results excluding exceptional items | (188) | (172) |
| Tax on exceptional items | 57 | (108) |
| | (131) | (280) |

8 Dividends

| | 1999 £m | 1998 £m |
|---|------------|------------|
| Equity dividends | | |
| Interim 3.00p dividend per ordinary share paid (1998 2.35p) | 53 | 41 |
| Final 5.00p dividend per ordinary share proposed (1998 4.15p) | 149 | 73 |
| | 202 | 114 |
| Non-equity dividends | | |
| 7.75p dividend per preference share | 21 | 21 |
| | 223 | 135 |

Notes to the accounts

9 Earnings per share

| | 1999 | | 1998 | |
|---|-------------|---------------|-------------|---------------|
| | Basic £m | Diluted £m | Basic £m | Diluted £m |
| Profit for the financial year | 324 | 324 | 692 | 692 |
| Preference dividends | (21) | — | (21) | — |
| Earnings including goodwill amortisation and exceptional items | 303 | 324 | 671 | 692 |
| Add back goodwill amortisation (notes 10 & 12) | 63 | 63 | 23 | 23 |
| Exceptional items (note 6) | 268 | 268 | (288) | (288) |
| Tax on exceptional items (note 7) | (57) | (57) | 108 | 108 |
| Earnings excluding goodwill amortisation and exceptional items | 577 | 598 | 514 | 535 |
| Basic earnings per share | | | | |
| Including goodwill amortisation and exceptional items | 16.2p | | 38.4p | |
| Excluding goodwill amortisation and exceptional items | 30.8p | | 29.4p | |
| Diluted earnings per share | | | | |
| Including goodwill amortisation and exceptional items | | 15.6p | | 35.1p |
| Excluding goodwill amortisation and exceptional items | | 28.8p | | 27.1p |

Reconciliation of the weighted average number of shares used in calculating basic earnings per share and that used in calculating diluted earnings per share.

| | 1999 Number m | 1998 Number m |
|---|---------------------|---------------------|
| Weighted average number of shares used in calculating basic earnings per share | 1,876 | 1,749 |
| Incremental shares in respect of options, warrants and preference shares | 197 | 224 |
| Weighted average number of shares used in calculating diluted earnings per share | 2,073 | 1,973 |

Earnings per share is calculated by reference to earnings excluding goodwill amortisation and exceptional items in addition to that required by FRS 3 as the directors consider that this gives a more appropriate indication of underlying performance.

10 Intangible fixed assets

| | Group £m |
|---|-------------|
| Goodwill arising from acquisition of subsidiary undertakings: | |
| Cost or valuation | |
| At 1 January 1999 | 334 |
| Additions (note 12) | 6,086 |
| At 31 December 1999 | 6,420 |
| Amortisation | |
| At 1 January 1999 | 12 |
| Amortisation charge | 43 |
| At 31 December 1999 | 55 |
| Net book value | |
| At 31 December 1999 | 6,365 |
| At 31 December 1998 | 322 |

Goodwill represents the excess of the fair value of the consideration given over the fair value of the separable net assets acquired.

Goodwill arising on joint ventures is set out in note 12.

Notes to the accounts

11 Tangible fixed assets

| | Group | | | Company | | |
|--|--------------------------|---------------------------|-------------|--------------------------|---------------------------|-------------|
| | Land and buildings £m | Plant and equipment £m | Total £m | Land and buildings £m | Plant and equipment £m | Total £m |
| Cost or valuation | | | | | | |
| At 1 January 1999 | 837 | 1,910 | 2,747 | 42 | 8 | 50 |
| Additions | 66 | 241 | 307 | — | 1 | 1 |
| Arising on acquisitions | 459 | 728 | 1,187 | — | — | — |
| Disposals | (19) | (64) | (83) | — | — | — |
| Stock transfers | — | 10 | 10 | — | — | — |
| Exchange adjustments | 3 | (3) | — | — | — | — |
| At 31 December 1999 | 1,346 | 2,822 | 4,168 | 42 | 9 | 51 |
| Depreciation and impairment | | | | | | |
| At 1 January 1999 | 71 | 1,072 | 1,143 | 7 | 6 | 13 |
| Disposals | (2) | (49) | (51) | — | — | — |
| Arising on acquisitions | 150 | 542 | 692 | — | — | — |
| Revaluation adjustment | 10 | — | 10 | — | — | — |
| Depreciation charge | 48 | 163 | 211 | 1 | 2 | 3 |
| Exchange adjustments | (1) | (3) | (4) | — | — | — |
| At 31 December 1999 | 276 | 1,725 | 2,001 | 8 | 8 | 16 |
| Net book value | | | | | | |
| At 31 December 1999 | 1,070 | 1,097 | 2,167 | 34 | 1 | 35 |
| At 31 December 1998 | 766 | 838 | 1,604 | 35 | 2 | 37 |
| The amounts above at 31 December 1999 include: | | | | | | |
| Capitalised finance leases: | | | | | | |
| Cost | — | 302 | 302 | — | 4 | 4 |
| Accumulated depreciation | — | 120 | 120 | — | 4 | 4 |
| Depreciation charge | — | 49 | 49 | — | — | — |
| Assets let under operating leases: | | | | | | |
| Cost | 76 | 5 | 81 | — | — | — |
| Accumulated depreciation | 3 | 3 | 6 | — | — | — |
| Non-depreciated assets | 131 | 38 | 169 | — | — | — |
| Net book value of: | | | | | | |
| Freehold property | 973 | — | 973 | 11 | — | 11 |
| Long leasehold property | 60 | — | 60 | 4 | — | 4 |
| Short leasehold property | 37 | — | 37 | 19 | — | 19 |
| Plant and machinery | — | 797 | 797 | — | — | — |
| Fixtures, fittings and equipment | — | 300 | 300 | — | 1 | 1 |
| | 1,070 | 1,097 | 2,167 | 34 | 1 | 35 |

Notes to the accounts

11 Tangible fixed assets continued

Land and buildings comprise:

- freehold and long leasehold land and buildings owned by the group as at 30 June 1996, excluding certain overseas properties, revalued at that date. The majority of the group's operational properties at that time were valued on a depreciated replacement basis, due to their specialisation, with the remainder on an existing use value basis. Other non-operational properties were valued on the basis of open market value;
- short leaseholds at cost;
- additions subsequent to 30 June 1996 at cost; and
- land and buildings owned by subsidiary undertakings acquired since 30 June 1996 at fair value at the date of acquisition.

Analysis of cost or valuation of land and buildings

| | Group £m | Company £m |
|---|--------------|---------------|
| At valuation – 1996 | 547 | 11 |
| At cost or fair value at acquisition included in gross cost | 799 | 31 |
| | <u>1,346</u> | <u>42</u> |

If land and buildings had not been revalued, the following amounts would have been included in the balance sheet:

| | Group £m | Company £m |
|-----------------------|--------------|---------------|
| Historical cost | 1,081 | 37 |
| Depreciation | <u>(178)</u> | <u>(11)</u> |
| Net book value | | |
| At 31 December 1999 | <u>903</u> | <u>26</u> |
| At 31 December 1998 | <u>577</u> | <u>27</u> |

The depreciation and impairment charge for the year, based on the historical cost, would have been £46 million for the group (1998 £25 million).

Notes to the accounts

12 Fixed asset investments

| | Joint ventures | | | Own shares £m | Others £m | Total £m |
|---|-------------------------------|-----------------------------|-------------------------|------------------|--------------|-------------|
| | Shares of net assets £m | Purchased goodwill £m | Carrying value £m | | | |
| Group | | | | | | |
| Net book value | | | | | | |
| At 1 January 1999 | 121 | 336 | 457 | 5 | 134 | 596 |
| Arising at acquisition | (108) | 488 | 380 | — | — | 380 |
| Additions | 2 | — | 2 | 7 | — | 9 |
| Share of results, after tax | 5 | — | 5 | — | — | 5 |
| Disposals | (7) | (6) | (13) | — | — | (13) |
| Joint venture funding | (137) | — | (137) | — | — | (137) |
| Dividends | (30) | — | (30) | — | — | (30) |
| Amortisation charge | — | (20) | (20) | — | — | (20) |
| Transfer to current asset investments (note 17) | — | — | — | — | (123) | (123) |
| Foreign exchange movement | 8 | (17) | (9) | — | 2 | (7) |
| At 31 December 1999 | (146) | 781 | 635 | 12 | 13 | 660 |

| | Subsidiary undertakings £m | Own shares £m | Others £m | Total £m |
|--|----------------------------------|---------------------|--------------|--------------|
| Company | | | | |
| Cost or carrying value | | | | |
| At 1 January 1999 | 2,153 | 5 | 13 | 2,171 |
| Additions | 1,402 | 7 | — | 1,409 |
| Provisions against diminution in value | (5) | — | — | (5) |
| At 31 December 1999 | 3,550 | 12 | 13 | 3,575 |

| Joint ventures – share of net assets | 1999 | 1998 |
|--------------------------------------|--------------|--------------|
| | £m | £m |
| Share of gross assets | | |
| Fixed assets | 1,730 | 985 |
| Current assets | 3,478 | 2,399 |
| | 5,208 | 3,384 |
| Share of gross liabilities | | |
| Liabilities due within one year | 2,889 | 2,306 |
| Liabilities due after one year | 1,684 | 621 |
| | 4,573 | 2,927 |
| Share of net assets | 635 | 457 |

