

A wireframe model of a human head and shoulders, rendered in a light yellow/gold color. The model is shown in profile, facing left. The background is dark blue with a pattern of small, glowing hexagons and a grid of dots.

Total Performance across our markets

BAE Systems continues to build on its position as one of the world's largest and most geographically diverse defence and security companies, focused on delivering sustainable growth in shareholder value through its commitment to Total Performance.

p20 For more information on the Group's key home markets



For more information visit our website: www.baesystems.com

How we report corporate responsibility (CR):

This report includes a summary of the Group's corporate responsibility activities during the 2010 calendar year. It focuses on our strategy, and performance in the key areas of business conduct, safety, diversity and inclusion, environment and community. The report also includes case studies from our businesses around the world that demonstrate our approach in practice.

In this report:

- Summary of our 2010 corporate responsibility performance
- Update on our approach to business conduct

On our website:

- Our approach to CR
- Managing CR
- Reporting and assurance
- Safety stories from our businesses
- Education and early careers
- Training and development
- Support for local communities

www.baesystems.com/corporateresponsibility/

Cover image:

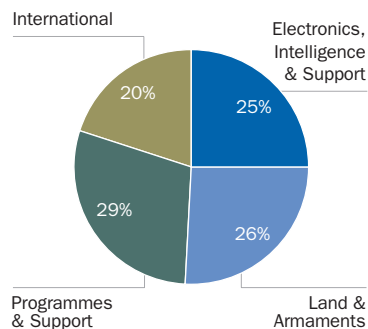
Cyber image sourced from istock.com

BAE Systems at a glance

BAE Systems is a global defence and security company with approximately 98,200 employees¹ worldwide. The Group delivers a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services.

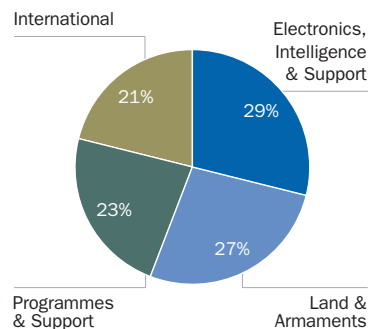
SALES^{1,2,3} BY OPERATING GROUP (%)

KPI

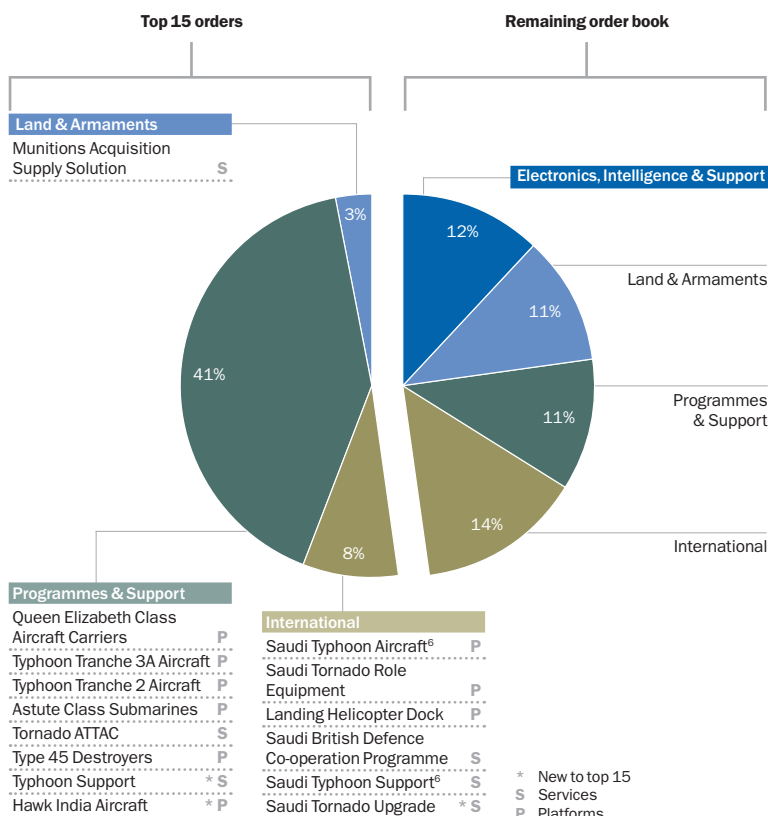


UNDERLYING EBITA^{4,3,4} BY OPERATING GROUP (%)

KPI



ORDER BOOK^{3,5} BY OPERATING GROUP (%)



1 Including share of equity accounted investments.
2 Before elimination of intra-group sales.
3 Excluding HQ & Other Businesses.
4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).
5 Including share of equity accounted investments' order books and before the elimination of intra-group orders of £1.5bn.
6 The appropriate work share of the Saudi Typhoon Aircraft and Support contracts is reported within Programmes & Support.

BAE Systems, Inc.

Electronics, Intelligence & Support (EI&S)

Principal operations

EI&S provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for US national security and federal markets, and ship repair and modernisation services.

Electronic Solutions
Intelligence & Security
Platform Solutions
Support Solutions

Main home markets

US
UK



Key points

- Acquisitions of Atlantic Marine and OASYS Technology completed
- Central operating group headquarters closed as part of the restructuring of BAE Systems, Inc.
- Continued to perform on legacy programmes and secured several strategic contract awards in new markets
- US Army qualified IMX-101 as a safer and effective alternative for the potential replacement of TNT in artillery
- Strong ship repair performance continued, with order intake totalling \$1bn (£0.6bn) in 2010

Sales^{1,2}

£5,653m

No. of employees¹

30,800

p66 For more information or visit www.baesystems.com/businesses/

Land & Armaments

Principal operations

Land & Armaments designs, develops, produces, supports and upgrades armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products.

Global Combat Systems
Global Tactical Systems
Security & Survivability
US Combat Systems
Products Group

Main home markets

US
UK



Key points

- Restructured to create a leaner, more responsive business to meet customers' needs
- Net headcount reduced by 5,500 (including contractors)
- Demand continues for land vehicle Readiness & Sustainment
- Continued progress in pursuit of supply chain efficiencies
- Continued Mine Resistant Ambush Protected vehicle activity

Sales^{1,2}

£5,930m

No. of employees¹

16,100

p68 For more information or visit www.baesystems.com/businesses/landarmaments/

Programmes & Support

Principal operations

Programmes & Support primarily comprises the Group's UK-based air, maritime and Cyber & Intelligence activities.

Military Air Solutions
BAE Systems Surface Ships
Submarine Solutions
Detica
Integrated System Technologies

Main home markets

UK



Key points

- £537m Hawk India contract secured
- Third Type 45 destroyer accepted off contract and sixth launched
- HMS Astute acceptance completed and second boat, Ambush, launched
- Nimrod MRA4 programme terminated and Harrier to be taken out of service in 2011 following Strategic Defence and Security Review (SDSR)
- Continued rationalisation and efficiency activity across the operating group and alignment of cost base post SDSR

Sales^{1,2}

£6,680m

No. of employees¹

31,600

p70 For more information or visit www.baesystems.com/businesses/programmessupport/

International

Principal operations

International comprises the Group's businesses in Australia, India and Saudi Arabia, together with interests in the pan-European MBDA joint venture and Air Astana.

BAE Systems Saudi Arabia
BAE Systems Australia
BAeHAL Software (40% shareholding)
Defence Land Systems India (26% shareholding)
MBDA (37.5% interest)
Air Astana (49% shareholding)

Main home markets

Australia
India
Saudi Arabia



Key points

- A further ten Typhoon aircraft delivered under the Salam programme
- Typhoon operational capability being provided under the support contract
- 157 Tactical vehicles accepted by the Saudi Arabia National Guard
- BAE Systems Australia selected as Lockheed Martin's partner for maintenance and upgrade support on the Australian F-35 programme
- Defence Land Systems India Private Limited joint venture became operational

Sales^{1,2}

£4,534m

No. of employees¹

17,200

p72 For more information or visit www.baesystems.com/businesses/international/

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Overview

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Strategy

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Segmental performance

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Governance

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Financial statements

Sections 1 to 5 make up the Directors' Report in accordance with the Companies Act 2006.

Cautionary statement: All statements other than statements of historical fact included in this document, including, without limitation, those regarding the financial condition, results, operations and businesses of BAE Systems and its strategy, plans and objectives and the markets and economies in which it operates, are forward-looking statements. Such forward-looking statements which reflect management's assumptions made on the basis of information available to it at this time, involve known and unknown risks, uncertainties and other important factors which could cause the actual results, performance or achievements of BAE Systems or the markets and economies in which BAE Systems operates to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements. Nothing in this document shall be regarded as a profit forecast. BAE Systems plc and its directors accept no liability to third parties in respect of this report save as would arise under English law. Accordingly, any liability to a person who has demonstrated reliance on any untrue or misleading statement or omission shall be determined in accordance with schedule 10A of the Financial Services and Markets Act 2000. It should be noted that schedule 10A and section 463 Companies Act 2006 contain limits on the liability of the directors of BAE Systems plc so that their liability is solely to BAE Systems plc.

2010 performance summary and outlook

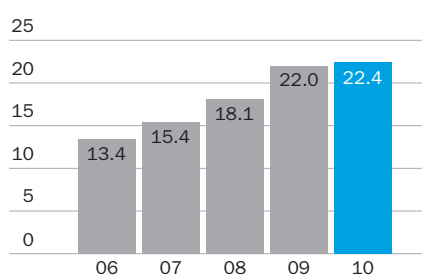
RESULTS IN BRIEF

Results from continuing operations		2010	Restated ¹ 2009
Sales ²	KPI	£22,392m	£21,990m
Underlying EBITA ³	KPI	£2,214m	£2,197m
Operating profit		£1,636m	£966m
Underlying earnings ⁴ per share	KPI	40.8p	40.1p
Basic earnings/(loss) per share ⁵		28.9p	(2.3)p
Order book ⁶		£39.7bn	£46.3bn
Other results including discontinued operations			
Dividend per share		17.5p	16.0p
Cash inflow from operating activities		£1,535m	£2,232m
Net (debt)/cash (as defined by the Group) ⁷		£(242)m	£403m

Results from continuing operations

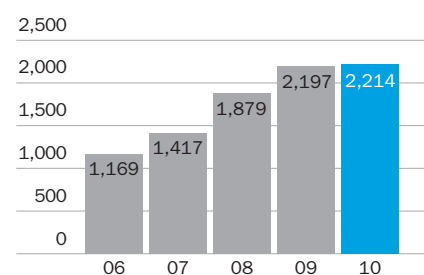
SALES^{1,2} (£BN)

KPI



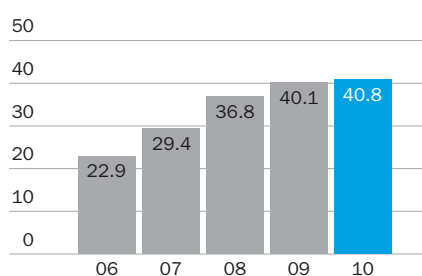
UNDERLYING EBITA^{1,3} (£M)

KPI



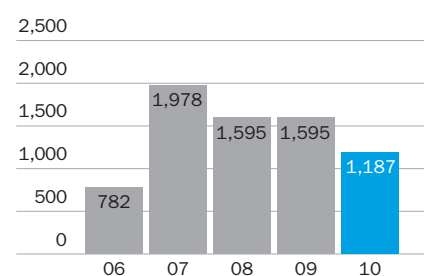
UNDERLYING EARNINGS^{1,4} PER SHARE (PENCE)

KPI



OPERATING BUSINESS CASH FLOW⁸ (£M)

KPI



KPI References Key Performance Indicators (KPIs) (see pages 16 to 19) throughout the Report.

- 1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation.
- 2 Including share of equity accounted investments.
- 3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).
- 4 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 10 to the Group accounts).
- 5 Basic earnings/(loss) per share in accordance with International Accounting Standard 33.
- 6 Including share of equity accounted investments' order books and after the elimination of intra-group orders of £1.5bn (2009 £1.7bn).
- 7 See page 39 and note 27 to the Group accounts.
- 8 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

p16

For more information on the Group's financial KPIs

p36

For more information on the Group's financial performance

KEY POINTS – FINANCIAL

- Headline sales² increased by 1.8%
- Underlying EBITA³ up 0.8% to £2,214m (2009 £2,197m) after a charge of £100m taken in respect of the terminated Trinidad and Tobago ship contract
- Underlying earnings⁴ per share increased by 1.7% to 40.8p (2009 40.1p)
- The total dividend has increased by 9.4% to 17.5p (2009 16.0p)
- £500m market purchase of shares completed

p18

For more information on the Group's non-financial KPIs

p45

For more information on the Group's corporate responsibility performance

KEY POINTS – NON-FINANCIAL

- The Group is on schedule to meet its three-year commitment to implement the 23 recommendations of the Woolf Committee by May 2011
- Good performance against targets for Customer Focus and Programme Execution
- The number of days lost to work-related injuries has reduced by 31%
- The Group's approach to diversity and inclusion was strengthened in 2010 to better support the recruitment, engagement and retention of talented people from all backgrounds

p64-74

For more information on the performance and outlook of the Group's operating groups

OUTLOOK

In 2011, a reduction in sales² is anticipated as the volume reduction in Land & Armaments is expected to complete and as the changes arising from the Strategic Defence and Security Review reduce activity in the UK businesses. The continuing actions to reduce cost and improve efficiency are expected to benefit return on sales and mitigate the impact of that lower activity. In addition, the 2011 results will benefit from the non-recurrence of the Trinidad and Tobago charge. The 2011 performance is expected to be weighted to the second half of the year. With the re-basing of the Land business in 2011, and the cost and efficiency actions, the Group will have established a resilient platform for future growth.

BAE Systems' business model

BAE Systems' business model is driven by its strategy to deliver sustainable growth in shareholder value. It is underpinned by the Group's commitment to Total Performance.

A strong portfolio of products, services and capabilities...

BAE Systems has three market segments designed to meet the evolving needs of its customers in both its home and export markets.

SERVICES

In **Readiness & Sustainment**, the Group provides total support for mission success, ranging from preparation and training programmes that are designed to ensure military personnel and equipment are ready for deployment (Readiness), through to maintenance and enhancement services (Sustainment).

In **Cyber & Intelligence**, the Group helps government and commercial clients to collect information to reveal intelligence, maintain security, manage risk and strengthen resilience, and also provides mission-critical cyber security solutions, information technology, intelligence and analytical tools, and support solutions to the intelligence, defence and civilian communities.

Contracts can be multi-year, thereby providing the Group with strong incumbent positions and intimacy with customers. BAE Systems has a track record of delivering both enhanced capability and cost savings, and this is an area of potential growth for the Group as customers' budgets remain under pressure.

ELECTRONIC SYSTEMS

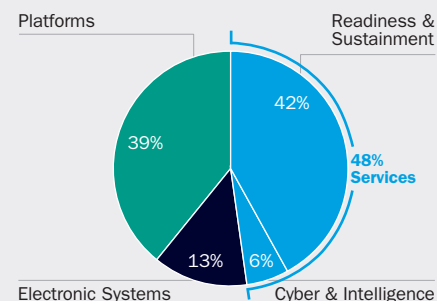
The Group designs, develops, manufactures and integrates a diverse portfolio of mission-critical electronic systems.

The Group's capabilities help meet its customers' requirements in the areas of electronic warfare, signal processing and battlespace management.

The Group's wide range of products include situational awareness and survivability systems, intelligence, surveillance and reconnaissance systems, secure networked communications and navigation systems, precision targeting and night vision systems.

This high technology business is underpinned by the investment of a significant proportion of the Group's research and development spend.

SALES¹ BY MARKET SEGMENT (%)



PLATFORMS

The Group designs, develops, manufactures and integrates a broad range of defence systems and equipment.

In air, the Group provides advanced military air capability through delivering combat aircraft and jet trainers, and is addressing the emerging global market for autonomous systems and related technologies.

In land, the Group provides armoured combat vehicles, tactical wheeled vehicles, missile launchers, artillery systems and munitions.

In maritime, the Group provides above and under water battlespace capability through the delivery of surface ships and nuclear powered submarines.

...and underpinned by a culture of Total Performance.

BAE Systems is committed to developing a culture of Total Performance, which encompasses Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour, and provides a platform to deliver sustainable growth in shareholder value and enhance the Group's reputation. The Group's success is measured by the Board with a range of financial and non-financial Key Performance Indicators (KPIs).

CUSTOMER FOCUS

The Group's priority to all its customers is to understand their needs and expectations, and deliver on its commitments throughout the life of the products and services it has delivered. Customer Focus is measured through schedule adherence metrics relating to milestone performance across the Group's major contracts, and customer satisfaction.

p16 For more information on the Group's KPIs

...across multiple home markets...

BAE Systems' business is based around identified home markets where the Group has established, or seeks to establish, a good position in the defence industrial base.

- United States
- United Kingdom
- Saudi Arabia
- Australia
- India



p20 For more information on the Group's key home markets

...delivered by four principal operating groups...

BAE Systems has four principal operating groups each with different characteristics resulting from the nature and phase in the lifecycle of programmes, products and services provided, procurement philosophies of their principal customers, and geographical areas in which they operate.

- Electronics, Intelligence & Support
- Land & Armaments
- Programmes & Support
- International



p64 For more information on the operating groups

...supported by essential resources...

The Group's key resources and arrangements, together with the application of the mandated policies and processes in the Operational Framework, help the Group achieve its strategy.

- Customers
- Subcontractors and other suppliers
- People
- Research and development
- Intellectual property



p32 For more information on the Group's resources

p84 For more information on the Group's Operational Framework

PROGRAMME EXECUTION

The Group's performance is dependent on the successful execution of its projects. It is important that the Group wins and contracts for high quality new programmes, and delivers on those projects within tight tolerances of quality, time and cost performance in a reliable, predictable and repeatable manner. Programme Execution is measured by reference to outturn projections of, and movements in, margin of key customer-funded projects.

FINANCIAL PERFORMANCE

The Group sets itself challenging financial targets through the Integrated Business Planning process. Financial Performance is measured through a range of key financial salients derived from the Group's consolidated financial statements, including order intake, sales, underlying EBITA², underlying Earnings per Share and operating business cash flow.

RESPONSIBLE BEHAVIOUR

Responsible Behaviour is measured with metrics relating to safety, the roll-out and training of the Code of Conduct, and the biennial employee opinion survey. BAE Systems' global Code of Conduct is a summary of the principles and standards of business conduct expected of all employees. Together with the Group's Responsible Trading Principles, the Code of Conduct underpins its business activities.

¹ Including share of equity accounted investments.

² Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

Chairman's letter

“BAE Systems delivered a solid performance in 2010, building on the progress in recent years.”

Dick Oliver
Chairman



Following six consecutive years of strong growth, 2010 was a year of robust performance across the Group – in the midst of market challenges. We continued to achieve progress by developing the business within a clear strategic framework (see page 14).

BAE Systems has a well-established strategic planning process that generates clear objectives cascaded throughout the business. The strategy is continually reviewed, and is evolved as objectives are achieved allowing us to proactively address changes in the business environment. We believe this structured approach provides clarity of our strategic direction for both our external stakeholders and for our employees.

There are three essential elements to the Group's strategy which have been incorporated into the Group Strategic Framework for 2011. Firstly, the Group plans to operate and target growth in the defence and security market segments of Services, Electronic Systems and Platforms. Secondly, to build upon the geographic diversity which has fostered growth to date, the Group will target growth in existing home markets and develop new home markets. Finally, building on its existing Platforms activity, the Group will target growth from export business.

The difficult global economic environment for many of our customers is inevitably being felt in a business that works closely with governments. BAE Systems has an excellent track record of adapting to market pressures and, whilst there will be challenges, such changes can present opportunities to generate new business and help customers deliver capability in a more cost effective way. Within the Group's Services activities there are numerous examples where we have enabled the armed forces to achieve large cost savings and to provide better value capability.

We believe there is further scope for value to be derived from the way defence capability is generated, in particular where traditional boundaries between industry and the armed forces can be changed. We look forward to continuing to help provide value enhancing solutions for our customers in this more difficult environment.

Recognising that security has become an increasing priority for governments alongside their traditional commitments to defence, our strategy has evolved to address these new opportunities. In particular, the Group is building a strong position in the Cyber & Intelligence domain.

In addition to pursuing financial goals, we remain committed to becoming recognised as a leader in business conduct. We attach great importance to the way we do business as well as to the results we achieve. We are approaching this through the development of a more integrated drive for performance in all aspects of our business life. Good progress has been

A robust governance structure underpins the delivery of the Group's strategy

made in embedding these principles of Total Performance, including the setting of financial and non-financial objectives for management. This year's inclusion of the Corporate Responsibility report within the pages of this Annual Report reflects this more integrated approach.

Achieving a culture of Total Performance depends on all our employees living a common set of Values – Trusted, Innovative and Bold – in their day-to-day work. Shared values and a global Code of Conduct are particularly important in our increasingly diverse global business.

The report published by the Woolf Committee in 2008 has been an important framework for the programme of ethical awareness which extends throughout the Group. We are on track to achieve implementation of the Woolf Committee recommendations by May 2011. The Company's core governance procedures and policies were reviewed during the year and updated to incorporate our Responsible Trading Principles.

In February 2010, the Company announced a global settlement of certain regulatory investigations with the US Department of Justice (DoJ) and the UK Serious Fraud Office (SFO), including an agreement with the SFO which provided for a payment of £30m for the benefit of the people of Tanzania less any penalty imposed by the Court in connection with the agreed basis of settlement. A penalty of £500,000 (together with costs of £225,000) was imposed by the Court in December 2010. The remaining balance of £29.5m (together with interest) will be applied by the Company for the benefit of the people of Tanzania in accordance with the applicable Company policies, including those relating to business conduct and the making of charitable contributions. The Company is in the process of creating an advisory board comprising suitably qualified and experienced individuals to guide the Company as to the possible approaches to the realisation of this objective.

Following the settlement with the DoJ, dialogue continues with other US regulatory agencies in order to address their concerns regarding matters arising from the settlement.

The composition of the Group's Board continues to evolve. In February 2010, Nick Rose was appointed a non-executive director of the Company. Phil Carroll and Andy Inglis, also non-executive directors, retired from the Board in May and July 2010, respectively. Harriet Green was appointed a non-executive director of the Company in November 2010.

Ravi Uppal has advised us that, in order to dedicate more time to his business activities in India, he wishes to stand down from the Board at the end of his three-year term on 1 April this year. I would like to thank him for the contribution he has made to the Board, especially the assistance he has provided in developing our interests in India.

George Rose, Group Finance Director, will retire from the Board on 31 March 2011 after 19 years with the Group. I would like to thank George for his very significant contribution to BAE Systems. Peter Lynas, currently Director, Financial Control, Reporting and Treasury, has been appointed Group Finance Director with effect from 1 April 2011, and will join the Board and Executive Committee on that date.

The success of the business is built on the hard work, creativity and commitment of our workforce. I am pleased to be able to formally recognise many of their achievements through the annual Chairman's Awards. A new category was introduced this year to recognise employees who have shown outstanding success in implementing our Total Performance culture.

In addition to BAE Systems' own programme to recognise the achievements of our people, we were delighted to also see external recognition. William McLachlan, a Safety, Health and Environment Advisor for Surface Ships, was made a Member of the Order of the British Empire (MBE) for services to charity, and Howard Robinson, Senior Support Engineer Tornado Software Support, was made MBE for services to the defence industry.

High quality, insightful narrative reporting is an important element of good governance. Over the last few years we have looked to develop the quality of our reporting so as to provide a fair and balanced view of the Company that is informative and accessible to readers. I am pleased that for the second year in a row this has been recognised at the ICSA Hermes Transparency in Governance Awards, with our 2009 report jointly winning the overall Best Annual Report award in 2010.

BAE Systems is performing well and the Group's strong position on programmes that provide key capability for customers, together with a large order book, provides good forward visibility.

The Board has recommended a final dividend of 10.5p per share making a total of 17.5p per share for the year, an increase of 9.4% over 2009. At this level, the annual dividend is covered 2.3 times by underlying earnings from continuing operations (2009 2.5 times). Subject to shareholder approval at the 2011 Annual General Meeting, the dividend will be paid on 1 June 2011 to holders of ordinary shares registered on 26 April 2011.



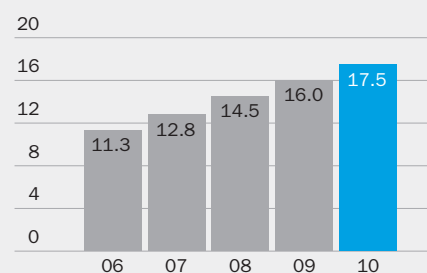
Dick Oliver
Chairman

I and my fellow directors are aware of the important responsibility we have for the good governance of the Company. We continue to review and evaluate the structure and quality of our governance arrangements with the aim of ensuring that they remain robust and in line with evolving best practice. Transparency is a critical element of good governance, and this Annual Report is the principal means by which we express our stewardship of the Company.

p78–95 For more information on our governance structure

The Board has recommended a final dividend of 10.5p making a total of 17.5p for the year, an increase of 9.4% on 2009

**DIVIDEND
(PENCE PER SHARE)**



Chief Executive's review

“BAE Systems is one of the world's leading defence and security companies.”

Ian King
Chief Executive



BAE Systems has business operations providing key national capabilities in many of the world's larger defence and security markets. Although the Group faces a more challenging trading environment as governments look for cost savings to address budgetary pressures, our broad base of activity results in a resilient business that is well positioned to withstand near-term market pressures.

Affordability and value for money are increasingly the priorities for customers. Early recognition by the Group of customer budgetary pressures resulted in significant cost reduction and efficiency actions being taken in 2009 which have continued throughout 2010. These actions have resulted in net headcount reduction of approximately 15,100 (including contractors) in the past two years. This cost reduction programme will enhance competitiveness, deliver further improved value for customers, and be of sustained benefit to the Group's performance.

BAE Systems has a substantial presence in Services activities in its defence and security markets. These activities, which represented 48% of sales in 2010, include Readiness & Sustainment business in the air, land and maritime defence domains, and provision of Cyber & Intelligence services. The Group is successfully growing its Services businesses, delivering enhanced capabilities whilst reducing costs for its customers.

BAE Systems' business is based around home markets where the Group has established, or seeks to establish, a strong position in the defence industrial base. The Group's key home markets are in Australia, India, Saudi Arabia, the UK and the US. Sweden and South Africa remain an important part of the Group's Land & Armaments business.

US

Following a review of markets and customers' needs in the US, changes to the Group's organisation were implemented in the first half of the year to realign BAE Systems, Inc. to better deliver on its strategy. Reductions in costs, benefiting both the Group's customers and shareholders, are flowing from the simplified organisation. These changes enable BAE Systems to be more competitive in a challenging environment and more agile in

BAE Systems is committed to progressing towards a recognised leadership position in Responsible Behaviour

Business conduct and safety continued to be our two key corporate responsibility priorities in 2010. Achieving high standards in ethics and safety will build trust and enhance our relationships with stakeholders.

p45 For more information on our approach to Responsible Behaviour

responding effectively to customers' needs. In July, following changes to the Group's US organisation, Larry Prior was appointed Executive Vice President, Service Sectors and Bob Murphy was appointed Executive Vice President, Product Sectors, both reporting to Linda Hudson, President and Chief Executive Officer of BAE Systems, Inc.. Larry and Bob are also members of the Group's Executive Committee.

In early February 2010, the US Quadrennial Defense Review (QDR) was released. The accompanying US defence budget for Fiscal Year 2011 identified growth in the allocation to the investment account element. The QDR restated the US's commitment to the large, next generation, F-35 combat aircraft programme. BAE Systems, through both its US and UK businesses, is a significant participant on this programme.

The US defence and security markets continue to generate a number of business opportunities, despite budgetary pressures. These pressures are leading to Department of Defense programme reprioritisations and a drive for greater efficiencies in procurement. These efficiencies are expected to help fund continued modest growth on investment in defence capability.

UK

Pressure to reduce government expenditure in the UK was reflected in the Comprehensive Spending Review and the findings of the UK Strategic Defence and Security Review (SDSR) were published in October. The review identified a number of changes to UK defence and security priorities over the coming years.

The Group continues to work with the UK Ministry of Defence to address the detailed implications of the changes identified by the SDSR. The Group believes that it can continue to help in delivering efficiency improvements and value for money in the way capability is generated and delivered. In aggregate, the changes resulted in some modest impact on the performance of the Group's UK business in 2010 and, thereafter, are expected to result in a reduction of approximately one pence in earnings per share, per annum, when compared with the Group's prior financial planning assumptions.

Other home markets

The Group continues to seek growth in Australia and the Kingdom of Saudi Arabia where it has strong, established home market positions.

In Australia, the defence budget is expected to grow following publication in 2009 of a Defence White Paper outlining the key areas for defence spend over the coming years.

In the Kingdom of Saudi Arabia, defence spending is expected to continue to be a high priority, representing some 10.9% of GDP in 2009.

Defence spending in India is expected to grow substantially. In the year, the Group has taken a number of steps to develop India as one of its home markets. A second major contract for the supply of Hawk aircraft to India was received, with local assembly to be undertaken by Hindustan Aeronautics Limited. A land systems joint venture with Mahindra & Mahindra Limited was established, which is currently developing and marketing several vehicles with the support of other BAE Systems' businesses.

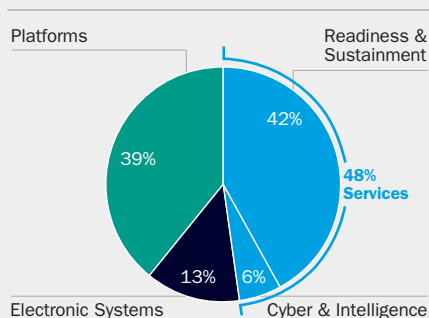
M&A activity

In addition to pursuing organic growth, the Group has continued to make progress in developing its business through targeted acquisitions. Notably, acquisitions have been made since January 2010 in Services and Electronic Systems, specifically high technology electronic and electro-optic systems. BAE Systems continues to target these areas, which are identified as priorities for customers and offer prospects for growth.

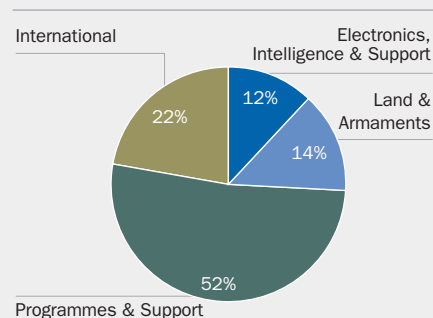
In July 2010, the Group completed the acquisition of Atlantic Marine Holding Company, a naval services business, for \$372m (£245m). The business employs approximately 1,500 people at Mayport and Jacksonville, Florida; Moss Point, Mississippi; and Mobile, Alabama. The acquisition complements BAE Systems' existing ship repair and upgrade capabilities serving the US Navy. The Group anticipates continued strong demand for naval support capabilities in the US, and the acquisition is consistent with our strategy to address anticipated growth in Services activities.

Our Services activities contributed 48% of Group sales¹ in 2010

SALES¹ BY MARKET SEGMENT (%)



ORDER BOOK^{2,3} BY OPERATING GROUP (%)



¹ Including share of equity accounted investments.

² Including share of equity accounted investments' order books and before the elimination of intra-group orders of £1.5bn.

³ Excluding HQ & Other Businesses.

In October, BAE Systems completed the acquisition of OASYS Technology, LLC, a US manufacturer of electro-optical systems and sub-assemblies, for an initial cash consideration of \$24m (£15m) and a potential earn out of up to \$29m (£18m). The acquisition complements BAE Systems' existing electro-optical capabilities, technologies and product offerings.

In January 2011, the Group completed the acquisition of stratsec.net Pty Limited, an Australian information security company supplying government and commercial customers. The A\$24m (£16m) acquisition supports the Group's strategy to add capabilities and footprint in the growing area of Cyber & Intelligence.

In February 2011, BAE Systems completed the acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, a leading provider of security and counter threat capabilities to the US government, for a cash consideration of approximately \$297m (£190m).

In December, the Group entered into a definitive agreement to acquire ETI A/S, a leading Danish Cyber & Intelligence company providing advanced technology products and services to government and commercial clients worldwide, for a cash consideration of DKK1.2bn (£138m).

In January 2011, the Group entered into an agreement to acquire the 91.3% outstanding equity of Fairchild Imaging, Inc. for a cash consideration of \$86m (£55m). The California-based business provides solid-state electronic imaging components, cameras, and systems for aerospace, industrial, medical and scientific imaging applications. The acquisition complements the Group's electro-optics and night vision capabilities.

The proposed acquisitions of ETI A/S and Fairchild are conditional, among other things, upon receiving regulatory approval.

In January 2011, the Group announced a recommended €217m (£186m) cash offer for Norkom Group plc, a provider of innovative counter-fraud and anti-money laundering solutions to the global financial services industry.

In June, BAE Systems completed the sale of half of its non-strategic 20.5% shareholding in Saab AB for a cash consideration of SEK1,041m (£92m). The sale of the Group's remaining investment in Saab is expected in due course.

In September, BAE Systems announced that it was reviewing strategic options with regard to its Platform Solutions business. In January 2011, the Group announced that the sale of the business was no longer being pursued.

Cash flow

Good cash generation has been achieved in the year, and is expected to continue, notwithstanding any short-term volatility. Use of this cash flow is expected to include a focus on pursuing opportunities for enhanced equity returns through investment in the business by way of organic development or precisely targeted acquisitions. In addition, the Group will continue to meet its pension funding obligations. Accelerated returns of capital to shareholders remain an option to address extended periods of balance sheet inefficiency.

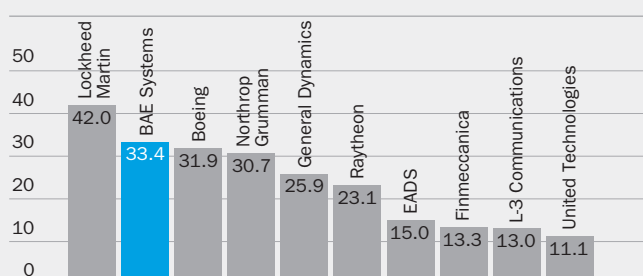
Market environment

The global defence market is expected to become increasingly competitive as government budgets remain under pressure. The Group now has better clarity as to the priorities of its UK and US customers following the publication of the UK Strategic Defence and Security Review, and the US Quadrennial Defense Review. Long-term spending commitments are being established across the Group's key home markets.

Against this backdrop, BAE Systems is positioned to weather market pressures with a geographically diverse and targeted portfolio of businesses.

Each of the Group's market segments, Services, Electronic Systems and Platforms, enjoy common attributes of long-term demand, customers with whom the Group has strong relationships and key intellectual property.

BAE SYSTEMS' GLOBAL DEFENCE MARKET POSITION (US\$BN)



Top ten global defence companies (based on 2009 defence revenues)

Source: Defense News

In 2009, BAE Systems was the second largest global defence supplier. This represented a continuation of the Group's position in its home and export markets.

p20 For more information on the Group's home and export markets

Total Performance

Total Performance is not just about what the Group does but also about how we do it. Building a culture of Total Performance means focusing on delivering shareholder value, on meeting the needs of our customers and acting responsibly at all times.

BAE Systems performed well in 2010, delivering against both its Financial Performance and non-financial objectives, including Customer Focus, Programme Execution and Responsible Behaviour. Embedding the importance of non-financial performance measures in the culture of the Group, through the drive for a more integrated, Total Performance, approach, has contributed to this success.

BAE Systems is committed to achieving the highest standards of business conduct to give its customers, suppliers, regulators, employees and shareholders the confidence that it is a business which they can trust. During the year, a major focus has been on embedding a culture of Responsible Behaviour across the business. Mandated policies and processes within our Operational Framework have been comprehensively updated to ensure they reflect our Responsible Trading Principles. Employees in all markets are receiving refresher training to help them to continue to apply our global Code of Conduct in their work. This training is scheduled to be completed by May 2011. We are pleased at the progress made and have commissioned ethics consultancy, Ethical Leadership Group, to review the work undertaken in response to the Woolf Committee recommendations. Interviews with a number of senior leaders in each home market and more than 60 employee focus groups across our businesses have been undertaken.

We are deeply saddened to report the death of one of our employees at our York facility in the US. We have reviewed the cause of this accident and co-operated fully with the regulatory investigation. The regulatory authority was unable to determine a cause for the accident or identify any non-compliances during the course of its investigation and, as a result, has taken no further action. Any lessons learnt from this incident will be applied across our global business.

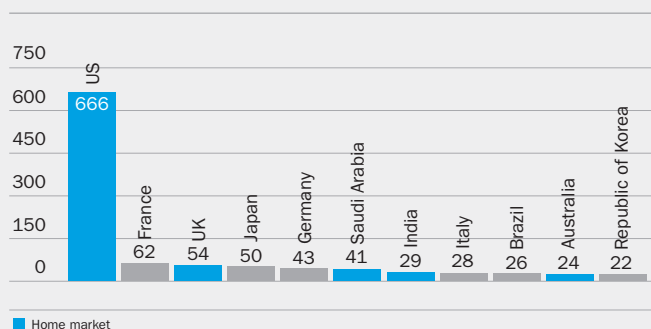
Maintaining and developing the skills and capabilities of our people is a key factor in the sustained success of the Group. As well as Total Performance Leadership (see page 34), programmes for high potential employees, leadership and competency frameworks were provided, and appropriately tailored, to each of the Group's home markets. The Group's 'Developing You' programme continued to deliver training across a number of functional specialities and a Diversity & Inclusion strategy was adopted to better support the recruitment, retention and engagement of talented employees from all backgrounds.

BAE Systems remains a broadly-based and resilient business, with a focus on business opportunities in Services, Electronic Systems and Platforms. In addition, cost efficiency will continue to be a priority focus for management to the benefit of customers and to extract greater performance from the Group's large order book.



Ian King
Chief Executive

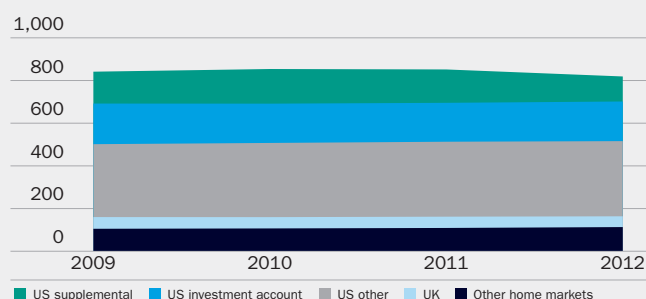
ACCESSIBLE DEFENCE MARKETS (US\$BN)



Top 11 markets accessible for business by the Group (based on 2009 total defence expenditure)
Source: BAE Systems' internal analysis

The US continues to dominate global defence expenditure. It is estimated to have accounted for approximately 44%¹ of the world's total defence expenditure in 2009. As a major supplier in the US market, BAE Systems remains well positioned to capture returns from that market.

FORECAST DEFENCE BUDGETS FOR BAE SYSTEMS' HOME MARKETS (US\$BN)



In constant 2010 prices
Source: BAE Systems' internal analysis

Whilst persistent pressure on spending is expected across government markets, defence and security expenditure is expected to remain an investment priority in the Group's key home and export markets. The Group is well positioned in Australia and the Kingdom of Saudi Arabia, and developing its position in India. These are markets in which defence spending is expected to increase over the medium term.

¹ Based on BAE Systems' internal analysis.

EXECUTIVE COMMITTEE TOP TEN OBJECTIVES – 2010 PERFORMANCE

The Board reviews and updates the Group's strategy annually. The Chief Executive and Executive Committee agree the Group's Strategy, Strategic Actions and Integrated Business Plans. In addition, there are ten annual objectives agreed by the Chief Executive and Executive Committee with the Board which focus on specific deliverables in support of both delivery of short-term results and the overall strategy. The specific in-year performance indicators used to measure performance against the Executive Committee's top ten objectives are discussed below.