Notes to the accounts

12 Fixed asset investments continued

| Businesses acquired | Book Value MES subsidiaries and joint ventures £m | Adjustments | | Fair Values £m |
|--|--|---|---------------------|-------------------|
| | | Accounting Policy Alignment £m | Fair value £m | |
| Share of joint ventures | (77) | — | (31) | (108) |
| Fixed assets | 496 | (39) | 39 | 496 |
| Stocks | 404 | (4) | (163) | 237 |
| Debtors and deferred tax | 573 | — | 159 | 732 |
| Current asset investments | 40 | — | 30 | 70 |
| Net cash | 21 | — | — | 21 |
| Creditors | (951) | — | (57) | (1,008) |
| Provisions | (156) | — | (226) | (382) |
| Net assets | 350 | (43) | (249) | 58 |
| Equity minority interests | (83) | — | 5 | (78) |
| | 267 | (43) | (244) | (20) |
| Consideration | | | | |
| Shares | | | | 4,619 |
| Capital amortising loan stock | | | | 369 |
| Cash | | | | — |
| Net debt assumed | | | | 1,444 |
| Costs | | | | 102 |
| Total consideration | | | | 6,534 |
| Goodwill arising on MES | | | | 6,554 |
| Goodwill arising on other acquisitions | | | | 20 |
| Total goodwill | | | | 6,574 |
| Goodwill allocation: | | | | |
| Subsidiaries: | | | | |
| MES | | | | 6,076 |
| Other | | | | 10 |
| | | | | 6,086 |
| Joint ventures: | | | | |
| MES | | | | 478 |
| Other | | | | 10 |
| | | | | 488 |

The net cash acquired with MES of £21 million represents net cash available on demand of £87 million together with net investments, loans and finance leases of £(66) million.

Notes to the accounts

12 Fixed asset investments continued

Acquisition of MES

The group acquired the Marconi Electronic Systems (MES) businesses from The General Electric Company, p.l.c. (GEC) on 29 November 1999. The transaction has been recorded under the acquisition method of accounting. Given the size and complexity of MES, together with the recent date of acquisition, provisional fair values have been assigned to the net assets acquired and certain elements of the consideration paid. These will be reviewed during the course of 2000 and amended as necessary in the light of subsequent knowledge or events to the extent that these reflect conditions at the date of acquisition.

The key features of the fair values assigned to the MES acquisition are as follows:

Fair value of consideration

Shares

The value assigned to the shares issued is based on the allotment of 1,167,811,580 ordinary shares at the market price on the date of completion of £3.955.

Capital Amortising Loan Stock (CALs)

On completion, the company issued the CALs to the shareholders of GEC. The CALs carry interest of 7.45 per cent, and are to be repaid by yearly instalments on the anniversary of the date of issue over four years. The amount paid on each occasion shall be £110 million representing both interest and a repayment of principal. The discounted fair value of the CALs on completion has been calculated at £369 million.

Assumed debt

The assumed debt of £1,444 million represents the intercompany debt repaid at acquisition.

Costs

The costs of acquisition of £102 million represent the directors' estimate of costs associated with the transaction and include advisers' fees, the company's share of tax costs under the Tax Deed entered into between the company and GEC, and other costs of separation. The actual amount of liabilities to tax will only be known following the submission of tax returns and, where appropriate, negotiations with the relevant authorities.

Adjustments to net assets

The material adjustments were determined as follows:

Fair Values

(a) Revaluation adjustments in respect of tangible fixed assets comprise the restatement of certain properties to their estimated market values. The carrying amount of the remaining tangible fixed assets approximated fair value.

(b) The adjustments to stock, creditors and provisions reflect the inclusion of amounts in respect of contract risks, onerous contracts and other commitments. Similar adjustments have been made to the net assets acquired within the joint ventures.

(c) Adjustments have been made to debtors to reflect deferred tax arising on the fair value adjustments (based on the likelihood of the recoverability taking into account the overall position of the enlarged group), and adjustments to balances owed by Marconi p.l.c.

(d) Two businesses acquired as a part of the MES acquisition are held with the intention of resale with the net carrying value being recorded as a current asset investment (note 15). Adjustments have been made to their net carrying value to reflect anticipated disposal proceeds.

Accounting policies

(e) The accounting policies of MES have been brought into line with those of the company. The most significant adjustment is in respect of software costs which under the MES policies were capitalised, but under the company's policy are charged as incurred.

Reorganisation provisions

The book values acquired included provisions for reorganisation and restructuring costs amounting to £21 million. These provisions relate to programmes and commitments established by MES in the periods prior to acquisition.

Notes to the accounts

12 Fixed asset investments continued

Summarised profit and loss account for the MES businesses for the period from 1 April 1999 to 28 November 1999.

| | £m |
|-------------------------------------|--------------|
| Sales | 2,393 |
| Less: adjustment for joint ventures | (531) |
| Turnover | <u>1,862</u> |
| Operating profit* | <u>99</u> |
| Joint venture results** | <u>(15)</u> |
| Profit before tax | <u>87</u> |
| Tax | <u>(12)</u> |
| Minority interests | <u>(2)</u> |

* includes goodwill amortisation of £31 million and exceptional reorganisation costs of £42 million.

** includes goodwill amortisation of £8 million.

Profit after taxation and minority interests for the year ended 31 March 1999 for the MES businesses totalled £289 million.

Statement of total recognised gains and losses for the MES businesses for the period from 1 April 1999 to 28 November 1999.

| | £m |
|--|-----------|
| Profit for the period | 73 |
| Currency translation on foreign currency net investments | (2) |
| Total recognised gains and losses for the period | <u>71</u> |

Non-trading subsidiary undertakings

Included within subsidiary undertakings is the company's interest in non-trading subsidiary undertakings whose assets comprise loans to the company totalling £187 million (1998 £187 million) which have been offset against the cost of the company's investment.

Disposals

The group received deferred consideration of £35 million during 1999 in respect of the disposal in 1998 of its Arlington Securities business.

In addition, £7 million was received in respect of other disposals made in the year.

Qualifying Employee Share Ownership Trust (QUEST)

The group established a Qualifying Employee Share Ownership Trust (QUEST) for the purposes inter alia of the SAYE Share Option Scheme (1993). During the year contributions of £27 million have been made to the QUEST. The contributions reduced reserves of the company and the group, as outlined in note 24. The QUEST used the funds to subscribe for 8,227,044 new ordinary shares in the company issued at the market price prevailing on the date of issue being £4.14 per ordinary share on 23 December 1999. At 31 December 1999, included within own shares is £7 million (1998 £nil) representing the holding of 8,227,044 shares held at the option price. The market value of shares held at 31 December 1999 was £34 million.

As at 2 March 2000, 7,181,747 shares had been transferred to option holders exercising options under the SAYE Share Option Scheme (1993).

British Aerospace ESOP Trust Limited

Included within own shares is £5 million (1998 £5 million) representing a holding of 2,837,240 (1998 2,841,552) ordinary shares of 2.5p each in the company, listed on The London Stock Exchange and held by the company's wholly owned subsidiary, British Aerospace ESOP Trust Limited acting as Trustee to the British Aerospace ESOP Trust (the ESOP Trust).

The market value of the shares held at 31 December 1999 was £12 million (1998 £18 million).

At 31 December 1999 a total of 2,114,888 ordinary shares held in the ESOP Trust were the subject of conditional awards under the company's Performance Share Plan, of which 1,043,131 had been granted to executive directors. In addition, 500,115 ordinary shares were held in trust for employees under the rules of the company's Restricted Share Plan, 206,791 of which were held for executive directors.

Dividends on the shares held in the ESOP Trust have not been waived. Finance costs and other administrative charges are dealt with in the profit and loss account on an accruals basis.