Objective	2010 Performance	For more information
1. Meet 2010 financial targets, and set challenging and realistic longer-term plans	The Group's targets for underlying EBITA ¹ and net debt were exceeded.	p36-41
2. Further enhance programme execution through cost performance	Programme execution has been good with the Group delivering an aggregated improvement in outturn margin across its major programmes.	p19
3. Focus on our commitments to our customers through schedule performance	The Group has continued to deliver on its commitments to customers, delivering an aggregated improvement in schedule adherence on milestones across major projects.	p18
4. Progress towards recognised leadership position in Responsible Behaviour	Management has continued to embed the Total Performance agenda across the Group. Objectives in respect of business conduct, safety, and diversity and inclusion have been achieved.	p45-55
5. Grow our Electronics, Intelligence & Support business both organically and via acquisitions, and improve efficiency	The agreed efficiency milestones were implemented and the business delivered a 1.6 percentage point improvement in return on sales. Order intake growth of 7.5% was achieved. The Group acquired Atlantic Marine and OASYS Technology during the year, and, in February 2011, completed the acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, a leading provider of security and counter threat capabilities to the US government.	p66-67
6. Implement our global land systems strategy, and deliver on our efficiency and rationalisation plans	Planned rationalisation milestones were implemented and headcount reduction is exceeding plan. The Group has continued to support the US Army's Heavy Brigade Combat Team – a \$629m (£402m) contract to upgrade 1,700 Caiman Mine Resistant Ambush Protected (MRAP) vehicles was received, and the South African business was awarded contracts for the manufacture and upgrade of MRAP RG31 vehicles.	p68-69
7. Establish in the UK sustainably profitable through-life business in air, land and sea	The Strategic Defence and Security Review has set the agenda and defined the areas for future UK spend in security and defence. Transformation and rationalisation plans within Military Air Solutions, Surface Ships and Insyte are continuing to plan. In Submarine Solutions, HMS Astute was accepted by the MoD and the second boat, Ambush, was launched in January 2011. The Detica Cyber & Intelligence business delivered sales growth of 12.7%.	p70-71
8. Grow our home markets in the Kingdom of Saudi Arabia, Australia and India	Within the International business, like-for-like sales grew by 15.3%. In Saudi Arabia, an additional 162 Saudi nationals were recruited. In India, the land systems joint venture with Mahindra & Mahindra became operational and its first new product unveiled. The Indian Defence Acquisition Council approved an accelerated process for the procurement of the M777 howitzer.	p72-73
9. Implement our global initiatives	A global Cyber & Intelligence strategy and implementation plan across the US, UK and Australia has been issued. The Group acquired stratsec.net, an Australian information security company, in January 2011, and announced the proposed acquisitions of ETI A/S and Norkom Group plc, both Cyber & Intelligence companies. A global Readiness & Sustainment plan has been developed and Atlantic Marine, a US naval services and marine fabrication business, was acquired in the year.	p15
10. Continue to develop our global markets	Following successes in 2010 on MOKYS ² , Hawk and Archer, the Group continues to pursue export opportunities, including on Typhoon, Hawk and land prospects.	p21

p16 For more information on the quantitative Key Performance Indicators (KPIs) used to measure performance against the Executive Committee's top ten objectives

p56 For more information on the Group's approach to risk management

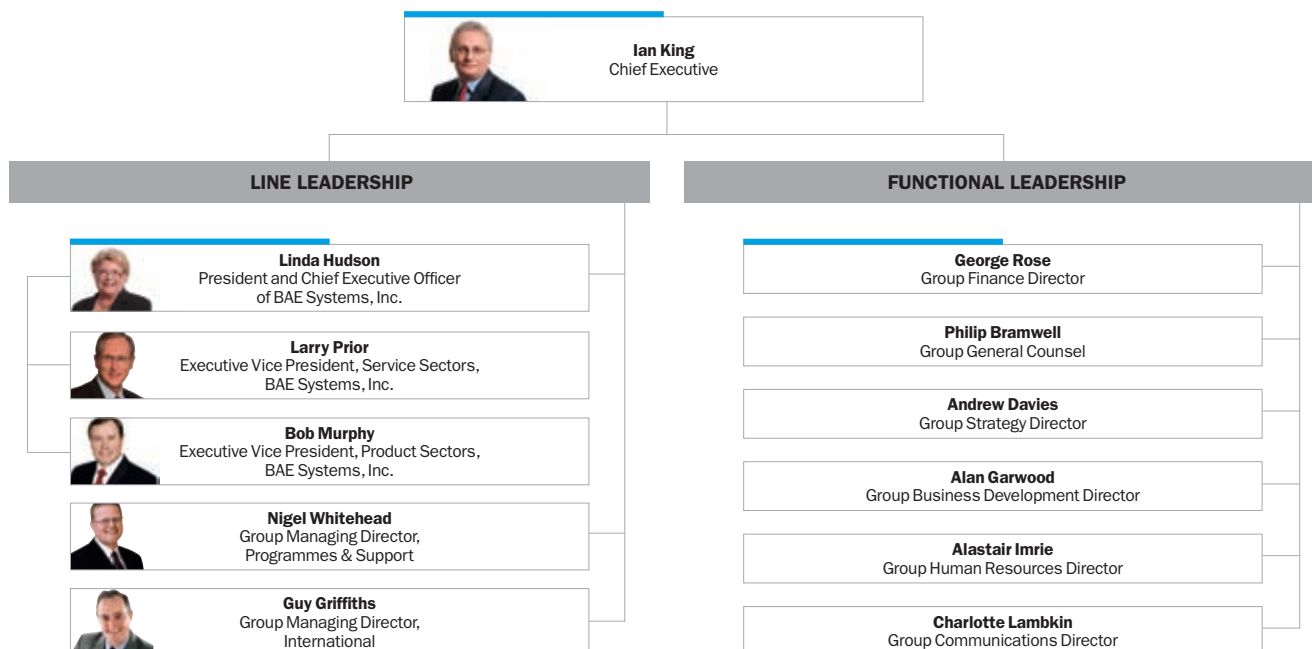
p107 For more information on how the Executive Committee's top ten objectives relate to the remuneration of executive directors

¹ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

² Mobile military communications system.

THE EXECUTIVE COMMITTEE

The Executive Committee is the forum chaired by the Chief Executive in which the operating group and functional leaders come together to communicate, review and agree on issues and actions of Group-wide significance.



Executive Committee top ten objectives – 2011

The Executive Committee has set the following objectives for 2011. A review of performance against these objectives will be contained in the Annual Report 2011. The aim of these objectives is to provide focus for the leadership and engagement of employees at all levels in the Group in support of both delivery of short-term results and the overall strategy.

Objective	
1. Financial Performance	Meet 2011 financial targets and deliver sustainable growth in shareholder value
2. Programme Execution	Further enhance programme execution through cost performance
3. Customer Focus	Focus on our commitments to our customers through schedule performance
4. Responsible Behaviour	Progress towards recognised leadership position
5. International	Grow our International presence through implementation of our home market strategy
6. US product businesses	Deliver actions to drive increased shareholder value
7. Programmes & Support	Deliver in the UK sustainably profitable through-life business in the air and maritime sectors, and grow our security business
8. US services businesses	Build a foundation for sustained profitable growth
9. Global initiatives	Implement our global initiatives within the five-year plan
10. Business development	Continue to develop and deliver business within export markets

Strategy

Our strategy

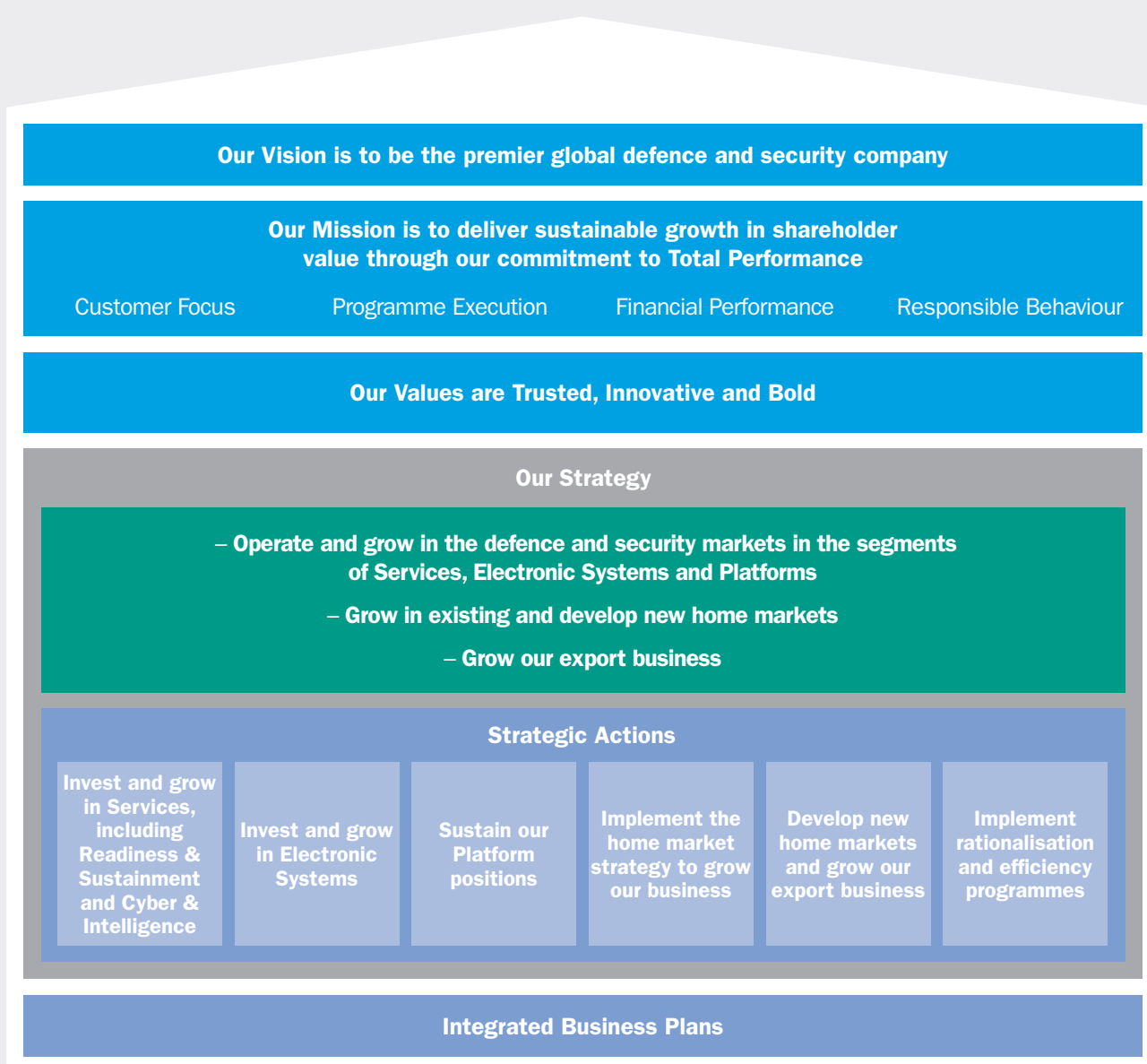
The Group's strategy integrates its major goals and actions into a cohesive whole. It provides the framework which defines the direction and shape of the Group over the long term. This enables the Group to prioritise the deployment of its resources.

To address evolving challenges and maximise the Group's resilience in the current environment, it has reviewed and refined the strategy, so as to ensure it remains robust, fit for

purpose and continues to deliver value. The Group is not complacent and efficiencies continue to be driven hard within the business.

Our business is focused on the defence and security markets, and our home market investments in Australia, India, Saudi Arabia, the UK and the US. Sweden and South Africa are no longer viewed as home markets, but remain an important part of the Group's Land & Armaments business.

GROUP STRATEGIC FRAMEWORK – 2011



The home markets in which the Group operates have been refined on the basis of strategic alignment, market materiality, financial and risk profile, and the presence of a sustainable business. The Group will continue to look for additional home markets, and its current focus is on markets in South America and Asia.

At the core of the Group's strategy is the creation of long-term sustainable value for the Group's shareholders, and leadership

in three market segments – Services, Electronic Systems and Platforms. The global initiatives in Land, Security, Readiness & Sustainment and Unmanned Aircraft Systems have now moved successfully from initiatives to fully embedded operational plans within the businesses.

The Group continues to evolve its strategy. The Group Strategic Framework has been refreshed for 2011.

Vision

The Group's consistent **Vision** provides a clear definition of the future state it wishes to attain – it is “to be the premier global defence and security company”.

Whilst the Group's Vision defines the destination, a commitment to **Total Performance** guides its actions. This is embedded in the Group's Mission.

Mission

The Group's **Mission** describes its overall goal and the philosophy that underpins its activities – it is “to deliver sustainable growth in shareholder value through our commitment to Total Performance” wherever we operate.

The Group believes that by embodying the four elements of **Total Performance** – Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour – it will deliver that growth in shareholder value.

Values

Achieving a culture of Total Performance depends on all employees living the Group's **Values** – Trusted, Innovative and Bold. Having shared values helps to bind the Group together and underpins delivery of its strategy.

Trusted

We deliver on our commitments:

- We are honest and take responsibility
- We can be relied upon
- Everyone matters

Innovative

We create leading edge solutions:

- We value imagination and experience
- We empower teams
- Working together we turn our ideas and technologies into solutions

Bold

We constructively challenge and take the initiative:

- We operate with tenacity and resolve
- We accept challenges and manage risk
- We set stretching goals

Strategy

There are three essential elements to the Group's **Strategy** which have been incorporated into the Group Strategic Framework for 2011.

Firstly, the Group plans to operate and target growth in the defence and security market segments of Services, Electronic

Systems and Platforms. Secondly, to build upon the geographic diversity which has fostered growth to date, the Group will target growth in existing home markets and develop new home markets. Finally, the Group will target growth from export business.

Strategic Actions

For 2011, the Group has revised its six **Strategic Actions** to reflect the market environment. They are designed to shape its business portfolio and strengthen performance over the long term. These actions translate the Group's overarching strategy into operational plans, delivered through its lines of business.

To this end, the Group plans to invest in Services, including Readiness & Sustainment and Cyber & Intelligence, and in Electronic Systems. It will seek to sustain the Group's Platforms positions across air, maritime and land. Whilst continuing to implement the home market strategy, the Group will also seek to develop both new home markets and its export business. The execution of the Group's strategy is underpinned by continuous implementation of rationalisation and efficiency programmes.

Integrated Business Plans

The **Integrated Business Planning** process is an annual, two-stage process that culminates in a BAE Systems Board and Executive Committee approved five-year strategic and financial plan, which is used to shape the Strategic Actions.

The plan is based on individual Integrated Business Plans from each of our businesses, which are prepared in accordance with our Operational Framework (see page 84).

Key Performance Indicators (KPIs)

The Board uses a range of quantitative financial and non-financial performance indicators, reported on a periodic basis, to monitor the Group's performance against its Total Performance and Executive Committee top ten objectives. Executive directors' remuneration is linked to certain of these measures. The specific in-year performance indicators used to measure performance against the Executive Committee's top ten objectives are discussed on page 12.

Financial Performance

The Group sets itself challenging financial targets through the Integrated Business Planning process.

Link to 2010 Executive Committee top ten objectives p12

1. Meet 2010 financial targets; 5. Grow our Electronics, Intelligence & Support business; 6. Implement our global land systems strategy; 7. Establish in the UK sustainably profitable through-life business in air, land and sea; 8. Grow our home markets in the Kingdom of Saudi Arabia, Australia and India; 9. Implement our global initiatives; 10. Continue to develop our global markets

Link to executive directors' 2010 annual incentive p107

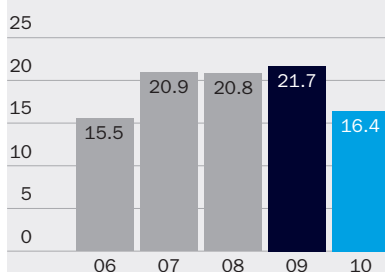
Group Earnings per Share, Group cash

Link to principal risks p58

All of the Group's principal risks could materially impact its Financial Performance

Performance

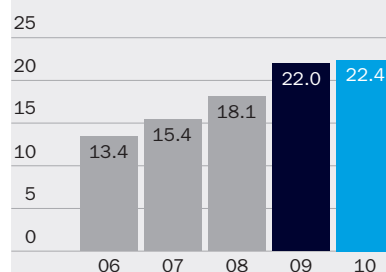
ORDER INTAKE^{1,2} (£BN)



£16.4bn

2009: £21.7bn¹

SALES^{1,2} (£BN)



£22.4bn +1.8%

2009: £22.0bn¹

Definition

Order intake² represents the value of funded orders received from customers in the year. It is a measure of in-year performance and supports future years' sales performance.

Sales² represents the amounts derived from the provision of goods and services, and includes the Group's share of sales of its equity accounted investments.

Comment

The reduction in order intake² reflects the significant awards received in 2009 for long-term production of Typhoon Tranche 3A aircraft, and support for Typhoon, Harrier, Type 45, and Spearfish and Sting Ray torpedoes.

A 1.9% like-for-like decrease in sales² this year has primarily been driven by the expected lower level of US land vehicle sales in the Land & Armaments business, which was largely offset by increased Typhoon deliveries and support activities in the Kingdom of Saudi Arabia.

All Financial Performance KPIs, with the exception of operating business cash flow, reflect results from the Group's continuing operations.

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

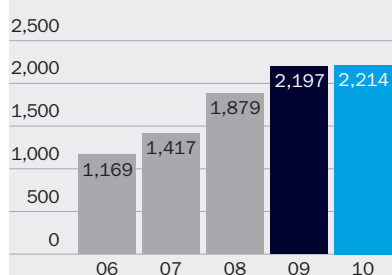
2 Including share of equity accounted investments.

3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

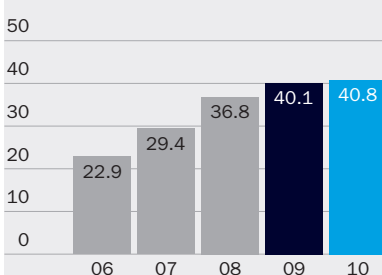
4 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 10 to the Group accounts).

5 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

6 The target is the Group's budget for the year, which represents the first year of the five-year Integrated Business Plan (see page 15).

UNDERLYING EBITA^{1,3} (£M)

£2,214m +0.8%
2009: £2,197m¹

UNDERLYING EARNINGS^{1,4} PER SHARE (EPS) (PENCE)

40.8p +1.7%
2009: 40.1p¹

✓ Target⁶ achieved

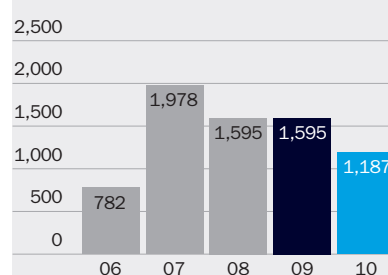
▶ Part of the executive directors' 2010 annual incentive

Underlying earnings⁴ represent profit for the year attributable to equity shareholders excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items (see note 10 to the Group accounts). Underlying EPS provides a measure of shareholder return that is comparable over time.

The charge of £100m taken in respect of the terminated Trinidad and Tobago ship contract amounted to a 2.1p reduction in reported EPS. Excluding this charge, underlying EPS growth was 7.0%.

Underlying EBITA³ is used to monitor the year-on-year profitability of the Group. It excludes amortisation and impairment of intangible assets, finance costs and taxation expense, and non-recurring items (these are profit/loss on disposal of businesses, pension accounting gains, and regulatory penalties levied by the US Department of Justice and the UK's Serious Fraud Office).

Excluding favourable exchange translation, underlying EBITA³ was broadly unchanged. Excluding a charge of £100m taken in respect of the terminated Trinidad and Tobago ship contract, return on sales improved to 10.3%.

OPERATING BUSINESS CASH FLOW⁵ (£M)

£1,187m
2009: £1,595m

✓ Target⁶ achieved

▶ Part of the executive directors' 2010 annual incentive

Operating business cash flow⁵ represents net cash flow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

Relative to 2009, the reduction in operating business cash flow⁵ reflects the utilisation of customer advances in the Programmes & Support and International operating groups, incremental deficit funding primarily in respect of the UK pension schemes, and a payment made in respect of the regulatory penalty levied by the US Department of Justice.

p36 For more information on the Group's financial performance

p64 For more information on the financial performance of the operating groups

Customer Focus

The Group's priority is to understand its customers' needs and expectations, and deliver on its commitments throughout the life of its products and services.

Link to 2010
Executive Committee
top ten objectives **p12**

3. Focus on our commitments to our customers through
schedule performance

Link to executive directors'
2010 annual incentive **p107**

Other objectives

Link to principal risks
p58

Defence spending, government customers, global market, contract
award timing

Performance

SCHEDULE ADHERENCE

The Group targets an aggregated improvement in schedule adherence metrics relating to milestones across its major contracts.

Schedule adherence metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.

✓ Target achieved

➤ Part of the executive directors' 2010 annual incentive

Definition

Schedule adherence measures the timing of achievement of key milestones. It shows how well the Group is performing against key contract commitments to its customers.

Comment

The data for the schedule adherence metric included 91 (2009 88) contracts reported in Contract Reviews prepared under Lifecycle Management (LCM). Performance was strong, achieving the year's target.

CUSTOMER SATISFACTION

The Group targets an aggregated year-on-year improvement in customer satisfaction across its major contracts.

Customer satisfaction metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.

✓ Target achieved

➤ Part of the executive directors' 2010 annual incentive

Customer satisfaction surveys are used to collect customer opinions on key customer-funded projects. This provides an opportunity for customers to share information on perceived performance levels, and identify areas of strength and weakness.

The data for the customer satisfaction metric included 90 (2009 85) contracts reported in Contract Reviews prepared under LCM. The year's target was achieved. Plans to improve performance on those contracts reporting a deterioration in customer satisfaction are being implemented.

p32 For more information on LCM, which provides a structured approach to managing contractual commitments and investments throughout project and product lifecycles

Programme Execution

The Group's performance is dependent on the successful execution of projects. It is important that the Group wins and contracts for high quality new programmes, and delivers on its projects within tight tolerances of quality, time and cost performance.

Link to 2010 Executive Committee top ten objectives p12	2. Further enhance programme execution through cost performance
Link to executive directors' 2010 annual incentive p107	Other objectives
Link to principal risks p58	Large contracts, fixed-price contracts, component availability, subcontractor performance and key suppliers

Responsible Behaviour¹

High standards of business conduct are essential to the Group's mission to deliver sustainable growth.

Link to 2010 Executive Committee top ten objectives p12	4. Progress towards recognised leadership position in Responsible Behaviour
Link to executive directors' 2010 annual incentive p107	Business conduct, safety
Link to principal risks p58	Laws and regulations

PROGRAMME MARGIN VARIATION

The Group targets an aggregated year-on-year improvement in programme margin across its major contracts.

Programme margin variation metrics can only be fully interpreted and understood on a contract-by-contract basis and, therefore, aggregated data is not presented.

✓ Target achieved

▶ Part of the executive directors' 2010 annual incentive

Programme margin variation measures outturn projections of and movements in margin of key customer-funded projects. It provides an indicator of the Group's ability to effectively manage major programmes.

The data for the programme margin variation metric included 105 (2009 105) contracts reported in Contract Reviews prepared under LCM, representing over 70% of the Group's order book. The target was achieved despite the impact of the termination of the Trinidad and Tobago ship contract.

RESPONSIBLE BUSINESS CONDUCT AWARENESS TRAINING²

The Group's target is to train all employees during the period May 2010 to May 2011.

During the period to 31 December 2010, more than 50% of employees were trained.

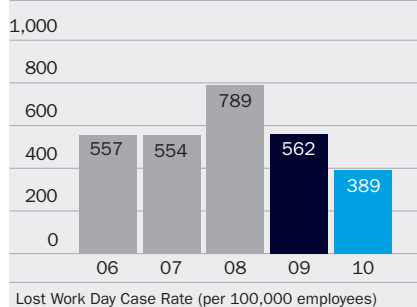
Objective ongoing

The global Code of Conduct was launched in January 2009. It defines the principles and standards of responsible business conduct the Group expects of employees wherever they work globally. Following the completion of the roll-out of the global Code of Conduct in early 2010, managers throughout the Group were asked to lead face-to-face training on responsible business conduct to raise further the ethical awareness of its employees. Accordingly, this year, the global Code of Conduct KPI has been replaced by the Responsible Business Conduct Awareness Training² KPI.

Training was completed by employees in the Electronics, Intelligence & Support and Land & Armaments businesses. All other businesses are on track to complete training by the end of May 2011.

An update on performance to 31 May 2011 will be provided in next year's Annual Report.

SAFETY



Lost Work Day Case Rate (per 100,000 employees)

The Group targeted a 20% improvement in the Lost Work Day Case Rate compared with 2009.

✓ Target achieved

▶ Part of the executive directors' 2010 annual incentive

The number of incidents resulting in days lost to injuries per 100,000 employees is monitored, and actions taken to minimise the risk to the Group's employees and its operations, and drive continual performance improvement.

In 2010, the overall Group improvement was 31%.

p45 For more information on the Group's corporate responsibility performance

p66–72 For more information on the safety performance of the operating groups

- 1 In the Annual Report 2009, a KPI was presented relating to a 20% targeted improvement in the Group's Operational Assurance Statement (OAS) scores below the minimum standard. In 2010, the Executive Committee's objective relating to OAS was to agree action plans in respect of all scores below minimum standards. Whilst this objective has been achieved, it is not presented as a Responsible Behaviour KPI this year. Further information on OAS is provided on page 87.
- 2 The Responsible Business Conduct Awareness Training objective is not a 2010 Executive Committee objective, but the Executive Committee has committed to complete this for all employees by 31 May 2011.

Key home markets

Global positions in home markets and export opportunities

UNITED KINGDOM



No.1

supplier to the Ministry of Defence

38,400

Employees²

\$54bn (£35bn)

Defence expenditure³

2.5%

of GDP³

UNITED STATES



6th

largest supplier to the Department of Defense¹

39,200

Employees²

\$666bn (£426bn)

Defence expenditure³

4.7%

of GDP³

The Group's five key home markets generated 92% of Group sales⁴ in 2010

Home markets

BAE Systems continues to benefit from a broad and diverse market base, operating indigenous businesses in market segments where it sees good, sustainable growth prospects. Today, the Group is focused on five key home markets, in Australia, India, the Kingdom of Saudi Arabia, the UK and the US.

These markets are identified as having a significant and sustained commitment

to defence and security budgets across multiple domains. They are countries that welcome foreign investment to develop and sustain a domestic industrial capability. They are also markets where we have established, or seek to establish, a good position in their defence industrial base along with strong customer relationships and high standards of responsible business conduct.

1 Based on 2009 Department of Defense expenditure. Source: GovernmentExecutive.com

2 Excluding the Group's share of equity accounted investments.

3 Based on 2009 data.

4 Including share of equity accounted investments.

5 Mobile military communications system.

SAUDI ARABIA

p26

No.1

in-country defence supplier

5,300

Employees²

\$41_{bn} (£26_{bn})

Defence expenditure³

10.9%

of GDP³

INDIA

p30

New

home market in 2009

\$29_{bn} (£19_{bn})

Defence expenditure³

2.4%

of GDP³

AUSTRALIA

p28

No.1

in-country defence supplier

5,700

Employees²

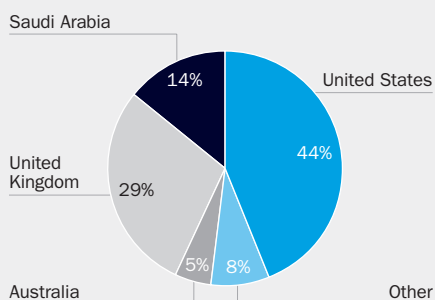
\$24_{bn} (£15_{bn})

Defence expenditure³

2.4%

of GDP³

SALES⁴ BY KEY HOME MARKET (%)



Export markets

Exports are an increasingly important part of the Group's business. BAE Systems has opportunities to export its products to many countries around the world. There is renewed support from both the US and UK governments for defence and security export efforts.

Export successes in 2010 include MOKYS⁵ to Slovakia, Hawk Advanced Jet Trainer to India and Archer self-propelled artillery system to Norway.

Many of the Group's products have export potential, but the focus in 2011 will be on the Typhoon combat aircraft, M777 howitzer, Bradley and CV90 vehicles, and Hawk trainer.

The Group will continue to evaluate potential new home markets in countries that match the Group's established criteria. The economic strength and growing defence budgets of markets in South America and Asia make them particularly suitable.

Key home markets in detail

United States

Market context

The US remains the largest single defence market with 2009 defence spending of \$666bn (£426bn). The 2010 Quadrennial Defense Review (QDR) identified growth in investment allocations and confirmed strategic priorities.

Our position

BAE Systems is a large and high-performing part of the US defence industrial base, ranked the sixth largest US defence contractor in 2009. The Group is well positioned to support its US customers with a balance of products, technologies and services. The US business encompasses a diverse range of customers and contracts with relatively low exposure to any single programme.



Atlantic Marine acquisition

In July 2010, BAE Systems acquired Atlantic Marine, a naval services business. The acquisition has enhanced BAE Systems' ability to support current and future US Navy home-porting strategies, broadened the customer base, and increased capabilities in maritime maintenance and modernisation activities.

Outlook

After exceptional growth in the last decade, the US Department of Defense now forecasts a declining rate of growth and eventual flattening of the defence budget, representing an overall reduction of approximately \$78bn (£50bn) to the Five Year Defense Plan 2010 to 2015. However, the US government remains committed to protecting the size, reach and fighting strength of the military, and has committed to substantial investments in high priority capabilities and programmes.

Increases in procurement funding are expected to be largely funded through new cost efficiencies as operations and maintenance funding is expected to occupy an increasing proportion of the baseline budget. More than \$100bn (£64bn) in savings have already been identified to allocate to high priority programmes, and a new initiative has been launched to ensure value from contracting for defence goods and services.

In recognition of the growing importance of affordability and efficiencies, BAE Systems streamlined the organisation of its US business in 2010 to reduce costs and improve flexibility. With the Land & Armaments market impacted by lower demand for new vehicles, BAE Systems continues to rationalise its facilities and other costs to sustain profitability, and compete more effectively for development, production, upgrade and Readiness & Sustainment contracts.

The Cyber & Intelligence market segment is a priority area for further investment by the US government and represents one of the opportunities for growth in the US.

Opportunities

BAE Systems continues to benefit from its presence in capability and product sectors that are expected to grow against the general downturn and wider market pressures.

The Group continues to invest in distinctive capabilities that provide competitive advantage. In Services, the acquisition of Atlantic Marine in July enhances the ability of the Group's ship repair business to support maritime maintenance and modernisation. The acquisition of OASYS Technology enhances the Group's product offerings in growing markets for Electronic Systems, as would the proposed acquisition of Fairchild Imaging. In February 2011, the Group completed the acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, which expands its existing presence in the US intelligence community.

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

Opportunities in action ►

In the US, the business is focused on expanding capabilities and contracts in the Cyber & Intelligence market segment – bringing BAE Systems to new markets and customers. In September, BAE Systems was selected to provide critical information security safeguards, including certification and accreditation, to ensure the confidentiality and privacy of US Federal Bureau of Investigation (FBI) computer networks in the US and around the world.

Under this \$40m (£26m) contract, BAE Systems serves as the prime contractor offering information security risk assessments, a form of quality control. The information assurance process is continuously monitored and improved as risks change so that data, some of it classified, is transmitted, stored and protected safely. Continuous monitoring is a technique to address the security impacts on an information system resulting from changes to the hardware or software during the lifecycle.

Following this win, BAE Systems was also selected as one of 45 IT contractors to participate in the FBI's largest ever Indefinite Delivery, Indefinite Quantity (IDIQ) contract, potentially worth up to \$30bn (£19bn) amongst the competing contractors over an eight-year period.



United Kingdom

Market context

The 2010 National Security Strategy (NSS), and Strategic Defence and Security Review (SDSR) have defined the areas for future UK spend in security and defence.

Our position

The Group has a key role in supporting the UK armed forces, and the nation's security and intelligence capabilities. Together, the NSS and SDSR have confirmed that the Group's strategy for the UK market is focused on the appropriate areas. In defence, the business has a secure backlog of contracted business across air, maritime and land platforms, including significant Readiness & Sustainment contracts. In Cyber & Intelligence, the business continues to play a formative role supporting customers in the growing intelligence, civil government and commercial markets.



Type 45 programme

The Type 45 build programme is more than half complete, with delivery of the third of class, Diamond, sea trials for fourth of class, Dragon, and the launch of the final ship, Duncan, during 2010.

Outlook

In the air domain, the SDSR committed the UK to modernise and upgrade the capabilities of Typhoon, and to procure F-35 for operation from the Queen Elizabeth class aircraft carriers. In addition, the UK and France are expected to develop ideas for closer co-operation on Unmanned Aircraft Systems. These factors will contribute to the future sustainment of the Group's combat air capability.

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

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

Opportunities

Across all domains, the Group has been working with the Ministry of Defence to reduce costs and deliver military capability more effectively. Broad service offerings, including Readiness & Sustainment solutions, will be a key contributor to delivering additional savings and efficiencies. The Group is well positioned to expand these service offerings in support of the UK customer.

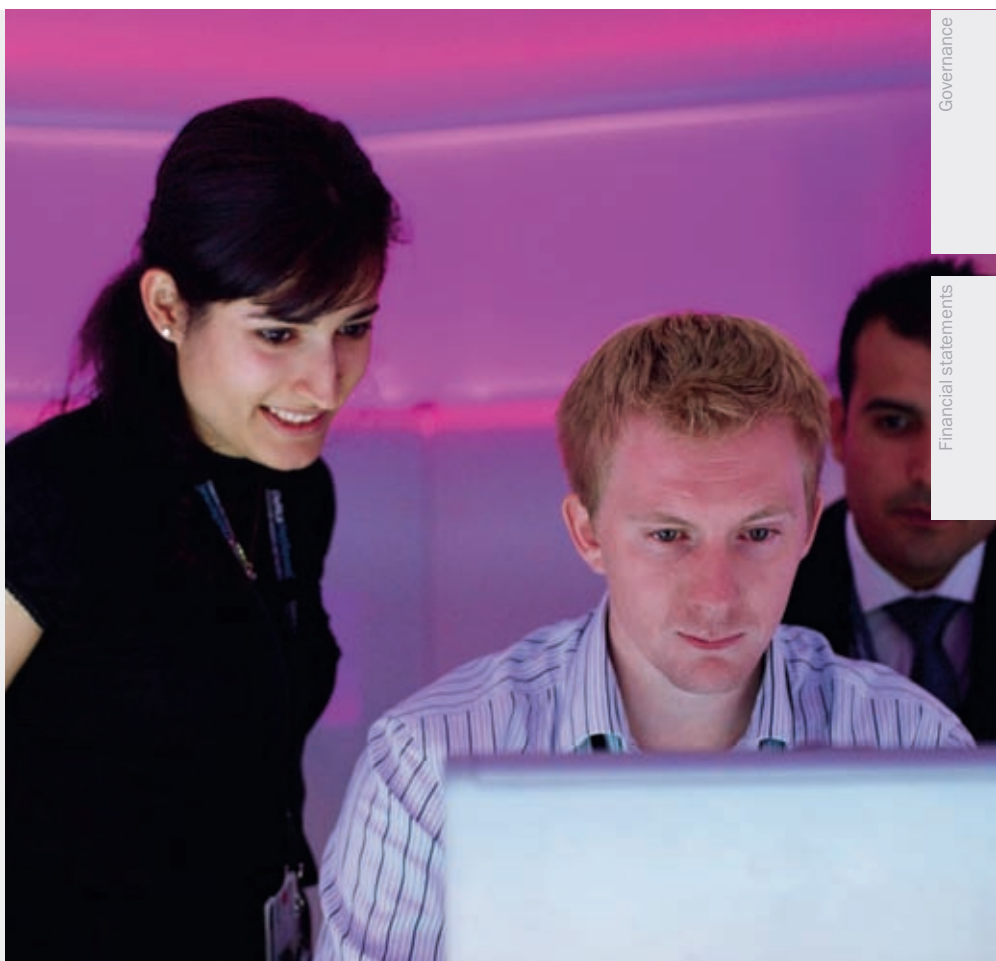
The Group's investment in Cyber & Intelligence positions it for growth in this expanding market segment. The Group is committed to delivering world class technologies and services to assist the government and commercial sectors to detect and defend against cyber attacks, prevent fraud and money laundering, and ensure secure delivery of services.

Opportunities in action ►

During 2010, the Group launched the Detica Treidan™ cyber threat detection service and is working with a number of clients including major private sector organisations to detect and stop sophisticated intrusions into their IT systems.

Building on the Group's capabilities in data capture and large scale data analytics, the Detica Treidan™ service hunts out patterns of unusual behaviour in order to detect unauthorised intruders who have gained access to protected systems using cyber attacks, and to stop these incursions before the attacker has had the opportunity to identify and compromise sensitive systems and information.

Findings from these highly sensitive operations confirm many of the messages in the SDSR about the threat to the UK's security and economic prosperity. The Group continues to invest in a wide range of new technologies and approaches in this area for which it forecasts growing demand as both public and private sector organisations become increasingly aware of the nature and scale of the threat to their operations.



Saudi Arabia

Market context

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

Our position

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

Investing in Saudi industry

BAE Systems continues to develop its presence in Saudi Arabia and remains committed to developing a greater indigenous capability in-Kingdom. The business is pursuing a policy of transferring technology and work to Saudi Economic Offset companies in areas such as the Tornado Programmed Depot Maintenance and Upgrade facility.



Outlook

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

Opportunities

BAE Systems is seeking to extend its activities to support all Saudi military and paramilitary forces.

In the air domain, availability contracting and additional support on the Salam Typhoon contract represent opportunities for the business.

In the land and maritime domains, there are a number of near-term direct programme prospects for vehicle artillery systems and maritime equipment.

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

Opportunities in action ►

The RSAF is now the sixth air force in the world to be flying Typhoon aircraft.

In 2007, a contract to supply 72 Typhoon aircraft to KSA was agreed and 18 were delivered by the end of 2010 in line with the programme.

In 2009, to support continued aircraft availability, the governments of the Kingdom of Saudi Arabia and the UK reached agreement on detailed arrangements under the Salam support solution to provide support for operations by the RSAF Typhoon fleet for a three-year period.

Building on BAE Systems' knowledge and experience gained working alongside the Royal Air Force in supporting the UK's Typhoon fleet, the Salam support solution provides a full availability service contract – the first of its kind for Typhoon. The contract includes training in the UK for RSAF Typhoon pilots and multi-skilled aircraft technicians. In support of the contract, BAE Systems continues to invest in local Saudi companies, develop an industrial technology transfer plan and train Saudi nationals to assist in the provision of Readiness & Sustainment.



Australia

Market context

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

Our position

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



Readiness & Sustainment

BAE Systems and Australian Army personnel inspect an upgraded M113AS4 Armoured Personnel Carrier at Bandiana, Victoria.

Outlook

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

Opportunities

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

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

Opportunities in action ►

In January 2010, BAE Systems began modifying the first of the Royal Australian Navy's ANZAC Class frigates to be upgraded under the Anti-Ship Missile Defence project. The upgrade will significantly improve the anti-ship self defence capabilities of the ANZAC Class by integrating leading-edge CEA Phased Array Radar, Vampir New Generation Infrared Search & Track, Sharpeye Navigation Radar Systems and an upgraded Combat Management System which will include an improved Operations Room layout. The platform integration of these systems requires significant structural modifications, and BAE Systems has developed innovative design solutions to minimise the impact on the ship's weight and stability.

In October 2010, the first ship departed from the BAE Systems production facility, and entered its test and trials phase, with delivery back to the customer anticipated in mid-2011.

This upgrade contract is a key example of BAE Systems' strong position in the Services segment of the Australian maritime market, a key focus for future growth.