Notes to the accounts

12 Fixed asset investments continued

| | <u>Principal activities</u> | <u>Principally operates</u> | <u>Country of incorporation</u> |
|---|---|-----------------------------|---------------------------------|
| Principal subsidiary undertakings | | | |
| BAE SYSTEMS (Operations) Ltd (Held via BAE SYSTEMS Enterprises Ltd) | Defence and commercial aerospace activities | UK | England and Wales |
| BAE SYSTEMS Australia Ltd (Held via BAE SYSTEMS Australia Holdings Ltd) | Defence and commercial aerospace activities | Australia | Australia |
| BAE SYSTEMS (Land and Sea Systems) Ltd (Held by British Aerospace plc) | Manufacture of command and communication systems | UK | England and Wales |
| BAE SYSTEMS Electronics Ltd (Held via Meslink Ltd) | Defence electronics | UK | England and Wales |
| BAE SYSTEMS Marine Ltd (Held via VSEL Ltd) | Shipbuilding | UK | England and Wales |
| BAE SYSTEMS Avionics (Management) Ltd (Held via BAE SYSTEMS Electronics Ltd) | Avionics | UK | England and Wales |
| BAE SYSTEMS North America Inc. (Held via BAE SYSTEMS Holdings Inc.) | Defence systems | US | US |
| Royal Ordnance plc (Held by British Aerospace plc) | Manufacture of ammunition and weapon systems | UK | England and Wales |
| Principal joint ventures | | | |
| Airbus Industrie GIE (20%) (Held via BAE SYSTEMS (Operations) Ltd) | Commercial aerospace activities | Europe | — |
| Eurofighter Jagdflugzeug GmbH (33%) (Held by British Aerospace plc) | Management and control of Eurofighter Typhoon programme | Germany | Germany |
| Matra BAe Dynamics SAS (50%) (Held via BAE SYSTEMS (France) SAS) | Manufacture of guided weapons | France and UK | France |
| Panavia Aircraft GmbH (42.5%) (Held by British Aerospace plc) | Management and control of Tornado programme | Germany | Germany |
| Saab AB (35%) (Held via British Aerospace Sweden AB) | Defence and commercial aerospace activities | Sweden | Sweden |
| Alenia Marconi Systems NV (50%) (Held via BAE SYSTEMS Electronics Ltd) | Defence electronics | UK and Italy | Holland |
| Matra Marconi Space NV (50%) (Held via BAE SYSTEMS Electronics Ltd) | Space systems | Europe | Holland |
| Thomson Marconi Sonar NV (49.9%) (Held via BAE SYSTEMS Electronics Ltd) | Underwater systems | UK and France | Holland |

The above list includes the company's principal subsidiaries and investments. It does not represent a full list of subsidiaries and investments. All holdings represent 100% of ordinary share capital, except where otherwise indicated.

Notes to the accounts

13 Stocks

| | Group | | Company | |
|--------------------------------------|--------------|--------------|------------|------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Long term contract balances | 2,343 | 1,067 | — | — |
| Less: attributable progress payments | (1,927) | (760) | — | — |
| | 416 | 307 | — | — |
| Short term work in progress | 978 | 1,009 | — | — |
| Less: attributable progress payments | (101) | (145) | — | — |
| | 877 | 864 | — | — |
| Raw materials and consumables | 135 | 124 | — | — |
| Finished goods and goods for resale | 104 | 108 | — | — |
| Development properties | 27 | 39 | 8 | 14 |
| | 1,559 | 1,442 | 8 | 14 |

Included within short term work in progress of the group are unamortised launch costs of £422 million (1998 £465 million) relating to programmes supported by externally funded launch aid.

14 Debtors

| | Group | | Company | |
|---|--------------|--------------|--------------|--------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Due within one year | | | | |
| Amounts recoverable under long term contracts | 2,459 | 2,698 | — | — |
| Trade debtors | 529 | 145 | — | — |
| Corporation tax recoverable | 1 | — | 26 | — |
| Amounts owed by subsidiary undertakings | — | — | 4,490 | 1,975 |
| Amounts owed by joint ventures | 159 | 52 | 28 | 4 |
| Other debtors | 303 | 181 | 53 | 61 |
| Prepayments and accrued income | 196 | 125 | 39 | 37 |
| | 3,647 | 3,201 | 4,636 | 2,077 |
| Due after one year | | | | |
| Trade debtors | 68 | 66 | — | — |
| Amounts owed by joint ventures | — | 28 | — | — |
| Deferred tax (note 22) | 146 | 118 | — | — |
| Advance corporation tax recoverable | — | 5 | — | 3 |
| Other debtors | 80 | 82 | 62 | 91 |
| Pensions | 201 | 195 | 123 | 115 |
| Prepayments and accrued income | 17 | 17 | 4 | 4 |
| | 512 | 511 | 189 | 213 |
| Total debtors | 4,159 | 3,712 | 4,825 | 2,290 |

15 Current asset investments

| | Group | | Company | |
|---|--------------|--------------|--------------|------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Investments held by fund managers | 318 | 306 | — | — |
| Commercial Paper | 99 | — | — | — |
| Term Deposits | 486 | 760 | 398 | 635 |
| Exchange Property (note 17) | 686 | — | 686 | — |
| Other securities | 54 | — | — | — |
| Liquid current asset investments | 1,643 | 1,066 | 1,084 | 635 |
| Businesses held for resale | 70 | — | — | — |
| Total current asset investments | 1,713 | 1,066 | 1,084 | 635 |

The Exchange Property at the time of issue of the Exchangeable Bond was represented by the company's underlying interest in Orange plc comprising 60 million ordinary shares. During December 1999 the company exchanged part of its interest in Orange plc for shares in Mannesmann AG and at 31 December 1999 the Exchange Property comprised 45 million ordinary shares in Orange plc together with two million ordinary shares in Mannesmann AG. The aggregate market value of the Exchange Property at 31 December 1999 was £1,252 million.

As part of the acquisition of MES the group acquired two businesses in the US, Actuation Systems Inc. and Precision Aerostructures. These businesses have not been consolidated on the basis that they are held exclusively with a view to subsequent resale. Actuation Systems Inc. was sold in February 2000 subject to regulatory clearance in the US.

Notes to the accounts

16 Loans and overdrafts

| | Group | | Company | |
|---|--------------|------------|------------|------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Due within one year | | | | |
| Bank loans and overdrafts | 259 | 219 | 130 | 123 |
| Medium term notes | 3 | 31 | — | — |
| European Investment Bank loan | 14 | 11 | — | — |
| Capital Amortising Loan Stock (CALs) | 83 | — | 83 | — |
| Schuldschein 9.2% bond | 34 | — | — | — |
| Exchangeable Bond (note 17) | 673 | — | 673 | — |
| Commercial Paper | 955 | — | — | — |
| Obligations under finance leases | 4 | 3 | — | — |
| | 2,025 | 264 | 886 | 123 |
| Due after one year | | | | |
| Medium term notes | 42 | 45 | — | — |
| Schuldschein 9.2% bond, repayable 2000 | — | 34 | — | — |
| US\$ 7% note, repayable 2007 | 120 | 120 | — | — |
| Euro-Sterling 11½% bond, repayable 2008 | 150 | 150 | 150 | 150 |
| European Investment Bank loan, final instalment 2009 (secured) | 143 | 137 | — | — |
| Euro-Sterling 10½% bond, repayable 2014 | 100 | 100 | 100 | 100 |
| US\$ 7.5% bond, repayable 2027 | 300 | 300 | — | — |
| CALs | 286 | — | 286 | — |
| Obligations under finance leases | 14 | 12 | — | — |
| | 1,155 | 898 | 536 | 250 |

Bank loans and overdrafts are at a floating rate of interest. The medium term notes are at fixed rates of interest between 7.6% and 9.3% and are repayable between 2000 and 2002. The US Commercial Paper is at floating rates of interest, with a weighted average rate of 6.0% and is repayable between 10 and 76 days. The European Investment Bank loan weighted average fixed rate of interest of 6.39% was renegotiated during 1999 and is secured against the net amounts payable by Airbus Industrie to the group. The CALs carry a fixed rate of interest of 7.45% on the principal amount outstanding and are repayable in broadly four equal annual instalments over the period to 2003. Finance lease obligations are generally repayable in annual instalments, and incur interest based on the 3 month LIBOR, or at rates between 8% and 10%. The remaining borrowings identified above are all at the fixed rate shown. At 31 December 1999 borrowings of £1,948 million (1998 £928 million) are at a fixed rate of interest compared to £1,232 million (1998 £234 million) at floating rates of interest. The floating rate borrowings include bank debt bearing interest at rates based on the relevant inter-bank rate or base rates.

Loans and overdrafts are repayable as follows:

| | Group | | Company | |
|----------------------------|--------------|--------------|--------------|------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| In one year or less | 2,025 | 264 | 886 | 123 |
| Between one and two years | 118 | 20 | 88 | — |
| Between two and five years | 294 | 130 | 198 | — |
| In later years | 743 | 748 | 250 | 250 |
| | 3,180 | 1,162 | 1,422 | 373 |

The total amount of loans repayable by instalments, where any instalment is due after five years, is £157 million for the group (1998 £148 million) and £nil for the company (1998 £nil).

17 Exchangeable Bonds

On 21 July 1999 the company issued £686 million 3.75% Senior Unsecured Exchangeable Bonds due 2006 (the Bonds). In summary the Bonds are exchangeable with the company's investment in the ordinary shares of Orange plc and Mannesmann AG (the Exchange Property). The Bondholders have the right, at any time on or after August 1999, to exchange their Bonds; alternatively, at the option of the company, the Bonds may be settled in cash based on the prevailing market value of the Exchange Property. Notwithstanding that the Bondholders currently have exchange rights (the Bonds accordingly are being disclosed as a current liability) the company does not at present anticipate any material exchange much before maturity in 2006.

Consistent with the company's strategy of disposing of its non-core assets, the company does not intend currently to settle any amounts due to a Bondholder in cash. The substance of the transaction has therefore been to affect the probable future disposal of the Exchange Property at the issue price of the Bonds. To reflect this the Exchange Property has been transferred from fixed asset investments to current asset investments, and is recorded at the effective realisable value being the issue price of the Bonds of £686 million. One effect of transferring the Exchange Property to current asset investments has been to include it within net debt at 31 December 1999 at that value.

Within the group accounts the uplift from previous book value of £123 million has been credited as a unrealised gain of £563 million within the revaluation reserve, pending the ultimate settlement of the Bonds. This, together with the previous revaluation over the negligible historical cost to the group, takes the cumulative unrealised gain to £686 million. The Bonds are recorded at issue price (less unamortised issue costs) within current liabilities, being the group's maximum economic exposure.

This treatment of the Exchange Property (with the effect described above) represents a departure from the normal requirements of the Companies Act 1985 under which current asset investments are to be carried at the lower of cost and net realisable value. This basis would, for the reasons set out above, in the opinion of the directors not reflect the economic substance of the transaction nor show a true and fair view.

Within the company accounts the Exchange Property is recorded within current asset investments at the lower of cost and net realisable value of £686 million.

Notes to the accounts

18 Creditors

| | Group | | Company | | | Group | | Company | |
|---|--------------|--------------|--------------|--------------|--------------------------------------|--------------|--------------|--------------|--------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m | | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Due within one year | | | | | Due after one year | | | | |
| Trade creditors | 1,709 | 1,309 | — | — | Trade creditors | 5 | 204 | — | — |
| Customer stage payments: | | | | | Customer stage payments: | | | | |
| Long term contracts | 395 | 278 | — | — | Long term contracts | 57 | 1 | — | — |
| Others | 115 | 111 | — | — | | | | | |
| Cash received on customers' account: | | | | | Cash received on customers' account: | | | | |
| Long term contracts | 42 | 16 | — | — | Long term contracts | 50 | — | — | — |
| Other | 7 | — | — | — | Other creditors | 394 | 482 | 2 | 1 |
| Amounts owed to subsidiary undertakings | — | — | 6,556 | 3,075 | Accruals and deferred income | 36 | 14 | — | — |
| Amounts owed to joint ventures | 132 | 20 | 92 | — | | 542 | 701 | 2 | 1 |
| Corporation tax | 147 | 232 | — | 127 | Total creditors | 5,413 | 4,770 | 7,085 | 3,378 |
| Other taxes and social security costs | 66 | 42 | — | — | | | | | |
| Dividends | 160 | 84 | 160 | 84 | | | | | |
| Other creditors | 438 | 364 | 207 | 25 | | | | | |
| Accruals and deferred income | 1,660 | 1,613 | 68 | 66 | | | | | |
| | 4,871 | 4,069 | 7,083 | 3,377 | | | | | |

Included in other creditors for the group is £422 million (1998 £522 million) of externally funded launch aid provided to the group on risk sharing terms. Of this £102 million (1998 £101 million) is due within one year. Company £nil (1998 £nil).

19 Provisions for liabilities and charges

| | Deferred tax Note 22 £m | Post retirement benefits Note 27 £m | Contracts £m | Warranties and after-sales service £m | Closure and reorganisation costs £m | Recourse Note 20 £m | Total £m |
|--------------------------------------|-------------------------------|---|-----------------|--|--|---------------------------|--------------|
| Group | | | | | | | |
| At 1 January 1999 | 38 | 25 | 260 | 90 | 189 | 490 | 1,092 |
| Provisions created | 17 | 2 | 58 | 14 | 177 | — | 268 |
| Provisions released | — | — | (53) | (18) | (3) | — | (74) |
| Provisions utilised | — | (2) | (102) | (7) | (112) | (90) | (313) |
| Provisions arising from acquisitions | 22 | 23 | 280 | 6 | 51 | — | 382 |
| Other provision movements | — | (1) | (2) | 1 | 1 | 42 | 41 |
| At 31 December 1999 | 77 | 47 | 441 | 86 | 303 | 442 | 1,396 |
| Company | | | | | | | |
| At 31 December 1999 (note 22) | 38 | — | — | — | — | — | 38 |

In respect of ongoing contracts, in assessing profitability, provision is made to cover costs and losses identified where there is a likelihood of crystallisation. The associated outflows are estimated to occur over the period of the contract, normally between one and five years.

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 one to five years post delivery.

Closure and reorganisation provisions reflect costs to be incurred in respect of committed programmes. The provision brought forward at 1 January 1999 primarily relates to after sales support costs post closure of operations and covers costs to be incurred over a period of six years from the balance sheet date. In addition, provisions created during 1999 relate to the Defence sector rationalisation (note 6). The amount arising from acquisitions represents provisions for closure and reorganisation held within MES at acquisition (note 12) together with fair value adjustments of £30 million created in respect of estimated costs associated with environmental site rectification on already vacated properties.

Other provision movements for the group within recourse comprise adjustments to net present value provisions.

There were no provisions in the company at 1 January 1999.

Notes to the accounts

20 Commercial aircraft financing

Commercial aircraft are frequently sold for cash with the manufacturer retaining some financial exposure. Aircraft financing commitments of the group can be categorised as either direct or indirect. Direct commitments arise where the group has sold the aircraft to a third party lessor and then leased it back under an operating lease (or occasionally a finance lease) prior to an onward lease to an operator. Indirect commitments (contingent liabilities) may arise where the group has sold aircraft to third parties who either operate the aircraft themselves or lease the aircraft on to operators. In these cases the group may give guarantees in respect of the residual values of the related aircraft or certain head lease and finance payments to be made by either the third parties or the operators. The group's exposure to these commitments is offset by future lease rentals and the residual value of the related aircraft.

During 1998, an external review was commissioned of the likely income to be generated from the portfolio of aircraft to which the group has either direct or indirect financing exposures. This review identified a most likely level of income of some £2.4 billion. Following this analysis, in September 1998, the group entered into arrangements which reduced its exposure from commercial aircraft financing by obtaining insurance cover from a syndicate of leading insurance companies over a significant proportion of the contracted and expected income stream from the aircraft portfolio including those aircraft where the group has provided residual value guarantees. At the start of the insurance arrangements £2.2 billion of income was underwritten, of which £1.9 billion remained underwritten as at 31 December 1999.

The net exposure of the group to aircraft financing as at 31 December was:

| | 1999 £m | 1998 £m |
|---|------------|------------|
| Direct operating lease commitments | 722 | 854 |
| Direct finance lease commitments | 5 | 6 |
| Indirect exposure through aircraft contingent liabilities | 1,589 | 1,481 |
| Exposure to residual value guarantees | 542 | 504 |
| Income guaranteed through insurance arrangements | (1,885) | (2,053) |
| Net exposure | 973 | 792 |
| Expected income not covered by insurance arrangements | (43) | (43) |
| Expected income on aircraft delivered post insurance arrangements | (330) | (99) |
| Adjustment to net present value | (158) | (160) |
| Recourse provision | 442 | 490 |

Income guaranteed through insurance arrangements represents the future income stream from the aircraft assets guaranteed under the insurance arrangements after deducting the policy excess.

The external review identified likely income of £250 million above the level guaranteed under the insurance arrangements. *Expected income not covered by insurance arrangements* represents the amount of this income assumed by management for the purpose of provisioning.

Expected income on aircraft delivered post insurance arrangements represents the level of future income anticipated on aircraft delivered since the start of the insurance arrangements.

Given the long term nature of the liabilities, the directors believe it is appropriate to state the recourse provision at its net present value. The provision covers costs to be incurred over a forecast period of 13 years from the balance sheet date. The *adjustment to net present value* reduces the expected liabilities from their outturn amounts to their anticipated net present value.

Saab AB

The group is involved in similar transactions through its shareholding in Saab AB including aircraft financing commitments and contingent liabilities arising from guarantees in connection with aircraft sales.

Where Saab AB is exposed to financial risk from the above transactions, it makes provision against the expected net exposure on a net present value basis, after taking into account the expected future sub-lease income and residual values of the aircraft. The group's exposure is limited to its 35% shareholding in Saab AB.

Airbus

The group is involved in similar transactions through its participation in Airbus Industrie GIE (AI) including aircraft financing commitments and contingent liabilities arising from credit guarantees and financing receivables under customer financing programmes.

Where AI is exposed to financial risk from the above transactions, it makes provision against the expected net exposure, after taking into account future sub-lease rentals and residual values of related aircraft where appropriate. Provision for the net exposure is included within the group's share of the results of AI. The group's obligations under the financing commitments of AI are joint and several with the other partners.

Notes to the accounts

21 Contingent liabilities and commitments

Aircraft contingent liabilities

Under the arrangements described in note 20, the group is exposed to risk arising from default by individual aircraft operators where the group is unable to re-lease or re-sell the underlying aircraft, and to risk where it has provided residual value guarantees.

The group has guaranteed borrowings of Airbus Finance Company Limited totalling £51 million (1998 £32 million).

Treasury contingent liabilities

Treasury contingent liabilities are set out in note 30.

Company guaranteed borrowings

Borrowings of subsidiary undertakings totalling £1,740 million (1998 £699 million) which are included in the group's borrowings (note 16) have been guaranteed by the company.