India

Market context

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

Our position

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

Land systems joint venture

This year, the Group established a land systems joint venture with Mahindra & Mahindra Limited, which is currently marketing several vehicles, including the MPVi shown, with the support of BAE Systems' businesses across the world.



Outlook

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

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

Opportunities

The Group is committed to a programme of investment and technology transfer in support of its strategy to create indigenous capability in the Indian defence and security market, and significant order opportunities exist for BAE Systems.

In the air domain, BAE Systems continues to support EADS in the promotion of Typhoon for the Indian Air Force Medium Multi-Role Combat Aircraft competition, as well as working with HAL on the supply of Hawk AJT aircraft.

In land, India is trialling the M777 howitzer in advance of a potential purchase and further opportunities exist to sell FH77-B05 artillery.

Opportunities also exist to import capability from other areas of the Group to meet growing requirements in the security and land domains.

Opportunities in action ►

In 2010, BAE Systems secured a new order with HAL, worth £537m, to supply products and services to enable a further 57 Hawk AJT aircraft to be built under licence in India for the Indian Air Force and Indian Navy. The aircraft will be manufactured under licence at HAL's facilities in Bangalore, and BAE Systems will provide specialist engineering services, the raw materials and equipment necessary for airframe production, and the support package for the customer.

The new order extends the current partnership with HAL for a further six years.

The Hawk AJT fast jet training solution enables an air force or navy to prepare front-line pilots for the most modern fighter aircraft.



Resources

The Group's key resources and arrangements include its relationships with customers, subcontractors and other suppliers, people, research and development, and intellectual property. These resources, together with the application of the mandated policies and processes in the Operational Framework, help the Group to achieve its strategy.

Customers

The Group's core businesses are primarily defence and security-related, selling products and services in its home and export markets both directly and indirectly, mainly to government, but also to commercial, customers. Customer relationships often extend over decades, and span the full product and service lifecycle from initial concept definition, through the system development phase, into production and then on to support for the system in service.

– Improvements in schedule adherence and customer satisfaction achieved

Principal customers

The Group's most significant customers are the governments of the US, UK, Kingdom of Saudi Arabia and Australia. In the US, BAE Systems is subject to a Special Security Agreement that safeguards US national security interests, as a result of which BAE Systems is allowed to supply products and services of a highly sensitive nature to the US government. Agreements between the governments of the United Kingdom and Kingdom of Saudi Arabia relating to defence co-operation programmes remain essential to the development of the Group's business in Saudi Arabia. In Australia, BAE Systems is subject to an Overarching Deed with the Commonwealth of Australia that protects their national security and other interests, and allows the Group to own certain Australian defence-related industrial assets.

Indian government policy on Foreign Direct Investment mandates that foreign partners can hold a maximum of 26% equity in defence ventures.

Lifecycle Management (LCM)

The application of LCM, which is a mandated project management process, is fundamental to the Group's capability to deliver projects on time, within cost and according to agreed requirements, thereby meeting customer commitments. It provides a structured approach to managing the Group's projects throughout their lifecycles, promoting the application of best practice management, facilitating continuous improvement and providing a competitive advantage in the way that projects are managed.

The lifecycle of a project comprises business winning and contract execution phases. During business winning, management focuses on the customer's requirements and the ability of the Group to deliver a product or service at acceptable risk and profitability. In the contract execution phase, management concentrates on developing and proving the product or service to deliver to customers' requirements and planned margins.

Schedule adherence and customer satisfaction metrics are regularly reviewed by the Board to monitor contract milestone achievement, and to ensure that the Group is delivering on its commitments to its customers.

Customer Reviews

Throughout the project lifecycle, the Group engages extensively with its customers and undertakes Customer Reviews to drive change, and promote and sustain the growth and development of customer relationships.

Under the Operational Framework, businesses are required to undertake a Customer Review at least every two years with their key customers, using specified processes. Customer Reviews also include questions to determine customer perceptions of BAE Systems' ethics.

These reviews help the Group to understand how its customers perceive its performance and behaviours, and help to understand customer priorities, and to reshape services and behaviours when necessary.

Responsible Behaviour – business conduct

BAE Systems does not compromise on the way it conducts business, and consistency of this approach is key in defining its reputation. The Group has four Responsible Trading Principles (see page 33), which underpin all of its business activity.

The Group's corporate responsibility agenda, including its commitment to be recognised as a leader in business conduct, contributes to successful long-term relationships with customers.

KPI

The Group measures the success of its customer relationships through the schedule adherence and customer satisfaction KPIs (see page 18)

Working closely with the customer at the Group's new design and prototyping centre

BAE Systems opened a new state-of-the-art design and prototyping centre in Sterling Heights, Michigan, in close proximity to its customer to allow further development of an ongoing, collaborative working relationship. The centre houses facilities for vehicle and subsystem modifications, integration and testing, electrical assembly fabrication, software development and system integration of vehicle control and crew station electronics.



Subcontractors and other suppliers

Subcontractors and other suppliers provide the products and services needed to manage the business from design to manufacturing to Readiness & Sustainment. Managing performance and expenditure with suppliers, which can represent a significant portion of project cost, is an important value driver for the Group.

- **Top 1,000 suppliers are provided with the Group's global Code of Conduct and encouraged to work to equivalent standards**
- **Standard terms and conditions introduced across the UK and US**

Business sustainability

BAE Systems is committed to developing and improving relationships with suppliers to deliver better value and innovation for customers. To minimise risk to the Group, the financial health of key suppliers is assessed to ensure they can continue to deliver essential products and services. The Group's global database of vulnerable suppliers identifies those which may be at risk during the economic downturn, and which may need support to ensure business continuity.

Terms and conditions

Standard terms and conditions have now been introduced across the Group's UK businesses to help to ensure that a consistent approach to supplier management is adopted for routine purchases. These include clauses on environmental sustainability, business conduct and responsible trading. Other home markets are following suit. Standard terms and conditions had already been established by the Group's businesses in the US, and the majority have adopted the standards.

Capability development

Professional development of procurement staff is important. A training programme has been developed in partnership with the Chartered Institute of Purchasing and Supply in the UK, and with the Institute of Supplier Management in the US. The UK programme was launched in 2010, and the US version is scheduled to pilot in 2011.

Responsible Trading Principles

BAE Systems has four Responsible Trading Principles that underpin all of the Group's business activity. These are:

- we understand and support our customers' national security and other requirements;
- we work to BAE Systems' Values in all that we do;
- we assess carefully our products and services with the objective that neither BAE Systems nor our customers are exposed to significant reputational risk; and
- we are as open as practicable about the nature of our business.

Responsible Behaviour – business conduct

The behaviour of suppliers could potentially impact the Group's reputation and performance, and the Group is taking steps to encourage suppliers to adopt standards of Responsible Behaviour consistent with the Group's. In March 2010, the Group's Code of Conduct was sent to the top 1,000 suppliers who are encouraged to work to equivalent standards. Tenders from major suppliers are now also assessed against the Group's Responsible Trading Principles (see above).

Guidance has been introduced to help procurement teams apply the Group's Responsible Trading Principles, and criteria relating to business conduct, safety and environmental management have been integrated into supplier selection criteria and ongoing supplier management.

Responsible Behaviour – environment

Reducing environmental impacts in the supply chain continues to be a focus, with guidance published by the Group's Sustainable Procurement Working Group. BAE Systems remains committed to the UK Ministry of Defence's Sustainable Procurement Charter that seeks to improve environmental standards in the defence supply chain.

Supporting employment in the UK

In 2009, the Group's UK businesses spent an estimated £5.9bn on procurement of equipment, components, raw materials, rent, energy and services from its suppliers. It is estimated that some £4.1bn of this was spent in the UK.

Distributing BAE Systems' UK procurement spending across industrial sectors and examining the impact of that spending on total sales of different industries, using input/output tables, suggests that a typical job in BAE Systems in the UK supports a total of 1.2 jobs elsewhere in the economy. Put another way, taking into account the first and second tiers of suppliers, together the 42,360 Full-Time Equivalent (FTE) UK jobs at BAE Systems in 2009 supported a further 52,088 FTE jobs further down the supply chain.

Source: Oxford Economics



People

The Group's investment in its current and potential future workforce is designed to provide the capabilities and skills needed to deliver on the Total Performance objective. The Group takes a through-career approach to skills development, from influencing the choices made by people in full time education and early careers programmes to continuous professional development. Through the global application of its People Policy, the Group aims to provide an employment proposition that attracts, retains and engages highly skilled, motivated and valued people.

– 98,200 employees¹ globally

– During 2010, the Group recruited 441 graduates and 338 apprentices globally

Responsible Behaviour – safety

The Group's commitment to a strong safety performance is a fundamental responsibility, and contributes to business performance and employee engagement (see page 50).

Responsible Behaviour – diversity and inclusion

A focus on diversity and inclusion encourages innovation and enhances productivity by helping the Group to recruit, motivate and retain the best people (see page 51).

The People Policy within our Operational Framework obliges each employee to contribute to the creation of an inclusive work environment where individuals are respected and the value of a diverse workforce is recognised. Diversity and inclusion are included in the performance objectives of senior leaders.

The Group is committed to giving full and fair consideration to applications for employment from disabled people who meet the requirements for roles, and making available training opportunities and appropriate accommodation to disabled people employed by the Group. Unlawful discrimination against individuals with disabilities is not tolerated. The principles set out in the People Policy are subject to relevant legislative, regulatory and security requirements.

Capability development

Focused training and development programmes help to ensure that employees have the skills and technical know-how to meet our customers' changing needs. A strategic approach to training helps us to map employees' skills against changing business requirements and identify training priorities. Flexible training and development programmes encourage a culture of lifelong learning, helping employees to reach their full potential.

Developing leadership capability

The Total Performance Leadership framework provides an integrated approach to performance management, resourcing

and leadership development. It aims to strengthen leadership capabilities to optimise delivery of the Group's strategy. The framework provides a set of tools for matching individual's skills and potential with business goals, as well as feedback from employee surveys and customer reviews. It includes training, coaching and mentoring to support managers and aspiring leaders in achieving their career goals.

Education and early careers

Education programmes in the Group's home markets aim to interest young people in science and engineering careers. The schools road show in the UK, and the Group's sponsorship of FIRST (For Inspiration and Recognition of Science and Technology) in Australia and the US target school age students. The Group also partners with universities to develop courses that meet the needs of industry and provide placement opportunities for undergraduates.

In 2010, the Group launched its Skills 2020 strategy in the UK, a programme for delivering the skills the engineering and manufacturing sectors need over the next ten years. In the US, the Group is a member of Change the Equation (CTEq), an initiative to improve Science, Technology, Engineering and Mathematics (STEM) education for children. The goals of CTEq are to improve teaching in STEM subjects and inspire student learning and career choices in STEM.

The Group's education and early careers programmes support its commitment to diversity and inclusion, by tackling perceptions that engineering is a male career choice, and encouraging female and minority students to consider a career in the industry (see page 51).

Employee engagement

Regular internal communication, including newsletters and the intranet, keeps employees involved and motivated. Results from the 2010 biennial Group-wide employee survey demonstrated that the Group continues to engage proactively with its employees despite ongoing restructuring activities. The Group will analyse the results and develop action plans to address areas where appropriate to enhance its engagement with employees.

The Group has constructive relationships with trade unions, and regularly communicates and discusses business developments which impact the Group and its employees.

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



The Group measures its safety performance using the Lost Work Day Case Rate KPI (see page 19)

BAE Systems' commitment to future capability development

BAE Systems' graduate programmes are part of its wider commitment to future capability development, and are designed to help meet its future technology and leadership requirements. BAE Systems' core graduate programmes provide graduates with a development programme, which includes a residential Graduate Developing You programme and an annual conference. The Group's new UK graduate recruitment website won the best new corporate graduate recruitment website award at the 2010 Onrec Awards, the leading industry online recruitment awards.

In the UK, the Group is one of the biggest recruiters of engineering apprentices, employing 286 new apprentices in 2010.



¹ Including share of equity accounted investments.

Research and Development (R&D)

The Group is engaged in leading edge R&D programmes in support of the Services, Electronic Systems and Platforms that it provides to its customers.

– In 2010, R&D expenditure was £1,298m (2009 £1,211m) of which £270m (2009 £278m) was funded by the Group

The Group's R&D activities cover a wide range of programmes, and include technological innovations and techniques to improve the manufacturing and service of products.

The Group funds strategic R&D across the business, particularly in the Electronic Systems, Cyber & Intelligence and military Services market segments. Customers fund much of the near-term product development work undertaken by the Group.

BAE Systems has an Investment in Innovation programme aimed at small and medium-sized enterprises and academia to identify and accelerate the development of new technologies in support of customers' requirements. As well as providing financial support, BAE Systems offers expertise and resources, including the use of test and evaluation facilities. Current investments focus on the areas of cyber security, surveillance and biometrics.

An example of the Group's R&D activities within Cyber & Intelligence is the development of a technology demonstrator that integrates biometrics in the form of face and iris recognition to a prototype system that can recognise subjects on the move.

In military Services, for example, the Group has developed processes for the installation and testing of new capabilities on Tornado aircraft, including for urgent operational requirements, which have reduced timescales for delivery to the customer.

The Group continues to invest in autonomous systems in the air domain to address emerging global demand. In conjunction with its customer and industry partners, BAE Systems has designed, developed and built the Taranis autonomous stealthy unmanned combat air vehicle, which was unveiled during 2010.



BAE Systems is developing 'liquid armour' to protect frontline troops

BAE Systems has developed a counterintuitive liquid which hardens when struck as part of a project to create future body armour, offering soldiers greater ballistics protection and ease of movement in combat situations. The technology, referred to as 'liquid armour', harnesses the unique properties of shear thickening fluids which 'lock' together when subjected to a force to enhance the existing energy absorbing properties of material structures like Kevlar.

Ceramic-based armour plates used in current body armour systems to cover large areas of the torso are heavy and bulky, restricting movement and contributing to fatigue, particularly in harsh environments like Afghanistan.

'Liquid armour' seeks to address a requirement for materials which can offer troops increased protection with reduced mass, wider area cover, greater manoeuvrability and easy integration with other systems. The technology can be integrated into standard Kevlar body armour.

Intellectual property

Intellectual property is vital to the Group's success in obtaining and maintaining a competitive advantage.

– In 2010, the Group filed patent applications covering over 250 new inventions

– At 31 December 2010, BAE Systems had a total portfolio of patents and patent applications covering more than 2,000 inventions worldwide

The Group's intellectual property is a key competitive differentiator to the business in all market segments – Services, Electronic Systems and Platforms. It takes many forms, in products, processes and know how.

The Operational Framework mandates a policy to protect the Group's intellectual property (including patents, copyrights and trade marks) through appropriate use and observance of intellectual property law, so that returns made from the investment in R&D and technological innovation are protected, and commercial and business innovations are adequately safeguarded.



DEMON demonstrates 'flapless flight technology'

In September, the DEMON Unmanned Air Vehicle (UAV) successfully demonstrated 'flapless flight' in the UK. Developed by Cranfield University, BAE Systems and nine other UK universities, DEMON is designed to be able to forgo the use of conventional mechanical elevators and ailerons, which usually control the movement of an aircraft, in favour of novel aerodynamic control devices using blown jets of air. The aircraft is the outcome of a five-year programme jointly funded by BAE Systems and the UK's Engineering and Physical Sciences Research Council.

Financial performance

“A robust performance evidencing the quality and resilience of the Group.”

George Rose
Group Finance Director



FINANCIAL HIGHLIGHTS

- Headline sales² increased by 1.8%
- Underlying EBITA³ up 0.8% to £2,214m (2009 £2,197m) after a charge of £100m taken in respect of the terminated Trinidad and Tobago ship contract
- Underlying earnings⁴ per share increased by 1.7% to 40.8p (2009 40.1p)
- The total dividend has increased by 9.4% to 17.5p (2009 16.0p)
- £500m market purchase of shares completed

SUMMARY INCOME STATEMENT – CONTINUING OPERATIONS

		2010 £m	Restated ¹ 2009 £m
Sales²	KPI	22,392	21,990
Underlying EBITA³	KPI	2,214	2,197
Return on sales		9.9%	10.0%
Profit on disposal of businesses		1	68
Pension accounting gains		2	261
Regulatory penalties		(18)	(278)
EBITA		2,199	2,248
Amortisation of intangible assets		(392)	(286)
Impairment of intangible assets		(125)	(973)
Finance costs ²		(194)	(698)
Taxation expense ²		(461)	(352)
Profit/(loss) for the year		1,027	(61)

Exchange rates – average

£/\$	1.545	1.566
£/€	1.166	1.123
£/A\$	1.682	1.990

Following the sale of half of the Group's 20.5% shareholding in Saab AB, its share of the results of Saab AB to the date of disposal are now shown within discontinued operations for the current and prior periods (see note 9 to the Group accounts).

Income statement – continuing operations

Sales² increased by 1.8% to £22.4bn (2009 £22.0bn).

Like-for-like sales², after adjusting for the impact of exchange translation, and acquisitions and disposals, reduced by 1.9% as increased Typhoon deliveries and support activities in the Kingdom of Saudi Arabia were more than offset by the planned lower level of land vehicle sales in the US.

US-led businesses were responsible for 51% (2009 55%) of sales². Sales² generated from home markets represented 92% (2009 92%) of sales². The Group's sales² performance is illustrated in the bridge chart below.

Underlying EBITA³ Management uses an underlying profit measure to monitor the year-on-year profitability of the Group. This is defined as earnings before amortisation of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Underlying EBITA³ increased by 0.8% to £2,214m (2009 £2,197m). This increase includes favourable exchange translation of £25m. A charge of £100m was taken in the year in respect of the terminated Trinidad and Tobago ship contract. Excluding that charge, return on sales increased to 10.3%.

US-led businesses delivered 56% (2009 52%) of the Group's underlying EBITA³. The increase in underlying EBITA³ is illustrated in the bridge chart below.

Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature. The non-recurring items, which are unchanged from the prior year, are as follows:

In the prior year, **profit on disposal of businesses** of £68m included £58m for the finalisation of the accounting gain arising from the BVT joint venture transaction.

The **pension accounting gain** in the prior year of £261m resulted from pension benefit restructuring in the US.

The **regulatory penalties** of £278m in the prior year reflect the global settlement of the regulatory investigations by the US Department of Justice (DoJ) and the UK's Serious Fraud Office. The £18m charge in the current year reflects the US dollar exchange rate movement on payment of the penalty in respect of the DoJ.

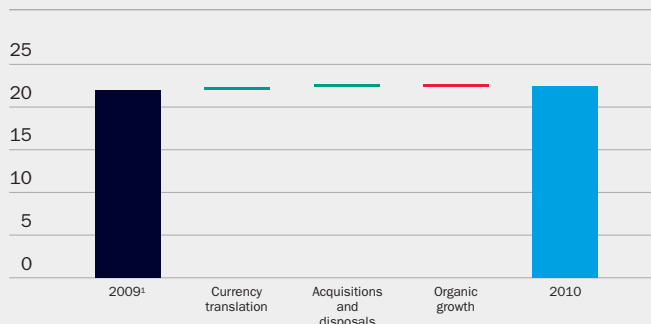
Amortisation of intangible assets is £106m higher at £392m mainly reflecting the profile of vehicle deliveries under the Family of Medium Tactical Vehicles (FMTV) contract.

Impairment of intangible assets of £125m includes £70m relating to the Surface Ships business primarily arising from the underperformance of the ex-VT Group export ship contracts. The £973m charge in the prior year primarily reflected the non-award of the follow-on FMTV production contract (£592m) and the weaker outlook for the US-based Products Group business (£264m).

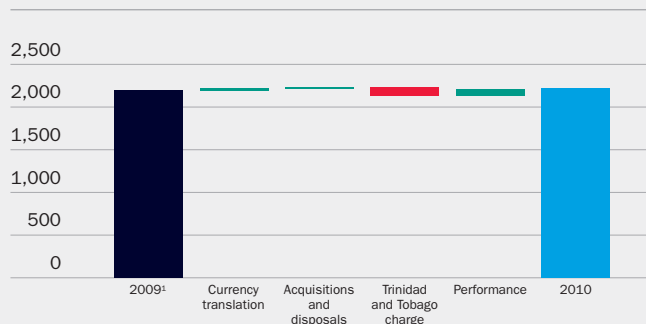
Finance costs² were £194m (2009 £698m). The underlying interest charge was £191m (2009 £193m). A net expense of £3m (2009 £505m) arose from pension accounting, marked-to-market revaluation of financial instruments and foreign currency movements. The net expense in the prior year arose from movements in exchange rates on the unhedged element of an intercompany loan from the UK to the US business. That loan has subsequently been capitalised.