Operating lease commitments

The commitments of the group in respect of expenditure in the year ahead arising from operating leases are set out below:

| | Aircraft | | | Aircraft | | |
|-------------------------------|------------------------|-------------------------|---------------------|------------------------|-------------------------|---------------------|
| | Property 1999 £m | financing 1999 £m | Other 1999 £m | Property 1998 £m | financing 1998 £m | Other 1998 £m |
| Operating leases | | | | | | |
| which expire: | | | | | | |
| In one year or less | — | 2 | 1 | 1 | 16 | 1 |
| Between one and five years | 18 | 25 | 1 | 19 | 27 | 3 |
| In later years | 25 | 88 | 9 | 22 | 80 | 8 |
| | 43 | 115 | 11 | 42 | 123 | 12 |

Capital commitments

Capital expenditure for tangible fixed assets contracted for but not provided for in the accounts comprised £84 million for the group (1998 £37 million) and £nil for the company (1998 £nil).

22 Deferred tax

| | Asset | (Liability) | Asset | (Liability) |
|--|------------|-------------|------------|-------------|
| | 1999 £m | 1999 £m | 1998 £m | 1998 £m |
| Group | | | | |
| At 1 January | 118 | (38) | 94 | (3) |
| Arising on acquisition of MES | 115 | (22) | — | — |
| Other movements | — | — | — | (38) |
| (Charge)/release to profit and loss account | (87) | (17) | 24 | 3 |
| At 31 December | 146 | (77) | 118 | (38) |

Deferred tax balances comprise:

Group

| | | | | |
|---|------------|-------------|------------|-------------|
| Accelerated capital allowances and other timing differences | 146 | (77) | 11 | (38) |
| Deferred tax assets established on a net present value basis | — | — | 107 | — |
| | 146 | (77) | 118 | (38) |

The composition of the net deferred tax asset at 31 December 1999 and of the additional amounts for which no asset has been recognised in the accounts is set out below:

| | Recognised | Not recognised | Total |
|--------------------------------|--------------------------|--------------------------|------------|
| | in the accounts £m | in the accounts £m | £m |
| Accelerated capital allowances | (12) | (124) | (136) |
| Other timing differences | 81 | 270 | 351 |
| | 69 | 146 | 215 |

No significant potential liability to tax is expected to arise if properties included at valuation in the accounts were realised at their revalued amounts and in respect of rolled over capital gains (1998 £nil potential liability).

No deferred tax has been provided in respect of future remittances of the accumulated reserves of overseas subsidiary undertakings, since the directors believe that no remittances will be made for the foreseeable future.

Included within provisions of the company is a deferred tax provision of £38 million (1998 £nil) in respect of the Exchange Property.

Notes to the accounts

23 Share capital

| | Equity | | Non-equity | | Nominal value £m |
|---|-----------------------------------|------------------------------------|---------------------|--|---------------------|
| | Ordinary shares of 2.5p each m | Preference shares of 25p each m | Special share of £1 | | |
| Authorised | | | | | |
| At 1 January 1999 | 2,180 | 275 | 1 | | 123 |
| Increase following MES acquisition | 1,670 | — | — | | 42 |
| At 31 December 1999 | 3,850 | 275 | 1 | | 165 |
| Issued and fully paid | | | | | |
| At 1 January 1999 | 1,764 | 270 | 1 | | 111 |
| Increase following MES acquisition | 1,103 | — | — | | 28 |
| Issuance of shares to QUEST | 8 | — | — | | — |
| Exercise of options, warrants, preference share conversion and dividend scrip issue | 39 | (1) | — | | 1 |
| At 31 December 1999 | 2,914 | 269 | 1 | | 140 |

On 29 November 1999 the company allotted 1,167,811,580 new ordinary shares of 2.5p, such shares to be issued to former GEC shareholders as part of the consideration for the MES business. On 31 December 1999 a total of 1,103,367,741 shares had been issued with 64,443,839 shares remaining unissued pending the receipt of the necessary declaration required pursuant to the company's Articles of Association concerning the nationality of the allottee.

The 7.75p (net) cumulative redeemable preference shares of 25p each are convertible into ordinary shares of 2.5p each at the option of the holder on 31 May in any of the years up to 2007, on the basis of 0.47904 ordinary shares for every preference share. During the year 68,741 shares were converted for 32,929 ordinary shares.

The company may redeem all of the remaining preference shares at any time after 1 July 2007 and, in any case, will redeem any remaining shares on 1 January 2010, in each case at 100p per share together with any arrears and accruals of dividend. The maximum redemption value of the preference shares, ignoring any arrears or accruals of dividend, is therefore £269 million and this amount has been disclosed on the face of the balance sheet as the total of non-equity shareholders' funds.

The preference shares carry voting rights at a general meeting of the company only where the preferential dividend is six months or more in arrears, or where a motion is to be proposed which abrogates, varies or modifies the rights of the preference shareholders, or where a motion is to be proposed for the winding up of the company. On a winding up, holders of the preference shares are entitled, after repayment of the capital paid up on the special share and in priority to any payment to any other class of shareholder, to the return of amounts paid up or credited as paid up on the preference shares together with a premium of 75p per share, and all arrears of preferential dividends.

Warrants are in issue to subscribe for ordinary shares of the company. The warrants may be exercised at six monthly intervals until 15 November 2000. Holders of the warrants may subscribe for four ordinary shares in the company for each warrant held, normally at a subscription price of 550p for four ordinary shares. Following the exercise of 7,424,069 warrants during the year, 8,176,158 warrants remain outstanding.

Under the British Aerospace Executive Share Option Scheme the British Aerospace Joint Venture Executive Share Option Scheme (JV) and the British Aerospace International Executive Share Option Scheme (INT), options to purchase ordinary shares of 2.5p each are exercisable not later than ten years and normally not earlier than three years from the date of the grant. The number of options exercised (in accordance with the Rules of the Scheme) and outstanding at 31 December 1999, together with their exercise prices rounded to the nearest penny, was as follows:

| | Exercise price p | Exercised during the year '000 | Lapsed during the year '000 | Outstanding '000 |
|---------------------|---------------------|-----------------------------------|--------------------------------|---------------------|
| Granted | | | | |
| 1989 (October) | 160 | — | 14 | — |
| 1990 (April) | 122 | — | — | 318 |
| 1991 (March) | 150 | — | — | 154 |
| 1992 (March) | 76 | 69 | — | 685 |
| 1992 (November) | 51 | — | — | — |
| 1994 (March) | 124 | — | — | 239 |
| 1994 (November) | 112 | — | — | 311 |
| 1995 (March) | 122 | 120 | — | 903 |
| 1995 (October) | 186 | 294 | 102 | 2,088 |
| 1995 (December) | 206 | — | — | 291 |
| 1996 (March) | 216 | 232 | 26 | 979 |
| 1996 (October) | 265 | 119 | 11 | 1,235 |
| 1996 (October) | 275 | 43 | — | 1,072 |
| 1997 (March) | 339 | 6 | 29 | 1,662 |
| 1997 (October) | 430 | — | 13 | 686 |
| 1998 (March) | 487 | — | — | 455 |
| 1998 (October) | 329 | — | 94 | 1,299 |
| JV 1998 (October) | 329 | — | 25 | 563 |
| 1999 (March) | 395 | — | 17 | 1,468 |
| JV 1999 (March) | 395 | — | — | 15 |
| 1999 (October) | 402 | — | 21 | 1,270 |
| JV 1999 (October) | 402 | — | — | 49 |
| 1999 (December) | 421 | — | — | 3,875 |
| JV 1999 (December) | 421 | — | — | 209 |
| INT 1999 (December) | 421 | — | — | 3,436 |
| | | 883 | 352 | 23,262 |

Notes to the accounts

Under the British Aerospace SAYE Share Option Scheme and the British Aerospace Joint Venture SAYE Share Option Scheme for employees, options to purchase ordinary shares of 2.5p each are exercisable normally on completion of the related savings contracts. The number of options exercised (in accordance with the Rules of the Scheme) and outstanding at 31 December 1999, together with their exercise prices rounded to the nearest penny, was as follows:

| | Exercise price p | Exercised during the year '000 | Lapsed during the year '000 | Out-standing '000 |
|---|------------------|--------------------------------|-----------------------------|-------------------|
| Granted | | | | |
| British Aerospace SAYE Share Option Scheme | | | | |
| 1994 (November) | 89 | 164 | 130 | 8,235 |
| 1996 (March) | 175 | 157 | 275 | 10,380 |
| 1997 (March) | 271 | 143 | 486 | 12,574 |
| 1998 (October) | 290 | 13 | 349 | 13,945 |
| 1999 (October) | 321 | — | 8 | 13,843 |
| | | <u>477</u> | <u>1,248</u> | <u>58,977</u> |
| British Aerospace Joint Venture SAYE Share Option Scheme | | | | |
| 1998 (November) | 353 | — | 34 | 1,212 |
| 1999 (October) | 321 | — | — | 1,080 |
| | | <u>—</u> | <u>34</u> | <u>2,292</u> |
| Total | | <u>477</u> | <u>1,282</u> | <u>61,269</u> |

On 23 December 1999, and as explained further in note 12, the company issued 8,227,044 ordinary shares to the QUEST for the purposes of settling future SAYE option obligations. Consideration in respect of this share issue amounted to £34 million.

24 Reserves

| | Share premium account £m | Shares to be issued £m | Other reserves £m | Profit and loss account £m |
|---|--------------------------|------------------------|-------------------|----------------------------|
| Group | | | | |
| At 1 January 1999 | 110 | — | 324 | 1,273 |
| Retained profit | — | — | — | 101 |
| Shares to be issued relating to MES | — | 255 | — | — |
| Realisation of revaluation reserve | — | — | (11) | 1 |
| Exercise of share options, warrants, preference share conversion and dividend scrip issue | 68 | — | — | — |
| Unrealised profit relating to the Exchange Property | — | — | 563 | — |
| Merger reserve relating to MES | — | — | 4,336 | — |
| Shares issued to QUEST | 34 | — | — | (27) |
| Exchange adjustment | — | — | — | (9) |
| At 31 December 1999 | <u>212</u> | <u>255</u> | <u>5,212</u> | <u>1,339</u> |
| Company | | | | |
| At 1 January 1999 | 110 | — | 216 | 765 |
| Retained loss | — | — | — | (173) |
| Shares to be issued relating to MES | — | 2 | — | — |
| Shares issued to QUEST | 34 | — | — | (27) |
| Exercise of share options, warrants, preference share conversion and dividend scrip issue | 68 | — | — | — |
| At 31 December 1999 | <u>212</u> | <u>2</u> | <u>216</u> | <u>565</u> |

Other reserves for group include: revaluation reserve £876 million (1998 £324 million), and merger reserve £4,336 million (1998 £nil).

Other reserves for company include: revaluation reserve £192 million (1998 £192 million), and capital reserve £24 million (1998 £24 million).

Revaluation reserve

The company's revaluation reserve includes amounts relating to properties sold to other group undertakings as part of operational reorganisations in prior years. This element of the revaluation reserve is realised by the company when the related properties are disposed of outside the group, or written down following a permanent diminution in value.

Amounts taken directly to reserves on acquisitions

The cumulative negative goodwill arising prior to 1999 is £33 million (1998 £33 million). The cumulative amount of goodwill arising on consolidation is £114 million (1998 £114 million).

Company profit

The company's profit for the financial year was £50 million (1998 £311 million).

Notes to the accounts

25 Statutory reserve

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

26 Equity minority interests

| | 1999 | 1998 |
|------------------------------|------|------|
| | £m | £m |
| At 1 January | 6 | — |
| Movements in respect of: | | |
| Saab AB | 2 | 2 |
| BAeSEMA Ltd | — | 3 |
| MES on acquisition | 83 | — |
| Canadian Marconi Company | (5) | — |
| MES fair value adjustments | (5) | — |
| Share of profit for the year | 4 | 1 |
| At 31 December | 85 | 6 |

27 Post retirement benefit schemes

Pension schemes

The group operates pension schemes in the UK and overseas. The main schemes are funded defined benefit schemes and the assets are held in separate trustee administered funds. Pension scheme valuations are regularly carried out by qualified independent actuaries to determine pension costs for both pension funding and SSAP 24 purposes.

The principal schemes, and their respective latest valuation dates, are as follows: BAE SYSTEMS Pension Scheme (5 April 1999); Royal Ordnance Pension Scheme (31 December 1998); VSEL section - Shipbuilding Industries Pension Scheme (1 April 1998), and Tracor Employee Retirement Plan (31 March 1999).

In addition to the above schemes, from 29 November 1999 the group participated in the GEC 1972 Plan, which is operated wholly by Marconi p.l.c. This plan is to be split on 6 April 2000, with assets and liabilities attributable to the employees of MES and a proportion of the pensioners and deferred pensioners of the GEC 1972 Plan at that date to be transferred to a new scheme to be operated by BAE SYSTEMS.

As with the GEC 1972 Plan, the VSEL section - Shipbuilding Industries Pension Scheme and the Tracor Employee Retirement Plan relate to MES. For fair value purposes an estimate of £nil has been made as to the surplus/deficit for inclusion on balance sheet at the date of the acquisition for each of the three schemes. Valuations for funding and SSAP 24 purposes will be undertaken in future years in line with current practice for the BAE SYSTEMS Pension Scheme and the Royal Ordnance Pension Scheme.

The actuarial method used for the BAE SYSTEMS Pension Scheme and the Royal Ordnance Pension Scheme for SSAP 24 purposes was the projected unit method and the principal assumptions used were that in the long term the average return on investments would exceed:

| | % |
|----------------------------------|--------------|
| Average increases in pay by | 2.5 |
| Average increases in pensions by | 4.25 to 4.75 |
| Dividend growth by | 5.25 |

The actuarial method used for the VSEL section - Shipbuilding Industries Pension Scheme for SSAP 24 purposes was the attained age method and the principal assumptions used were that in the long term the average return on investments would exceed:

| | % |
|----------------------------------|------|
| Average increases in pay by | 2.25 |
| Average increases in pensions by | 3.75 |
| Dividend growth by | 5.00 |

The actuarial method used for the Tracor Employee Retirement Plan (operated in the US) for SSAP 24 purposes was the projected unit method and the principal assumptions used were that in the long term the average return on investments would be 9%, and average increases in pay would be 5%.

The aggregate of the market values of the principal schemes operated by the group at the latest date of actuarial valuation totalled some £6.0 billion (1998 £3.9 billion) and the market value at 31 December 1999 was approximately £7.2 billion (1998 £5.1 billion). The actuarial value of the assets covered approximately 95% (1998 104%) of the benefits that had accrued to members after allowing for expected future increases in wages and salaries.

The net deficit is being amortised using the straight line method over the estimated average service lives of the related scheme members of 13 to 14 years. The net charge to the profit and loss account amounted to £131 million (1998 £91 million).

Pension prepayments included in debtors of the group amounted to £201 million (1998 £195 million) (note 14) and pension provisions of the group amounted to £26 million (1998 £25 million) (note 19). Cash contributions by the group to the pension schemes totalled £156 million (1998 £107 million).

Post retirement benefits other than pensions

The group also operates a number of non-pension post retirement benefit plans, under which certain employees and former employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired former employees of the group's subsidiaries in the US. These schemes are generally unfunded. The latest valuations of the principal schemes, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 31 December 1999. The method of accounting for these is similar to that used for defined benefit pension schemes. The gross liability of £21 million at 31 December 1999 (1998 £nil) is included within provisions for liabilities and charges (note 19).

Notes to the accounts

28 Consolidated cash flow

The consolidated cash flow statement has been prepared in accordance with FRS 1 (revised) to show the net movement in net cash available on demand. In addition, the cash flow statement shows the movement in net cash/debt as defined by the group below:

| | |
|-----------------------------------|---|
| Net funds | Cash at bank and in hand plus liquid current asset investments less short and long term loans and overdrafts |
| Net cash/debt | Net funds excluding cash on customers' account |
| Cash on customers' account | Unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees |

On the above basis, the group's net funds and net cash/debt comprise:

| | At 1 January £m | Cash flows £m | MES acq.* £m | Exchange Property £m | Other £m | At 31 Dec. £m |
|---|-----------------------|---------------------|--------------------|----------------------------|-------------|---------------------|
| Current assets | | | | | | |
| Investments | 1,066 | (234) | 125 | 686 | — | 1,643 |
| Cash at bank and in hand: | | | | | | |
| Available on demand | 300 | 491 | — | — | — | 791 |
| Other | 8 | 12 | — | — | — | 20 |
| Current liabilities | | | | | | |
| Loans and overdrafts: | | | | | | |
| Repayable on demand | (130) | 170 | (185) | — | — | (145) |
| Other | (134) | (984) | (89) | (686) | 13 | (1,880) |
| Liabilities falling due after one year | | | | | | |
| Loans | (898) | 15 | (286) | — | 14 | (1,155) |
| Net funds | 212 | (530) | (435) | — | 27 | (726) |
| Current liabilities | | | | | | |
| Cash on customers' account | (16) | 6 | (89) | — | — | (99) |
| Net cash/(debt) | 196 | (524) | (524) | — | 27 | (825) |

* excludes cash and overdrafts assumed on acquisition

MES cash inflow in the period from 29 November 1999 to 31 December 1999 was £33 million.

29 Analysis of main headings in cash flow statement

| | 1999 £m | 1998 £m |
|--|----------------|--------------|
| Returns on investments and servicing of finance | | |
| Interest received | 102 | 229 |
| Interest paid | (106) | (112) |
| Interest element of finance lease rental payments | (2) | (2) |
| Exceptional interest | (22) | — |
| Dividends paid on preference shares | (21) | (21) |
| Issue costs on Exchangeable Bond | (13) | — |
| | <u>(62)</u> | <u>94</u> |
| Taxation | | |
| UK corporation tax paid | (79) | (125) |
| Overseas tax paid | (2) | (11) |
| | <u>(81)</u> | <u>(136)</u> |
| Capital expenditure and financial investment | | |
| Purchase of tangible fixed assets | (307) | (375) |
| Joint venture funding | 137 | (123) |
| Sale of tangible fixed assets | 38 | 66 |
| Sale of fixed asset investments | — | 851 |
| | <u>(132)</u> | <u>419</u> |
| Management of liquid resources | | |
| Net sale/(purchase) of: | | |
| Investments held by fund managers | (12) | (306) |
| Commercial paper and repurchase agreements | — | 325 |
| Term deposits | 280 | 425 |
| Other securities | (34) | 341 |
| | <u>234</u> | <u>785</u> |
| Financing | | |
| Proceeds from exercise of share options | 43 | 18 |
| Capital element of finance lease rental payments | (4) | (6) |
| Increase/(decrease) in loans | 961 | (139) |
| Proceeds from issue of Exchangeable Bond (note 17) | 686 | — |
| | <u>1,686</u> | <u>(127)</u> |
| MES acquisition | | |
| Net debt assumed (note 12) | (1,444) | |
| Net cash acquired on acquisition | 87 | |
| | <u>(1,357)</u> | |
| Net funds on acquisition | | |
| Investments | 125 | |
| Loans and overdrafts | (191) | |
| | <u>(66)</u> | |
| CALS issued as consideration (note 12) | (369) | |
| | <u>(435)</u> | |

Notes to the accounts

30 Financial instruments

A discussion of the group's treasury objectives and policies and the use of financial instruments can be found in the operating and financial review and the Directors' report. Financial instruments comprise net borrowings (note 16) together with other instruments deemed to be financial instruments under FRS 13 including certain fixed asset investments, long term debtors, other long term creditors and provisions for liabilities and charges. Disclosures dealt with in this note exclude short term debtors and creditors where permitted by FRS 13 except for the analysis of net currency exposures.