Taxation expense² reflects an effective tax rate of 29% (2009 28%). The effective tax rate is based on profit before taxation excluding goodwill impairment of £84m (2009 £725m) and regulatory penalties of £18m (2009 £278m). The underlying tax rate for 2011 is expected to be around 30%, with the final number dependent on the mix of profits between the UK and US.

SALES² BRIDGE (£BN)



UNDERLYING EBITA³ BRIDGE (£M)



- 1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation.
- 2 Including share of equity accounted investments.
- 3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

Earnings per share – continuing operations

RECONCILIATION FROM UNDERLYING EBITA³ TO UNDERLYING EARNINGS⁴ – CONTINUING OPERATIONS

	2010 £m	Restated ¹ 2009 £m
Underlying EBITA³	2,214	2,197
Finance costs excluding non-cash finance movements on pensions and financial derivatives (see note 6 to the Group accounts)	(191)	(193)
	2,023	2,004
Taxation	(587)	(567)
Non-controlling interests	(29)	(22)
Underlying earnings⁴	1,407	1,415
Weighted average number of shares	3,451m	3,532m
Underlying earnings⁴ per share	40.8p	40.1p

Underlying earnings⁴ per share was 40.8p (2009 40.1p), an increase of 1.7%. The effect of the Trinidad and Tobago £100m charge taken in 2010, net of tax, amounts to an earnings per share reduction of 2.1p. Excluding that charge, underlying earnings⁴ per share increased by 7.0% compared with 2009. The increase in underlying earnings⁴ per share is illustrated in the bridge chart below.

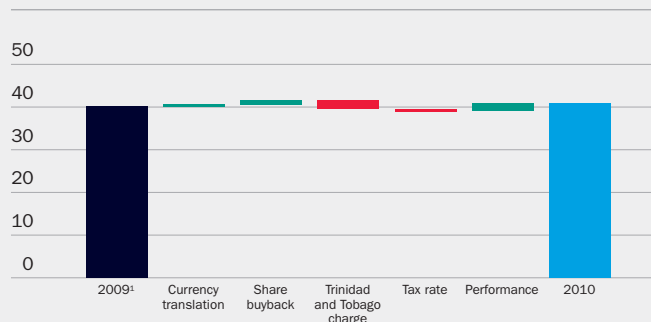
Basic earnings per share, in accordance with IAS 33, *Earnings per Share*, increased to 28.9p compared with a loss in 2009 of 2.3p.

Dividends

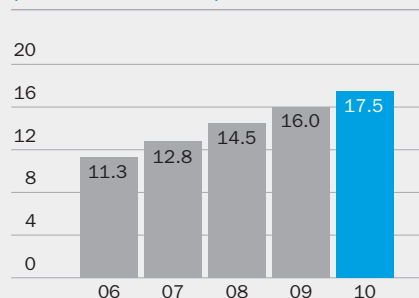
The Board is recommending a final dividend of 10.5p per share (2009 9.6p), bringing the total dividend for the year to 17.5p per share (2009 16.0p), an increase of 9.4%.

The proposed dividend is covered 2.3 times by underlying earnings⁴ from continuing operations (2009 2.5 times), which is consistent with the Group's policy of growing the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

UNDERLYING EARNINGS⁴ PER SHARE BRIDGE (PENCE)



DIVIDEND (PENCE PER SHARE)



1 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation.
2 Including share of equity accounted investments.
3 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items.

4 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items.
5 Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited.

Cash flow

RECONCILIATION OF CASH INFLOW FROM OPERATING ACTIVITIES TO NET (DEBT)/CASH (AS DEFINED BY THE GROUP)⁶

	2010 £m	2009 £m
Cash inflow from operating activities	1,535	2,232
Capital expenditure (net) and financial investment	(364)	(489)
Dividends received from equity accounted investments	71	77
Assets contributed to Trust	(25)	(225)
Cash held for charitable contribution to Tanzania	(30)	–
Operating business cash flow⁷	1,187	1,595
Interest	(173)	(186)
Taxation	(352)	(350)
Free cash flow	662	1,059
Acquisitions and disposals	(88)	(253)
Debt acquired on acquisition of subsidiary	–	(1)
Purchase of equity shares (net)	(520)	(20)
Equity dividends paid	(574)	(534)
Dividends paid to non-controlling interests	(32)	(5)
Cash (outflow)/inflow from matured derivative financial instruments	(123)	36
Movement in cash collateral	11	(11)
Movement in cash received on customers' account ⁸	7	(12)
Foreign exchange translation	(20)	262
Other non-cash movements	32	(157)
Total cash (outflow)/inflow	(645)	364
Opening net cash (as defined by the Group) ⁶	403	39
Closing net (debt)/cash (as defined by the Group)⁶	(242)	403

COMPONENTS OF NET (DEBT)/CASH (AS DEFINED BY THE GROUP)⁶

	2010 £m	2009 £m
Debt-related derivative financial assets	45	39
Other investments – current	260	211
Cash and cash equivalents	2,813	3,693
Loans – non-current	(2,133)	(2,840)
Loans and overdrafts – current	(920)	(453)
Less: Cash received on customers' account ⁸	(16)	(20)
Less: Assets held in Trust	(261)	(227)
Less: Cash held for charitable contribution to Tanzania	(30)	–
Net (debt)/cash (as defined by the Group)⁶	(242)	403

Cash inflow from operating activities was £1,535m (2009 £2,232m), which includes contributions in excess of service costs for the UK and US pension schemes totalling £554m (2009 £475m), and the payment of the regulatory penalty to the US Department of Justice (£266m).

There was an outflow from **net capital expenditure and financial investment** of £364m (2009 £489m). The prior year included £94m in respect of new residential and office facilities in Saudi Arabia.

Dividends received from equity accounted investments, primarily MBDA, FNSS, Air Astana, Advanced Electronics Company and Eurofighter GmbH, totalled £71m (2009 £77m).

Assets contributed to Trust comprise a £25m payment made during the year for the benefit of the Group's main pension scheme (2009 £225m).

Cash held for charitable contribution to Tanzania Whilst the £29.5m charitable contribution for the benefit of the people of Tanzania (referred to in the Chairman's letter on page 7) had not been made at the date of this Annual Report, the amount has been deducted from the Group's stated net debt at 31 December 2010 and, with effect from 1 January 2011, is being held by the Company in a notional deposit account accruing interest for the benefit of the people of Tanzania at the Sterling London Interbank Bid Rate.

Taxation payments were £352m (2009 £350m).

Net cash outflow in respect of **acquisitions and disposals** of £88m mainly comprises the acquisition of Atlantic Marine and OASYS Technology (£260m), less the disposal of half of the Group's 20.5% shareholding in Saab AB (£92m) and an initial payment of A\$112.5m (£65m, net of legal fees) received from the former owners of the Tenix Defence business relating to the resolution of outstanding issues from the 2008 acquisition. The prior year outflow of £253m mainly reflects £315m paid to acquire VT Group's 45% interest in BVT, less £70m deferred consideration received relating to the 2008 disposal of a 50% interest in Flagship Training.

The **net purchase of equity shares** of £520m (2009 £20m) includes 144 million shares purchased under the buyback programme at a cost of £500m (excluding transaction costs of £3m).

As a consequence of movements in the US dollar and Euro exchange rates during the year, there has been a **cash outflow from matured derivative financial instruments** of £123m (2009 inflow £36m) from rolling hedges on balances with the Group's subsidiaries and equity accounted investments.

Foreign exchange translation primarily arises in respect of the Group's US dollar-denominated borrowing.

⁶ See note 27 to the Group accounts.

⁷ See note 26 to the Group accounts.

⁸ Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance. It is included within trade and other payables in the Group's balance sheet.

Pensions

Pension schemes

The Group's principal pension plans are funded defined benefit plans. The two largest schemes are the BAE Systems Pensions Scheme (Main Scheme) and the BAE Systems 2000 Pension Plan (2000 Plan). In aggregate, these two plans represent 73% (2009 77%) of the total IAS 19, *Employee benefits*, deficit at 31 December 2010.

Investment strategy

In aggregate, some 60% of the Group's pension assets are held in equities due to the higher expected level of return over the long term. The investment portfolios are highly diversified in order to provide reasonable assurance that no single security or type of security could have a materially adverse impact on the total portfolio. In addition, some of the Group's pension schemes use derivative financial instruments as part of their investment strategy to manage the level of risk.

An analysis of pension scheme assets split between equities, bonds, property and other investments, together with the expected returns on those investments, is shown in note 21 to the Group accounts.

Valuation

Pension plan valuations are performed by independent actuaries for both IAS 19 accounting (see critical accounting policies on page 44) and funding purposes.

Accounting valuations

A summary of the Group's pension scheme assets and liabilities is set out on the opposite page.

Pension scheme assets are included in the valuation at bid value.

The key assumptions used to calculate pension scheme liabilities for the principal plans are shown below:

PRINCIPAL PENSION ACCOUNTING VALUATION ASSUMPTIONS

	UK		US	
	2010	2009	2010	2009
Real discount rate ⁹ (%)	2.1	2.2	2.5	2.9
Rate of increase in salaries (%)	4.4	4.5	4.5	4.5
Rate of increase in pensions in payment (%)	2.3–3.6	2.3–3.7	n/a	n/a
Rate of increase in deferred pensions (%)	2.8–3.4	3.5	n/a	n/a
Life expectancy of a male currently aged 65 (years)	19–23	19–23	19	19
Life expectancy of a female currently aged 65 (years)	22–26	22–26	21	21

The discount rate assumptions are based on third party AA corporate bond indices using yields that reflect the maturity profile of the expected benefit payments.

The valuation of the Group's pension liabilities is highly sensitive to movements in real discount rates. During the year, these rates have continued to be volatile. A ten basis point movement in the rate changes the pre-tax liability by some £0.3bn. The relationship between the UK pension deficit (as defined by the Group) and the real discount rate is illustrated in the chart opposite.

Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was sold in 2006. As these are multi-employer plans, the Group allocates an appropriate share of the IAS 19 pension deficit to those equity accounted investments and to Airbus SAS.

Funding valuations

The triennial funding valuations of the Group's two largest pension schemes, the Main Scheme and 2000 Plan, were performed as at 5 April 2008 and 2010, respectively.

Pension scheme assets are included in the valuation at market value, whilst the liabilities are determined based on prudent assumptions set by the trustees following consultation with scheme actuaries.

The triennial funding valuations form the basis for the Group's cash funding obligations to its pension schemes.

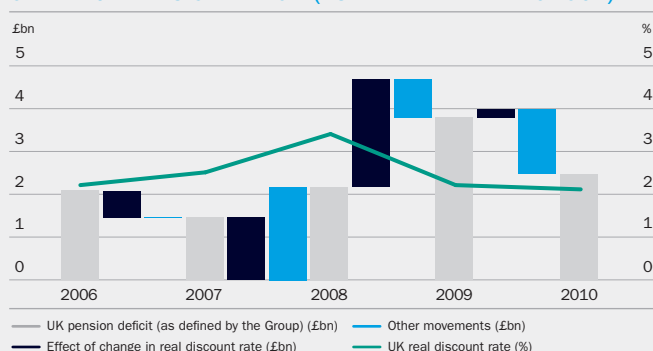
The current deficit recovery plan agreed with the trustees of the Main Scheme runs until April 2026 and includes annual lump sum contributions of £40m until 2016. In addition, as part of the agreed deficit recovery plan, the Group contributed a further £25m into Trust in 2010. The cumulative contributions into Trust of £250m are reported within other investments (£260m after cumulative fair value gains of £11m), and cash and cash equivalents (£1m) at 31 December 2010, and the use of these assets is restricted under the terms of the Trust. A final £25m is due to be paid into Trust in 2011. The Group considers these contributions to be equivalent to other lump sum contributions it makes into the Group's pension schemes and, accordingly, presents a definition of the pension deficit including them.

During the year, the Group made an incremental lump sum contribution of £51m into the 2000 Plan. This payment was made in advance of the finalisation of discussions between the trustees and the Group to determine the funding implications of the 2010 triennial valuation. The deficit recovery plan in respect of the 2010 triennial valuation was subsequently agreed and runs until April 2026. It includes lump sum contributions of £15m in 2011 and £77m in 2012, and annual lump sum contributions of £54m thereafter.

The Group also made contributions to the UK pension schemes totalling £157m following the £500m share buyback programme completed in July 2010.

The results of future triennial valuations and associated funding requirements will be impacted by the future performance of investment markets, and interest and inflation rates.

EFFECT OF CHANGES IN REAL DISCOUNT RATES⁹ ON THE UK PENSION DEFICIT (AS DEFINED BY THE GROUP)



⁹ Discount rate net of inflation.

Balance sheet

SUMMARY BALANCE SHEET

	2010 £m	Restated ⁵ 2009 £m
Intangible assets	11,216	11,306
Property, plant and equipment, and investment property	2,848	2,663
Equity accounted investments and other investments	798	852
Other financial assets and liabilities (net)	(10)	(45)
Tax assets and liabilities (net)	580	896
Pension deficit (as defined by the Group)	(3,146)	(4,410)
Working capital	(6,641)	(7,002)
Net (debt)/cash (as defined by the Group) ⁶	(242)	403
Net assets	5,403	4,663

Exchange rates – year end		
£/\$	1.565	1.615
£/€	1.166	1.125
£/A\$	1.526	1.795

Exchange translation, principally in respect of the Group's US dollar-denominated businesses, increased net assets by £154m.

The £90m reduction in **intangible assets** to £11.2bn (2009 £11.3bn) mainly reflects amortisation and impairments (£517m), largely offset by the acquisition of Atlantic Marine Holding Company (Atlantic Marine) (£170m) and exchange translation (£277m). Intangible assets are accounted for in accordance with IFRS 3, *Business Combinations* (see critical accounting policies on page 44).

The reduction in **equity accounted investments and other investments** from £852m to £798m includes a £155m impact from the sale of half of the Group's 20.5% shareholding in Saab AB.

The movement in the **pension deficit (as defined by the Group)** during the year was as follows:

MOVEMENT IN THE PENSION DEFICIT (AS DEFINED BY THE GROUP)

	£m
Total IAS 19 deficit at 1 January 2010	(5,616)
Actual return on assets above expected return	1,043
Decrease in liabilities due to changes in assumptions	55
Contributions in excess of service cost	554
Past service cost	(39)
Curtailment gains	2
Net financing charge	(103)
Exchange translation	(21)
Movement in US healthcare plans	22
Total IAS 19 deficit at 31 December 2010	(4,103)
Allocated to equity accounted investments and other participating employers	696
Group's share of IAS 19 deficit at 31 December 2010	(3,407)
Assets held in Trust	261
Pension deficit (as defined by the Group)	(3,146)

Better than expected investment returns, a £348m impact arising from the change from the Retail Prices Index to the Consumer Prices Index as the measure of price inflation for the purposes of determining minimum statutory pension increases, and deficit funding are the primary reasons for the Group's share of the pre-tax pension deficit reducing. With the exception of the 2000 Plan, the change to the measure for determining minimum statutory pension increases has affected all of the Group's UK pension schemes for deferred pension increases, but has only affected two of the Group's smaller schemes for increases to pensions in payment.

PENSION ASSETS AND LIABILITIES

	2010 £m	2009 £m
Fair value of plan assets	17,203	15,023
Present value of obligations	(21,306)	(20,639)
Total IAS 19 deficit, net	(4,103)	(5,616)
Allocated to equity accounted investments and other participating employers	696	979
Group's share of IAS 19 deficit, net	(3,407)	(4,637)
Assets held in Trust	261	227
Pension deficit (as defined by the Group)	(3,146)	(4,410)

A net deferred tax asset of £1.0bn (2009 £1.4bn) relating to the Group's pension deficit is included within net tax assets and liabilities, and disclosed in note 8 to the Group accounts.

Further disclosure is provided opposite and in note 21 to the Group accounts.

⁵ Restated following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited.

⁶ See note 27 to the Group accounts.

Capital

The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2010, the Group's capital was £5,356m (2009 £4,550m), which comprises total equity of £5,403m (2009 £4,663m), less amounts accumulated in equity relating to cash flow hedges of £47m (2009 £113m). Net debt (as defined by the Group)⁶ was £242m (2009 net cash £403m).

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. The Group's policy is to maintain an investment grade credit rating. The Group's dividend policy is to grow the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

Tax

The Group's tax strategy is fully aligned with its business strategy and, as part of that, the Group seeks to build constructive, open working relationships with tax authorities in all of the countries in which it operates.

Treasury

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

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

The Group monitors compliance against the principal policies and guidelines (including the utilisation against credit limits), and any exceptions found are reported to the TRMC.

The Group's treasury policies in respect of the management of debt, interest rates, liquidity, currency and credit quality are discussed below. All treasury policies remain under close review given the continuing volatility in the financial markets.

Further disclosure on financial instruments is set out in note 30 to the Group accounts.

Debt

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

All the Group's material borrowings are arranged by the central treasury department and funds raised are lent onward to operating subsidiaries as required. Surplus funds are lent back to the central treasury department where appropriate.

The maturity profile of the Group's borrowings is illustrated graphically below and a more detailed analysis is provided in note 19 to the Group accounts.

A \$500m 4.75% bond was repaid in August 2010. This repayment was pre-financed as part of \$1.5bn raised in the US bond market in 2009.

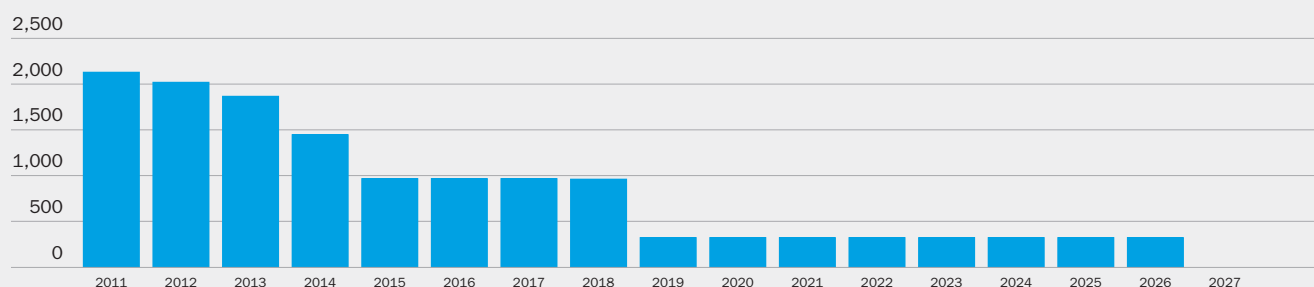
Generally, excluding the impact of acquisition or disposal financing and share repurchases, net cash/debt (as defined by the Group)⁶ is driven by the operational performance of the Group's subsidiaries and equity accounted investments, and the level of receipts on major contracts. Historically, the net cash/debt position of the Group has been at its best at the year end.

It remains the Group's intention to ensure the business is funded conservatively, and to be proactive in accessing bank and capital markets in achieving this aim.

Interest rates

The Group's objective is to mitigate its exposure to interest rate fluctuations on borrowings and deposits through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps.

MATURITY PROFILE OF THE GROUP'S BORROWINGS (£M)



⁶ See note 27 to the Group accounts.

The Group's interest rate management policy is that a minimum of 50% and a maximum of 75% of gross debt is maintained at fixed interest rates. At 31 December 2010, the Group had 65% (2009 62%) of fixed rate debt and 35% (2009 38%) of floating rate debt based on a gross debt of £3.0bn, including debt-related derivative financial assets (2009 £3.3bn).

Liquidity

The Group's objectives are to:

- maintain adequate undrawn committed borrowing facilities; and
- control and monitor bank credit risk and credit capacity utilisation.