Interest rate risk management

At 31 December 1999 after taking account of interest rate swaps and cross currency swaps the currency and interest rate profile of the financial assets and liabilities of the group was as follows:

Financial assets

The interest rate profile of the financial assets of the group was:

| Currency | Floating rate financial assets | | Financial assets on which no interest is paid | | Total | |
|--------------|--------------------------------|--------------|---|------------|--------------|--------------|
| | 1999 £m | 1998 £m | 1999 £m | 1998 £m | 1999 £m | 1998 £m |
| Sterling | 1,365 | 1,374 | 562 | 278 | 1,927 | 1,652 |
| US Dollar | 200 | 15 | 8 | — | 208 | 15 |
| Other | 188 | 14 | 8 | — | 196 | 14 |
| Total | 1,753 | 1,403 | 578 | 278 | 2,331 | 1,681 |

Not included in the above table are fixed rate Sterling financial assets of £4 million (1998 £nil).

Floating rate financial assets bear interest on short term interbank rates. The weighted average period until maturity for financial assets on which no interest is paid is two to five years.

Interest bearing financial assets comprise of cash, money market deposits, certain fixed asset investments, loans and debtors. Financial assets on which no interest is paid include certain fixed asset investments, loans and debtors.

Financial liabilities

The interest rate profile of the financial liabilities of the group was:

| Currency | Floating rate financial liabilities | Fixed rate financial liabilities | Financial liabilities on which no interest is paid | Total |
|--------------------------------|-------------------------------------|----------------------------------|--|--------------|
| | £m | £m | £m | £m |
| Sterling | 171 | 2,283 | 676 | 3,130 |
| Sterling own non-equity shares | — | 269 | — | 269 |
| US Dollar | 1,153 | 421 | 80 | 1,654 |
| Other | 15 | 1 | — | 16 |
| Total | 1,339 | 2,974 | 756 | 5,069 |

1998

| | | | | |
|--------------------------------|------------|--------------|------------|--------------|
| Sterling | 236 | 1,403 | 643 | 2,282 |
| Sterling own non-equity shares | — | 270 | — | 270 |
| US Dollar | 105 | 418 | 15 | 538 |
| Other | 11 | — | — | 11 |
| Total | 352 | 2,091 | 658 | 3,101 |

| Currency | Fixed rate financial liabilities | | Financial liabilities on which no interest is paid | |
|-----------|----------------------------------|---|--|--|
| | Weighted average interest rate | Weighted average period for which rate is fixed | Weighted average period until maturity | Weighted average period until maturity |
| 1999 | | | | |
| Sterling | 6.66% | 9.77 Years | see below | |
| US Dollar | 7.18% | 11.81 Years | 1 - 2 | |
| 1998 | | | | |
| Sterling | 8.53% | 11.1 Years | see below | |
| US Dollar | 7.00% | 11.2 Years | 1 - 2 | |

Floating rate financial liabilities bear interest based on short term interbank rates.

Interest bearing financial liabilities comprise bonds, commercial papers issued, net obligations under finance leases and bank overdrafts. Financial liabilities on which no interest is paid primarily consists of provisions for liabilities and charges.

Maturity of financial liabilities

Non-equity shares are redeemable on 1 January 2010. The maturity profile of loans and borrowings is set out in note 16. For the other financial liabilities, note 19 gives an indication of the nature of the underlying liabilities which in general cover a period of between one and five years from the balance sheet date.

Notes to the accounts

30 Financial instruments continued

Interest rate management

The group's current interest rate management strategy is that a minimum of 25% and a maximum of 75% of either net cash or debt is maintained at fixed interest rates. Following the MES acquisition the enlarged group is in a net debt position for the first time in recent years. The aim continues to be to restrict the volatility of interest income/expense below an agreed amount within a mathematical degree of confidence.

Currency management

The group's principal currency exposure is the US\$/£ Sterling exchange rate arising from the group's Commercial Aerospace manufacturing and sales activities. The group's overall strategy is designed to hedge, as far as practicable, net US\$ receipts by reference to rates representing the group's view of the long term US\$/£ Sterling exchange rates using forward contracts.

The group also has transactional currency exposure arising from exports/supplies denominated in currencies other than the US\$. The group's policy is to hedge such exposures where appropriate using forward contracts.

31 Related party transactions

The group has an interest in a number of joint ventures as disclosed in note 12. Transactions occur with these joint ventures in the normal course of business. 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 |
|-------------------------------|------------------------------|---------------------------------------|--|--|
| Related party | £m | £m | £m | £m |
| Airbus Industrie GIE | 1,220 | — | — | — |
| Eurofighter Jagdflugzeug GmbH | 780 | — | 88 | — |
| Matra BAe Dynamics SAS | 50 | 24 | 35 | 95 |
| Panavia Aircraft GmbH | 101 | 29 | 20 | 6 |
| Saab AB | 2 | 1 | — | — |
| Alenia Marconi Systems | 4 | 23 | 13 | 14 |
| Matra Marconi Space | — | — | 1 | — |
| Thomson Marconi Sonar | — | 8 | 1 | 12 |

Five year summary

| | 1999 | 1998 | 1997 | 1996 | 1995 |
|--|--------------|--------------|--------------|--------------|--------------|
| | £m | £m | £m | £m | £m |
| Profit and loss account | | | | | |
| Sales | | | | | |
| Defence | 5,837 | 6,353 | 6,357 | 5,339 | 4,531 |
| Commercial Aerospace | 2,970 | 2,523 | 2,465 | 2,120 | 1,984 |
| MES businesses | 455 | — | — | — | — |
| Property | — | 10 | 47 | 76 | 55 |
| Other businesses and head office | 35 | 37 | 34 | 34 | 164 |
| Intra group | (368) | (312) | (357) | (128) | (107) |
| | 8,929 | 8,611 | 8,546 | 7,441 | 6,627 |
| Profit/(loss) before interest* | | | | | |
| Defence | 760 | 638 | 607 | 546 | 487 |
| Commercial Aerospace | (10) | 12 | (25) | (90) | (118) |
| MES businesses | 28 | — | — | — | — |
| Property | — | — | — | (1) | (5) |
| Other businesses and head office | (15) | (12) | (24) | (22) | (10) |
| | 763 | 638 | 558 | 433 | 354 |
| Goodwill amortisation** | (63) | (23) | (5) | (1) | — |
| Exceptional operating costs | (210) | (51) | — | — | (46) |
| Exceptional (loss)/profit on closure and sale of operations | — | (22) | (330) | — | — |
| Exceptional profit/(loss) on disposal of fixed asset investments | — | 401 | — | — | (21) |
| | 490 | 943 | 223 | 432 | 287 |
| Interest | | | | | |
| Excluding exceptional items | 27 | 70 | 46 | 4 | (24) |
| Exceptional items | (58) | (40) | (36) | (31) | (29) |
| | (31) | 30 | 10 | (27) | (53) |
| Profit/(loss) before tax on ordinary activities | | | | | |
| Excluding exceptional items | 727 | 685 | 599 | 436 | 330 |
| Exceptional items | (268) | 288 | (366) | (31) | (96) |
| | 459 | 973 | 233 | 405 | 234 |
| Tax | (131) | (280) | (69) | (114) | (94) |
| | 328 | 693 | 164 | 291 | 140 |
| Balance sheet | | | | | |
| Fixed assets | 9,192 | 2,522 | 2,159 | 2,097 | 1,813 |
| Stocks | 1,559 | 1,442 | 1,703 | 1,477 | 2,171 |
| Creditors less debtors | (518) | (652) | (1,724) | (1,728) | (2,051) |
| Customer stage payments | (567) | (390) | (365) | (334) | (206) |
| Net cash excluding cash on customers' account | (825) | 196 | 761 | 726 | 203 |
| Provisions for liabilities and charges | (1,396) | (1,092) | (1,082) | (819) | (991) |
| | 7,445 | 2,026 | 1,452 | 1,419 | 939 |
| Capital and reserves | 7,445 | 2,026 | 1,452 | 1,419 | 939 |
| Equity minority interests | (85) | (6) | — | (13) | (11) |
| | 7,360 | 2,020 | 1,452 | 1,406 | 928 |
| Shareholders' funds | 7,360 | 2,020 | 1,452 | 1,406 | 928 |
| Cash on customers' account | 99 | 16 | 27 | 22 | 25 |

Five year summary

| | 1999 | 1998 | 1997 | 1996 | 1995 |
|--|----------------|--------------|------------|------------|------------|
| | £m | £m | £m | £m | £m |
| Cash flow statement | | | | | |
| Profit before interest* | 763 | 638 | 558 | 433 | 287 |
| Depreciation and impairment | 189 | 138 | 161 | 163 | 159 |
| Net capital expenditure | (280) | (280) | (165) | (84) | (41) |
| Movement in provisions excluding deferred tax | (210) | (93) | (63) | (214) | (303) |
| Customer stage payments | (44) | (31) | 31 | 128 | (36) |
| Working capital and sundry items | (94) | (1,211) | (307) | 125 | 89 |
| Operating cash flow | 324 | (839) | 215 | 551 | 155 |
| Net (purchases)/sales of operations | 49 | (493) | (137) | (43) | — |
| MES acquisition | (1,915) | — | — | — | — |
| Matra BAe Dynamics SAS merger | — | — | — | (80) | — |
| Orange Exchange Property | 686 | — | — | — | — |
| Orange plc loans | — | — | — | 194 | 40 |
| Sale of Orange plc shares | — | 764 | 19 | — | — |
| Sale of Orion Network Services Inc | — | 87 | — | — | — |
| Net interest | (6) | 115 | 32 | (1) | (10) |
| Tax and dividends | (202) | (217) | (111) | (104) | (75) |
| Net proceeds from equity issues | 43 | 18 | 17 | 6 | 10 |
| Movement in net cash | (1,021) | (565) | 35 | 523 | 120 |
| Cash flow by sector | | | | | |
| Defence | 410 | (631) | 292 | 586 | 152 |
| Commercial Aerospace | (138) | (180) | (88) | (45) | (127) |
| MES businesses | 37 | — | — | — | — |
| Property | — | — | 27 | 26 | 126 |
| Other businesses and head office | 15 | (28) | (16) | (16) | 4 |
| | 324 | (839) | 215 | 551 | 155 |
| Other information | | | | | |
| Basic earnings per share: | | | | | |
| <i>Excluding goodwill amortisation and exceptional items</i> | 30.8p | 29.4p | 25.0p | 17.4p | 12.2p |
| <i>Including goodwill amortisation and exceptional items</i> | 16.2p | 38.4p | 8.2p | 15.6p | 6.9p |
| Dividend per ordinary share | 8.0p | 6.5p | 4.9p | 3.9p | 3.1p |
| Personnel numbers at year end | 83,400 | 47,900 | 43,400 | 42,400 | 44,000 |
| Capital expenditure including leased assets | £307m | £375m | £211m | £194m | £139m |
| Order book including the group's share of joint ventures | £36.6bn | £28.1bn | £22.1bn | £19.4bn | £17.1bn |

* Excluding goodwill amortisation and exceptional items

** The goodwill amortisation relates to the Defence sector and MES

Shareholder information

Analysis of share register at 31 December 1999

| | Ordinary shares of 2.5p | | | | Preference shares of 25p | | | |
|-----------------------------------|-------------------------|--------------|----------------|--------------|--------------------------|--------------|----------------|--------------|
| | Accounts | | Shares | | Accounts | | Shares | |
| | Number '000 | % | Number million | % | Number '000 | % | Number million | % |
| By category of shareholder | | | | | | | | |
| Individuals | 145.3 | 76.1 | 149.2 | 5.1 | 4.1 | 36.9 | 21.1 | 7.8 |
| Nominee companies | 35.7 | 18.7 | 2,627.4 | 90.2 | 4.3 | 38.8 | 233.2 | 86.5 |
| Banks | 0.7 | 0.4 | 1.7 | 0.1 | 0.1 | 0.9 | 0.1 | — |
| Insurance and pension funds | 0.1 | 0.1 | 72.4 | 2.5 | 0.1 | 0.9 | 2.4 | 0.9 |
| Other | 9.0 | 4.7 | 62.9 | 2.1 | 2.7 | 22.5 | 12.8 | 4.8 |
| | 190.8 | 100.0 | 2,913.6 | 100.0 | 11.3 | 100.0 | 269.6 | 100.0 |
| By size of holding | | | | | | | | |
| 1-99 | 20.1 | 10.5 | 0.8 | — | 0.1 | 0.9 | 0.1 | — |
| 100-499 | 63.2 | 33.1 | 18.3 | 0.6 | 0.2 | 1.7 | 0.1 | — |
| 500-999 | 47.8 | 25.1 | 33.6 | 1.2 | 0.3 | 2.7 | 0.2 | 0.1 |
| 1,000-9,999 | 55.4 | 29.0 | 127.3 | 4.4 | 9.6 | 85.0 | 31.0 | 11.5 |
| 10,000-99,999 | 2.9 | 1.5 | 83.9 | 2.9 | 0.8 | 7.1 | 17.9 | 6.7 |
| 100,000-999,999 | 1.1 | 0.6 | 335.8 | 11.5 | 0.2 | 1.7 | 44.5 | 16.5 |
| 1,000,000 and over | 0.3 | 0.2 | 2,313.9 | 79.4 | 0.1 | 0.9 | 175.8 | 65.2 |
| | 190.8 | 100.0 | 2,913.6 | 100.0 | 11.3 | 100.0 | 269.6 | 100.0 |

Registered office

Warwick House
PO Box 87
Farnborough Aerospace Centre
Farnborough, Hampshire GU14 6YU
Telephone: 01252 373232
Website: www.baesystems.com

Registrars

Lloyds TSB Registrars
The Causeway
Worthing, West Sussex BN99 6DA
Telephone: 01903 502541

Company number 1470151
(Registered in England & Wales)

If you have any queries regarding your shareholding,
please contact the Registrars.

Shareholder dealing service

Hoare Govett Corporate Finance Ltd offer a low cost dealing facility enabling shareholders to acquire or dispose of British Aerospace plc ordinary shares. Commission of 1% is charged for both purchases and sales (a minimum charge of £10.00 will apply). Hoare Govett Corporate Finance Ltd is a member of the Securities and Futures Authority. If you require further information please contact:

Hoare Govett Corporate Finance Ltd, Share Dealing Department, 250 Bishopsgate, London EC2M 4AA Telephone: 020 7678 8300.

Share price information

The middle market price of the company's ordinary shares on 30 December 1999 was 410.0p, the range during the year was 343.0p to 519.0p.

Daily share prices are available on the FT Cityline service as follows:

| | |
|---|---------------|
| British Aerospace plc ordinary shares | 0906 003 1890 |
| British Aerospace plc preference shares | 0906 003 5174 |
| British Aerospace plc warrants | 0906 003 5074 |

(Calls are charged at 60p per minute at all times.)

Alternatively you can view teletext or similar service.

Shareholder information

Capital gains tax

For capital gains tax purposes the full adjusted market value of the ordinary shares of the company at 31 March 1982 was 47.27p.

For former GEC shareholders issued with new British Aerospace shares on completion of the merger the following values will be of assistance in capital gains tax calculations.

Closing price of GEC shares on 26 November 1999 - 962.5p

Opening price of British Aerospace ordinary shares on 30 November 1999 - 369p

Opening price of Marconi plc shares on 30 November 1999 - 751.25p

Apportionment of new issued stock to one GEC share:

| | |
|-------------------|-------------|
| Marconi plc | 82.7690871% |
| British Aerospace | 15.8827107% |
| CALS | 1.3482022% |

Scrip dividend

The company continues to offer holders of its ordinary shares the option to elect to have their dividend paid as shares instead of cash. If you would like to make this election, please request a scrip dividend mandate from our Registrars:

Lloyds TSB Registrars, The Causeway, Worthing, West Sussex, BN99 6DA Telephone: 01903 502541

American Depositary Receipts

The British Aerospace plc American Depositary Receipts (ADR) are traded on the Over The Counter market (OTC) under the symbol BTASY. One ADR represents four British Aerospace plc ordinary shares.

Morgan Guaranty Trust Company of New York is the depository. If you should have any queries, please contact:

Morgan Guaranty Trust Company of New York, ADR Service Center, PO Box 8205, Boston, Massachusetts, 02266-8205, USA
Telephone: +1 781 575 4328

Financial calendar

| | |
|---|------------------|
| Financial year end | 31 December |
| Warrant subscription rights exercisable | 15 May 2000 |
| Preference shares conversion date | 31 May 2000 |
| 1999 final ordinary dividend payable | 1 June 2000 |
| 2000 half yearly preference dividend payable | 1 July 2000 |
| 2000 interim results announcement | September 2000 |
| 2000 interim ordinary dividend payable | November 2000 |
| Warrant subscription rights exercisable | 15 November 2000 |
| 2000 half yearly preference dividend payable | 2 January 2001 |
| 2000 full year results – preliminary announcement | February 2001 |
| – report and accounts | April 2001 |
| 2000 final ordinary dividend payable | June 2001 |