The Group's committed Revolving Credit Facility (RCF) was renegotiated in December and was increased to £2bn (2009 £1.455bn). The RCF is syndicated amongst the Group's core relationship banks and is available to meet expected general corporate funding requirements. The RCF is contracted until 2015 and was undrawn throughout the year.

The RCF acts as a back stop to Commercial Paper issued by the Group. The Group had £144m of Commercial Paper at 31 December 2010 (2009 £nil).

Cash flow forecasting is performed by each line of business as part of the annual Integrated Business Planning process and the monthly reporting cycle. The Group monitors a rolling forecast of liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities.

The Group adopts a conservative approach to the investment of its surplus cash. It is deposited with strong financial institutions for short periods. Bank counterparty credit risk is monitored closely on a systematic and ongoing basis. A credit limit is allocated to each institution taking account of its market capitalisation, credit rating and credit default swap price. For internal credit risk assessment purposes, all transactions are marked-to-market and any resultant exposure is allocated against the credit limit. The Group had cash and short-term investments at 31 December 2010 of £3,073m (2009 £3,904m), which was invested with 25 financial institutions. The maximum amount deposited with any individual bank as at 31 December 2010 was less than £225m (2009 £300m).

Currency

The Group's objective is to reduce its exposure to volatility in earnings and cash flows from movements in foreign currency exchange rates. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.

Transactional risk

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

Translational risk

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

Credit quality

The Group's objective is to maintain an investment grade rating in order to ensure access to the widest possible sources of finance and minimise the cost of debt funding to support the efficient operation of the Group's activities. This is achieved through the delivery of planned operating cash flows, and management of its relationships with debt capital market investors, banks and rating agencies.

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

As at 31 December 2010, the Group's long-term credit ratings provided by these agencies were as follows:

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

Insurance

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

The Group insures its export contracts and associated on-demand bank guarantees against political and corporate risks. The Group monitors and benchmarks this insurance to ensure its adequacy and appropriateness.

During 2010, the Group again sought external validation of the credit rating of those insurers who have a significant proportion of the insurance portfolio. The views of a number of rating agencies and insurance intermediaries were considered to assess the long-term stability of the Group's insurers. It is the Group's policy that all its insurers have a minimum credit rating of A-.

Critical accounting policies

The Group's significant accounting policies are outlined in note 1 to the Group accounts. Not all of these significant accounting policies require management to make difficult, subjective or complex judgements or estimates.

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

Revenue recognition

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

Revenue on long-term contracts is recognised when performance milestones have been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved.

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

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

Other (IAS 18, *Revenue*)

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

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

Additional details are in note 1 to the Group accounts.

Retirement benefit plans (IAS 19, *Employee Benefits*)

For defined benefit retirement plans, the cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of comprehensive income. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period until the benefits become vested.

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

The main assumptions made in accounting for the Group's post-retirement plans are summarised on page 40. For each of these assumptions, there is a range of possible values and, in consultation with actuaries, management decides the point within that range that most appropriately reflects the Group's circumstances. Small changes in these assumptions can have a significant impact on the size of the deficit.

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

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

Additional details are in notes 1 and 21 to the Group accounts.

Intangible assets (IFRS 3, *Business Combinations*)

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

Goodwill arising on the acquisition of subsidiaries is capitalised and included in intangible assets. Goodwill on acquisition of joint ventures and associates is included in equity accounted investments.

Goodwill is not amortised, but is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment review calculations require the use of estimates related to the future profitability and cash-generating ability of the acquired businesses.

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

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

Additional details are in notes 1 and 11 to the Group accounts.

“We are continuing to embed a culture of Total Performance.”

Deborah Allen

Managing Director,
Corporate Responsibility



Responsible Behaviour means doing business in a way that reflects our values – Trusted, Innovative and Bold. It is a key element of Total Performance and works in harmony with the other three elements: Customer Focus, Programme Execution and Financial Performance. Responsible Behaviour is embedded within our business through delivery of our corporate responsibility (CR) strategy.

Our CR strategy covers the issues that have been identified as having the most potential to affect the sustainability of the Group, by directly impacting the Group's reputation or ability to operate. These priorities are outlined below.

We are committed to progressing our CR strategy by embedding it into all areas of our business. It supports the delivery of our Group strategy (see page 14), and helps build and maintain strong relationships with our stakeholders, including customers, regulators, investors, suppliers, employees and communities. It enhances our reputation, contributes to greater operational productivity and efficiency, and reduces risk to our business.

Our priorities

Business conduct and safety continued to be our two key CR priorities in 2010. Executive bonuses (see page 107) and management objectives (see page 12) linked to performance on these issues support driving the Group towards our desired leadership position.

We are increasing our focus on diversity and inclusion, and environmental performance. Both issues have the potential to impact the long-term sustainability of the Group: diversity and inclusion affects our ability to recruit, engage and retain the best people; and environmental management from increased awareness of impacts, growing customer interest, increasing regulation and cost.

During 2010, business conduct, safety, and diversity and inclusion were part of the Executive Committee objective on progressing towards a recognised leadership position in Responsible Behaviour (see page 12). Environment has been added to this objective in 2011. Our 2011 objectives for business conduct, safety, and diversity and inclusion are covered on page 46, and for environment, on page 52.

Governance

During 2010, CR key performance indicators, including business conduct, safety, and diversity and inclusion, were reviewed by the Executive Committee alongside financial and operational performance. The CR Committee, chaired by non-executive director Paul Anderson, provides independent oversight, advice and strategic direction on CR issues, and reviews progress against our CR objectives quarterly (see the Committee's report on page 92). Selected CR performance information, reported on pages 46 to 53, is also subject to external assurance by Deloitte LLP (see their assurance statement on page 54).

BAE Systems' CR strategy is driven by the Chief Executive and the Executive Committee. An element of senior executives' (i.e. the top 250 employees in the Group) remuneration in 2010 was directly linked to CR performance with up to 15% of potential annual incentive payment dependent on meeting objectives in the priority areas of business conduct and safety. All Group level targets relating to these priority areas have been met. The performance of the operating groups in respect of the Group's safety KPI is included in pages 66 to 72.

The Managing Director, Corporate Responsibility (MD CR) reports directly to the Chief Executive and leads our global CR team, which provides support in embedding aspects of CR throughout the Group. A cross-functional CR Forum, led by the MD CR, enables us to raise employee awareness, share best practice and drive improvements across the Group.

Performance in 2010 and objectives for 2011

Business conduct

2010 OBJECTIVES

All Line Leaders and Functional Directors are required to submit to the Chief Executive the level of implementation of core policies in their areas of responsibility through the twice yearly Operational Assurance Statement (OAS). In cases where a policy is judged not to be fully implemented a plan is required setting out the milestones to full compliance. The objective agreed for 2010 is that by December all of the milestones have been met and any future milestones are on track to be met.

PROGRESS

Line Leaders and Functional Directors confirmed progress following the revisions made to the core policies resulting from the Woolf implementation programme, through their six-monthly OAS.

2011 OBJECTIVES

Implementation of the Group's programme to address the Woolf recommendations to be complete by May 2011 and confirmed through external assurance at the end of 2011.

Safety

2010 OBJECTIVES

Continue the progress towards a world class level of safety performance:

- All businesses and BAE Systems' controlled sites with more than 150 personnel to attain Level 4 of the Safety Maturity Matrix (SMM), and those at Level 4 to show progress towards achieving Level 5 by the end of 2011.

- Deliver at least a 20% improvement in the Lost Work Day Case Rate compared with 2009.

PROGRESS

- Sites with more than 150 personnel (other than those acquired during 2010) have now progressed to Level 4 on the SMM.

- An overall 31% improvement in the Lost Work Day Case Rate was achieved, exceeding our target of 20%.

2011 OBJECTIVES

Continue to progress towards a world class level of safety performance:

- Demonstrate continued progress towards SMM Level 5. SMM clarification:
 - a. Level 5 achievement: All sites at Level 4 in 2009 to achieve Level 5 by the end of 2011;
 - b. Level 5 progress: All sites at Level 4 at the end of 2010 to demonstrate progress to achieve Level 5 by the end of 2012;
 - c. Level 4 achievement: All remaining sites to achieve Level 4 by the end of 2012.

- Continue to demonstrate year-on-year improvement in the Lost Work Day Case Rate.

Diversity and inclusion

2010 OBJECTIVES

Develop a global working climate which embraces diversity and inclusion:

- Create a plan to deploy the Diversity & Inclusion Maturity Matrix (D&IMM) by the end of the first quarter and meet the 2010 milestones towards desired end state to be achieved by the end of 2015.

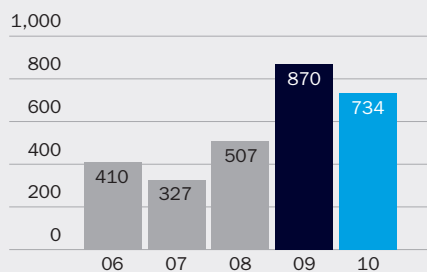
PROGRESS

- Each business deployed the matrix by the end of the first quarter. Business units have developed plans and milestones against the D&IMM reflecting their individual starting points and cultural context.

2011 OBJECTIVES

Continue to utilise the global D&IMM to achieve an improved level of performance for 2011.

EMPLOYEE ENQUIRIES TO ETHICS HELPLINE¹

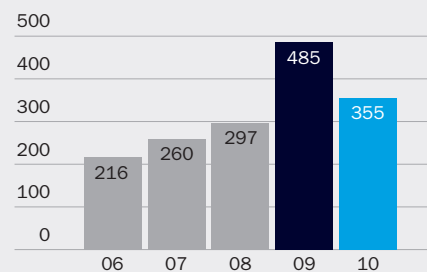


Our Ethics Helpline enables employees to request information and advice or raise any concerns about business conduct confidentially wherever they work and whatever their role¹. In 2010, employees made a total of 734 enquiries to the Helpline. All concerns raised with the Ethics Helpline were reviewed and reported either to the Ethics Review Committee or, in BAE Systems, Inc., to the Ethics Executive Oversight Committee.

2010 EMPLOYEE ENQUIRIES TO ETHICS HELPLINE¹



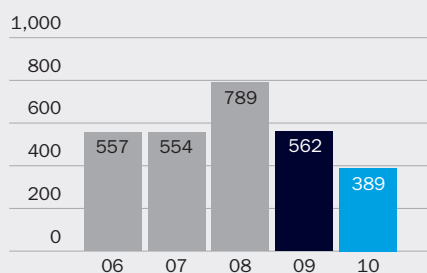
DISMISSALS FOR REASONS RELATING TO UNETHICAL BEHAVIOUR*



If an employee is found to be in breach of our Code of Conduct or any other relevant policies, appropriate disciplinary action is taken. In 2010, 355 employees were dismissed for reasons relating to breaches of our standards and policies.

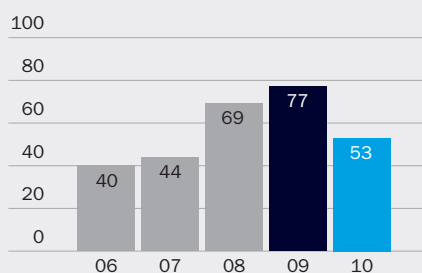
LOST WORK DAY CASE RATE (PER 100,000 EMPLOYEES)*

KPI



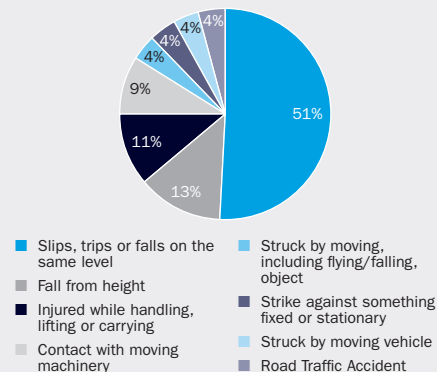
The Lost Work Day Case Rate fell from 562 in 2009 to 389 in 2010, equivalent to a 31% decrease, exceeding our target of 20%. In 2011, we will continue to monitor the number of incidents resulting in days lost to injury and take action to minimise the risk to the Group's employees and its operations, and drive continual performance improvement.

MAJOR INJURIES RECORDED*



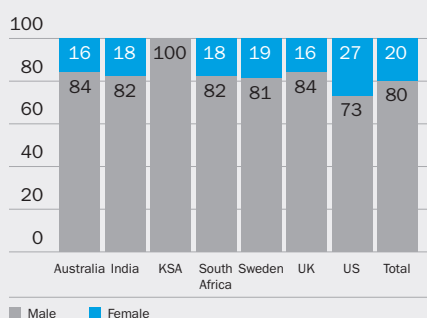
The number of major injuries recorded in 2010 has fallen to 53, a decrease of 31% on 2009 data. The normalised rate of major injuries per 100,000 employees has also decreased to 53 in 2010*. This demonstrates an overall improvement in our safety performance which reflects efforts to embed a 'safety first' attitude across the Group.

2010 CAUSE OF MAJOR INJURIES RECORDED (% OF TOTAL CAUSES)

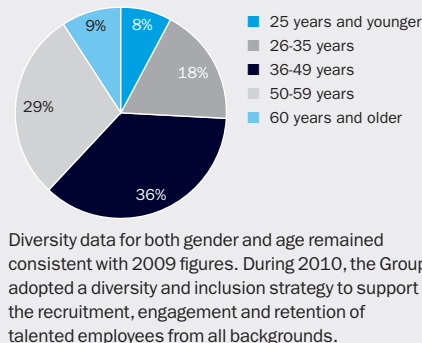


Slips, trips and falls on the same level were the main causes of major injury in 2010, accounting for over 50% of the total. Accidents that result in injury are investigated and solutions identified to help prevent future occurrence.

2010 GENDER DIVERSITY (%)*



2010 AGE DIVERSITY (%)*



2010 ETHNIC DIVERSITY*

In Saudi Arabia, less than 40% of our employees are expatriates, representing our commitment to 'localising' business talent. We continue to focus on skills transfer and increase the number of local nationals in our workforce. In South Africa, we are working towards improving workplace diversity, in line with the business's transformation objectives and the South African government's Broad Based Black Economic Empowerment (BBBEE) initiative. Currently, 41% of our workforce in South Africa is black. In the US, minority group representation is 25% and, in the UK, it remains low at 3%.

We do not collect ethnic diversity data for Australia, India and Sweden.

¹ * See Assurance statement on pages 54 and 55.

¹ In countries where there are no legal restrictions on the implementation of our helpline.

Business conduct

Goal

BAE Systems is committed to becoming a recognised global leader in business conduct by continuing to embed policies and processes across the Group, and integrate them into day-to-day business practice.

Strategy

We are placing business conduct at the heart of our business through implementation of our global Code of Conduct, our comprehensive response to the Woolf Committee Report, and our commitment to Total Performance.

The Group's Code of Conduct sets out the principles and standards we require all our employees to adopt. Used in conjunction with our Responsible Trading Principles (see page 33), it supports our business activities.

2010 performance

Training to ensure employees understand and comply with the Code of Conduct forms a core part of raising awareness and developing a culture of Total Performance throughout the business. This includes an induction for newly hired staff and regular refresher courses for employees. We have also issued the latest version of the Group's Integrity in Business Dealing training, an online course covering our Gifts and Hospitality, Facilitation Payments, Company Giving and Conflicts of Interest policies that is required to be taken by executives.

We are on schedule to meet our three-year commitment to address the 23 recommendations of the Woolf Committee – an external, independent committee appointed by the BAE Systems Board which reported its findings in May 2008. As well as guiding us towards a culture of responsible business conduct,

the recommendations have helped the Group review and strengthen policies and processes as part of our governance structure and integrate them into day-to-day business practice. An update on progress will be available at www.baesystems.com/corporateresponsibility/⁺

The Ethical Leadership Group, an ethics consultancy, has been commissioned to carry out an independent assessment of the Group's Business Conduct programme and to review the work undertaken in response to the Woolf Committee recommendations. This is based on a document review, interviews with the Chairman, the Chief Executive, the Chairman of the CR Committee and senior managers in each home market, and over 60 employee focus groups across our businesses. This review covers the Group's global operations and is expected to be completed by April 2011.

Putting policies into practice

The Responsible Trading Principles introduced at the beginning of 2010 are designed to ensure that the Group makes informed decisions about the business opportunities we pursue. Opportunities are assessed according to the level of risk associated with the type of product, its intended use, the end user and the country of sale. The Principles are also being used in the procurement process to assess major suppliers. Additional guidance is also being introduced on anti-bribery and anti-corruption.

The appointment of advisers for business development, security, offset and lobbying activities (with the exception of certain domestic lobbyists in the US whose appointment is subject to separate legislative controls) is reviewed and



Embedding Responsible Behaviour

In 2010, we have focused on integrating Responsible Behaviour into our core business policies and procedures, and ensuring that these fully reflect all four elements of Total Performance.

Policies relating to Responsible Behaviour are now integrated into every section of the Operational Framework (OF), the set of mandated policies, charters and processes that guide our work. This has included adding a number of new policies and strengthening existing policies, including those relating to Gifts and Hospitality, Facilitation Payments and Conflicts of Interest.

Line leaders report compliance against each part of the OF twice a year through the Operational Assurance Statement.

Our Lifecycle Management Framework (see page 32), used across all our major projects, has also been revised to reflect the four elements of Total Performance. This means, for example, that reviews carried out at the start of projects now include consideration of responsible trading risks.

⁺ ^ See Assurance statement on pages 54 and 55.

assessed by our Business Development Adviser Compliance Panel, chaired by independent lawyers. All such advisers appointed in 2010 were appointed in accordance with our global adviser policy.

Following the settlement reached with the US Department of Justice in February 2010, the Group has appointed Lord Gold, former Senior Partner at Herbert Smith LLP, as an independent corporate monitor for a period of up to three years. As part of his role, Lord Gold will serve as an ex-officio non-voting member of our Business Development Adviser Compliance Panel, review and evaluate certain of the Group's policies and procedures, and submit periodic reports to the Group's Board and the US Department of Justice.

The Group is currently reviewing its policies and procedures in preparation for the implementation of the new UK Bribery Act 2010. We believe our business conduct policies, including those covering advisers, facilitation payments, gifts and hospitality, conflicts of interest, offset and lobbying, will comply with the requirements of the Act.⁺

Working to improve industry standards

As a member of the Aerospace Industries Association of America and the Aerospace and Defence Industries Association of Europe, we are working with other companies to continue to embed the Global Principles of Business Ethics for the Aerospace and Defence Industry, that were agreed in 2009, and to raise standards of business conduct across the sector.

Code of Conduct

Following the introduction of the Code of Conduct and initial training in 2009, the focus in 2010 has been to further embed the Code throughout the Group. Employees are required to attend refresher training during the 12-month period to May 2011 – more than 50%[^] had already been trained by the end of 2010 (see KPI on page 19). New employees receive a copy of the Code and are required to complete training as part of their induction.

Business conduct survey results

We conduct a comprehensive Group-wide employee opinion survey every two years. The survey is designed and administered by an external company, Towers Watson. The survey includes questions on business conduct. In 2010, the survey results showed an improvement for the comparable questions on business conduct from 2008. The responses demonstrated that our employees have a good awareness of the business conduct standards we expect of them. We are pleased to be making progress but recognise that there is still much work to be done. We will continue to improve business conduct training and employee engagement to maintain high standards within our working culture, and support our people in speaking up and challenging any inappropriate behaviour they observe. Further analysis of the responses to the business conduct employee opinion survey questions can be found on www.baesystems.com/corporateresponsibility/⁺

Training on the Code of Conduct

Training on the Code of Conduct in 2010 emphasised employee engagement, leadership and embedding a culture of Responsible Behaviour throughout the Group. This built on training in 2009, designed to raise awareness and understanding of the Code.

The training is designed to prompt and promote discussion around ethical dilemmas during face-to-face sessions led by managers. Sessions include a team discussion looking at a series of potential ethical dilemmas employees could face in their work. An e-learning option is also available for those working remotely to ensure that training reaches everyone in the Group. Supporting articles in our internal newsletters have been used to reinforce messages from the training as well as position it as an important global activity for employees to participate in.

For more information about:

- Code of Conduct
- Progress against Woolf Committee recommendations
- How our business works

VISIT: www.baesystems.com/corporateresponsibility/



Safety

Goal

We aim to ensure consistently good safety management across the Group and, over time, to drive performance to a level comparable with the best performing global companies by continuing to progress towards Level 5 on our Safety Maturity Matrix (SMM).

Strategy

Protecting the health and safety of employees is a fundamental responsibility. Embedding a commitment to safety across the business is a priority for the Group. Education and awareness campaigns remind employees that they must put safety first in all their activities and speak up on safety issues.

Our safety management systems cover a wide range of risks associated with our manufacturing operations and diverse global business. The Group's Senior Safety Steering Group brings together business leaders who are responsible for driving BAE Systems towards a comparable level of safety performance with the best performing global companies.

Progress at site level is measured using our five-level SMM to help us drive safety performance. Businesses are required to assess safety risks associated with projects as part of the Lifecycle Management process (see page 32).

2010 performance

Improvements in safety performance during 2010 reflect continued efforts to embed a 'safety first' attitude and improve safety management in line with the Group's SMM. Sites with more than 150 personnel (other than those acquired during 2010) have now progressed to Level 4 on the matrix, demonstrating a proactive approach to safety across our sites. Businesses have also delivered a 31% improvement in the Lost Work Day Case Rate (see KPI on page 19) and a 31% reduction in major injuries.

During 2010, a benchmarking exercise was carried out which compared our safety performance in 2009 with other large global engineering and manufacturing companies with a proven track-record of world class safety performance. This benchmark has helped us to identify the gap in our performance against these companies to help us drive improvements for 2011.

Product safety

In October 2009, the Haddon-Cave report into the loss of Nimrod XV230 was published. After carefully studying the report, in December 2009, Ian King announced a review of the Group's approach to product safety in the UK businesses. Nigel Whitehead, Group Managing Director, Programmes & Support, led that review, which examined current policies, processes, governance, actions and behaviours associated with product safety. The review has developed a set of four principles of product safety which are being tested with the Group's businesses in the UK and across the world.

Although originally UK-specific, the principles are intended to be recognised by all business units as a sound basis for product safety. The review has now handed over to the Product Safety Implementation Project, which will ensure that the principles are translated into policies and processes.

Fatality

We are deeply saddened to report the death of one of our employees at our York facility in the US*. We have reviewed the cause of this accident and co-operated fully with the regulatory investigation. The regulatory authority was unable to determine a cause for the accident or identify any non-compliances during the course of its investigation and, as a result, has taken no further action. Any lessons learnt from this incident will be applied across our global business.



Safety First

Safety First is helping BAE Systems' businesses develop a common safety culture by encouraging employees to challenge unsafe practices and promote safe behaviour. Examples include:

- Submarine Solutions has established safety and environmental management systems for all its operational sites in line with the occupational health and safety standard OHSAS 18001 and environmental management standard ISO 14001. Safety, health and environment advisers have been appointed and additional training provided for employees. Safety systems have also been standardised to ensure a consistent approach is taken across Submarine Solutions' different UK sites.
- Military Air Solutions launched 'Think Safety First – Everyone's Responsibility' to raise safety awareness across its operations. The programme focuses on all aspects of safety and includes an employee guide providing information and advice on what employees should do if they have a safety concern.

For more information about:

- Our approach to safety
- Safety Maturity Matrix

VISIT: www.baesystems.com/corporateresponsibility/

* See Assurance statement on pages 54 and 55.

Diversity and inclusion

Goal

We are working to create an inclusive work environment where all individuals are respected, and where diversity is managed effectively via our Diversity & Inclusion Maturity Matrix (D&IMM), to improve business performance and enhance competitive advantage.

Strategy

A focus on diversity and inclusion encourages innovation and enhances productivity by helping us to recruit, engage and retain the best people. It is increasingly important to achieving business success in the diverse locations and cultures in which we operate.

The Group adopted a diversity and inclusion strategy in 2010 to support the recruitment, engagement and retention of talented employees from all backgrounds. It will help us to build a workforce that more closely reflects the diversity of the local population in each of our markets and will underpin the future sustainability of our business.

Our strategy also encompasses our education programmes (see page 34), which focus on supporting the teaching of science-based subjects and encouraging greater numbers of young people to study science, technology, engineering and mathematics. This is designed to ensure the Group has the right skills to remain competitive and operate successfully over the next decade, into 2020 and beyond.

A D&IMM is used to measure progress. It establishes a consistent benchmark to help our businesses chart progress from legal compliance (Level 1) to creating a culture that embraces diversity as a source of competitive advantage (Level 5).

The matrix provides sufficient flexibility within each home market for our business units to adapt their approach to meet operational characteristics and respect local cultures.

2010 performance

A communications plan was implemented to help employees understand the importance of diversity and inclusion, and how it contributes to Total Performance. This included a series of features in our internal newsletters and intranet sites, and a workshop at which senior leaders discussed and agreed the business benefits of diversity and inclusion. BAE Systems' Chief Executive, Ian King, signed the UK Resource Centre for Women in Science, Engineering and Technology's (UKRC) CEO Charter on Diversity, making public our commitment.

During 2010, in Australia and the UK, we reviewed our approach to external recruitment, including briefings to recruitment and advertising companies, to ensure that our recruitment processes support our commitment to diversity and inclusion.

Gender diversity

Achieving greater gender diversity remains a challenge for the defence and engineering sector. In the UK, for example, women account for just 10% of engineering graduates. Our education and early careers programmes are aimed at encouraging women to consider science, engineering and technical careers (see page 34).

We participate in and sponsor events organised by external organisations, including the UK Confederation of British Industry's First Women Awards and, in Europe, the International Women of Excellence. In the US, the Group is a member of the Society of Women Engineers, which promotes engineering as a desirable career option, whilst supporting females in advancing their careers in the field of engineering.

The Group's Women's Global Virtual Forums provide development and networking opportunities for female employees, complementing efforts by our business units to improve female representation at executive level through career planning and creating more flexible work cultures.



Integrating diversity and inclusion

Our businesses are taking steps to improve diversity and inclusion at all stages of employment. Examples include:

- Land & Armaments has integrated diversity and inclusion goals into succession planning and recruitment processes for its South African, Swedish, UK and US businesses, and developed diversity and inclusion training for line managers. The businesses will use a metrics dashboard to track progress and performance via quarterly business reviews.
- Military Air Solutions has published a briefing pack, launched a website and held a series of events to help employees understand the business case for diversity and inclusion. It introduced a Maternity Leave Workshop, to support mothers returning to work, and launched a Lesbian, Gay, Bisexual and Transgender Awareness Network.
- BAE Systems Australia's diversity and inclusion strategy, launched in 2010, is focused on increasing representation of women by promoting flexible working, increasing the number of part-time roles, and introducing talent management plans, women's networks and mentoring.

For more information about:

- Our approach to diversity and inclusion
- Our Diversity & Inclusion Maturity Matrix

VISIT: www.baesystems.com/corporateresponsibility/

Environment

Goal

We aim to improve the environmental performance of our products and operations by developing and launching an environmental sustainability programme.

Strategy

Reducing our use of resources and the waste we produce will improve operational efficiency, reduce costs and help us to comply with changing regulatory requirements. The environmental performance of our products is of increasing importance to our customers.

Environmental impacts including greenhouse gas emissions, material and solvent usage, waste products, and emissions to the atmosphere are managed by individual business units.

Our commitment to reduce the environmental impacts of our operations and products is outlined in our Environment Policy, and other key documents including our Code of Conduct.

2010 performance

An Environmental Sustainability Steering Group was established in 2010, comprising senior business and functional managers. It is chaired by the Managing Director, Corporate Responsibility, and sponsored by Executive Committee member, Nigel Whitehead, Group Managing Director, Programmes & Support. The Executive Committee has agreed goals and targets for the business in 2011 as part of an overall objective to improve environmental performance.

Our carbon footprint is calculated annually by the Coefficient Company. We also monitor and manage other environmental impacts.

The Group has made a number of improvements in the accuracy and expansion of data collection systems to include energy use from coal in the US and estimated data for a further 102 sites representing small offices across the markets in which we work. These data collection improvements and business acquisitions, plus a slight increase in energy use, increased our reported carbon footprint by 14% in 2009. 2010 data was not available at the time of this report, but will be available on our website in 2011.



Seal of Sustainability

BAE Systems has been awarded the Seal of Sustainability by the Sustainable Business Institute for progress at its Greenlawn site in New York. This recognises the site's achievements including:

- Participation in PowerPay! NY, a smart grid programme that manages energy demand
- Adoption of a recycling programme
- Water conservation efforts
- Use of renewable energy systems including a solar water heating system

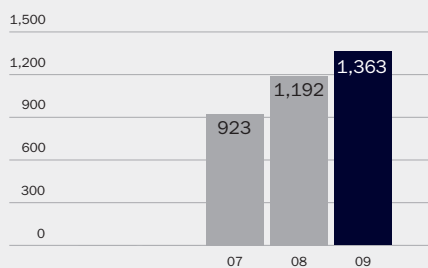
The seal is awarded to companies that demonstrate a continuous commitment to sustainable practices and helps the public to identify businesses that promote sustainability. Each company is evaluated against criteria relating to the economy, society and environment. Applications are reviewed by the US National Pollution Prevention Roundtable, a non-profit membership organisation.

2011 objectives

Develop and launch an environmental sustainability programme:

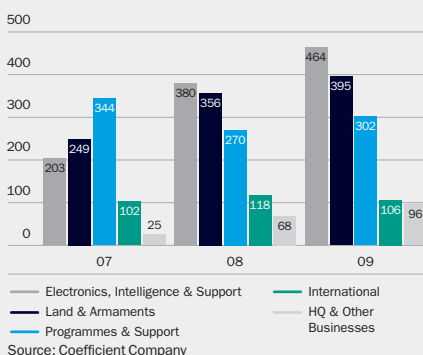
- Agree and implement an Environmental Sustainability Maturity Matrix (ESMM).
- Businesses to confirm a 2010 baseline, and set 2011 targets for energy, water and waste.

**TOTAL CO₂ EMISSIONS
(THOUSAND TONNES)**



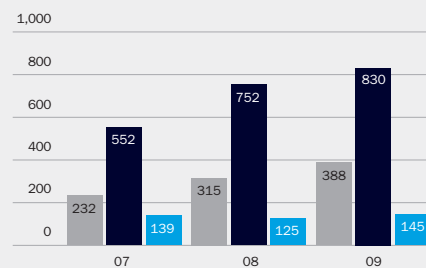
Source: Coefficient Company

**TOTAL CO₂ EMISSIONS BY OPERATING
GROUP (THOUSAND TONNES)**



Source: Coefficient Company

**TOTAL CO₂ EMISSIONS BY SCOPE
(THOUSAND TONNES)**



Source: Coefficient Company

Our 2010 global carbon footprint will be externally compiled by the Coefficient Company.



For more information about:

- Our Environmental Management System
- 2011 goals and targets

VISIT: www.baesystems.com/corporateresponsibility/

Community

Goal

Our goal is to support charities that make a positive contribution to the communities in which we operate.

Strategy

The BAE Systems Company Giving programme, which is underpinned by our Company Giving Policy, includes donations and other support for local, national and international charities and not-for-profit organisations. We focus on four areas that are relevant to our business:

- the armed forces and their families;
- science, technology, engineering and maths education;
- local communities; and
- employee volunteering.

Our approach is implemented locally to reflect the different needs of the communities in which we operate.

Charity Challenge is our Group-wide employee fundraising and volunteering programme. Employees in Australia, the UK and the US elect partner charities for a two-year period. Selected charities must fit within one of our core themes to be eligible for partner status. As well as fundraising and volunteering support from employees, partner charities receive supplementary funding from our Company Giving programme.

2010 performance

In 2010, our total community investment was more than £3.3m*. This includes donations in cash as part of our Company Giving and Charity Challenge programmes.

Our partner charities included: Make a Wish Foundation in Australia; Operation Homefront in the US; and armed forces charities, including Soldiers, Sailors, Airmen and Families Association (SSAFA), The Royal British Legion and The Army Benevolent Fund, in the UK.



Community involvement

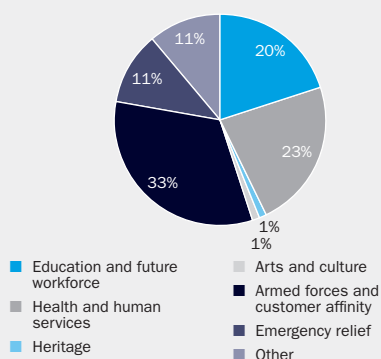
In the UK, BAE Systems is a founding supporter of the uk4u Thanks! 2010 Christmas Box campaign, which supports 22,500 boxes full of festive cheer being sent to servicemen and women across the world on active duty who are working away from their families during the holiday season. To support this activity closer to home, our UK employees donated items for Christmas parcels for veterans, and hospitals and care homes where injured soldiers receive treatment for their injuries while also spending Christmas with their families.

BAE Systems, Inc. employees were so moved by the destruction and suffering in Haiti following the earthquake in January 2010, that they donated \$436,000 (£282,000) to the American Red Cross's Haiti Relief and Development Fund and the International Response Fund. The Group matched employee contributions dollar for dollar, to donate a total of \$872,000 (£564,000). In addition to the cash donations, BAE Systems employees at sites across the US volunteered their time helping pack over one million dehydrated meals for the Kids Against Hunger programme. The Group also offered material support to the American Red Cross in the form of technology and systems. For example, FirstIntercom®, a first responders' radio system, was offered for use in the relief efforts.

The devastating floods in Australia have had a shattering impact on most people in Queensland and Northern New South Wales, including some of our employees, their families and many customers. In January 2011, the Group donated A\$200,000 (£119,000)¹ to the Queensland Premier's Disaster Recovery Relief Fund. Our employees have also supported fundraising efforts and some have volunteered supporting emergency services.

1 This figure is not included within 2010 community investment totals or the chart below.

COMMUNITY INVESTMENT SUBJECT FOCUS (%)



The Group uses the London Benchmarking Group methodology for calculating community giving.

The focus of our community investment activities includes Company donations and employee fundraising through Charity Challenge and payroll giving programmes.

Our total community investment in 2010 is made up of more than £2.6m in Company donations, and more than £715,000 in employee fundraising and payroll giving.



For more information about:

- Our approach to community relations
- Our employee fundraising and volunteering activities

VISIT: www.baesystems.com/corporateresponsibility/

* See Assurance statement on pages 54 and 55.

Assurance statement

Independent assurance report by Deloitte LLP to BAE Systems plc on the Corporate Responsibility section in the Directors' Report: Business Review of BAE Systems' Annual Report for the year ended 31 December 2010

What we looked at: scope of our work

BAE Systems plc ('BAE Systems') has engaged us to provide assurance on:

Limited assurance:

- The Group level business conduct, safety, diversity and inclusion, and community performance indicators on pages 47 and 53 indicated with a *
- Their statements on progress towards the Group level corporate responsibility (CR) objectives on page 46

Reasonable assurance:

- Their statements on business conduct made under the heading 'Business conduct' on pages 48 and 49, excluding all forward-looking sentences indicated with a +
- Their statement on safety strategy made under the heading 'Strategy' on page 50
- The business conduct performance indicators on page 47 indicated with a ^

What standards we used: basis of our work and level of assurance

Our work was carried out by a multi-disciplinary team of CR and business ethics assurance specialists in accordance with the International Standard on Assurance Engagements 3000 (ISAE 3000).

For the business conduct, safety, diversity and inclusion, and community performance indicators we planned and performed the work to provide limited assurance as to whether the BAE Systems' data on pages 47 and 53, indicated with a *, is not materially misstated. For the corporate responsibility objectives, we planned and performed the work to provide limited assurance as to whether the BAE Systems' statements on page 46 under the heading 'Performance in 2010 and objectives for 2011' are not materially misstated. This provides less assurance and is substantially less in scope than reasonable assurance.

For the statements on business conduct and safety strategy we planned and performed the work to obtain reasonable – not absolute – assurance as to whether the statements on business conduct on pages 48 and 49, excluding all forward-looking sentences indicated with a +, and on safety strategy on page 50 are a fair description of the activities undertaken. For the business conduct performance indicators we planned

and performed our work to obtain reasonable assurance that the business conduct indicators on page 47, indicated with a ^, are fairly stated.

The qualitative and subjective nature of non-financial information poses a number of inherent limitations for assurance engagements. The basis of reporting for each indicator marked with a * or a ^ is provided at www.baesystems.com/reporting/ and should be read in conjunction with statements made in this Annual Report.

What we did: key assurance procedures

Considering the risk of material error, we planned and performed the work to obtain all the information and explanations considered necessary to provide sufficient evidence to support our assurance conclusion. The key procedures we carried out were:

- Interviewing senior managers at BAE Systems in relation to activities undertaken during 2010 regarding responsible business conduct and CR performance reporting;
- Interviewing managers at BAE Systems' head office, including the CR and Safety, Health and Environment (SHE) team, and those with responsibility for CR management and reporting systems;
- Gaining an understanding of BAE Systems' own process to collect information from issue owners, and the process for collation and validation of performance data at Group level by the Group CR team;
- Analysing and reviewing on a sample basis the key structures, systems, processes, procedures and controls relating to the Group level collation, validation and reporting processes of the Annual Report, including:
 - the selection of issues to be reported on, related key performance indicators and other matters to be reported on;
 - the collection, collation, validation and reporting of selected safety, diversity, community and business conduct performance data at the year end; and
 - undertaking questionnaires and interviews with a limited purpose non-statistical sample of sites to gain an understanding of key processes and controls for reporting selected performance data to the Group CR team. Sites were selected based on safety performance, materiality to the Group and inherent risk of the location. We did not perform any site visits during our work.
- Interviewing members of BAE Systems' Legal department to understand the process followed to monitor compliance with

**Find out more
about corporate
responsibility in
BAE Systems...**

On our website



- Our approach to CR
- Managing CR
- Reporting and assurance
- Safety stories from our businesses
- Education and early careers
- Training and development
- Support for local communities

VISIT: www.baesystems.com/corporateresponsibility/

the Business Development Adviser Policy during 2010 and to prepare for compliance with the Bribery Act 2010;

- Performing limited purpose non-statistical sample testing to verify that a selection of advisers added to the BAE Systems' Approved Adviser Register during 2010 were appointed in compliance with the BAE Systems Adviser Policy;
- Interviewing members of BAE Systems' management to understand the scope and coverage of Code of Conduct refresher and induction training activities during 2010;
- Performing limited purpose non-statistical sample testing to verify the nature and extent of the roll out of Code of Conduct training for new and existing employees;
- Interviewing members of BAE Systems' management to understand the process followed to capture, investigate and report employee enquiries to the Ethics Helpline;
- Performing limited purpose non-statistical sample testing to verify that a selection of employee enquiries to the Ethics Helpline were appropriately captured, investigated, categorised and reported to the Ethics Committee;
- Examining underlying documents to corroborate interview outcomes and to inform our assessment of the subject matter to be assured; and
- Reviewing the CR section of the Annual Report against the findings of our work whilst assessing that the Annual Report has been compiled as described on page 55 in the section 'Scope and data'.

The scope of our work did not include the provision of assurance over whether BAE Systems' programme of work is adequately designed to, or will, meet the requirements of the Woolf Report.

What we found: our assurance opinion

Limited assurance conclusion:

- Based on the assurance work performed nothing has come to our attention to suggest that the business conduct, safety, diversity and inclusion, and community performance indicators on pages 47 and 53, indicated with a *, are materially misstated.
- Based on the assurance work performed nothing has come to our attention to suggest that the progress towards the Group level corporate responsibility objectives on page 46 is materially misstated.

Reasonable assurance opinion:

- BAE Systems' statements on business conduct made under the heading 'Business conduct' on pages 48 and 49,

excluding all forward-looking sentences indicated with a +, are, in our opinion, in all material respects fairly stated as at 18 February 2011.

- BAE Systems' statement on safety strategy made under the heading 'Strategy' on page 50 is, in our opinion, in all material respects fairly stated as at 18 February 2011.
- The business conduct indicators on page 47, indicated with a ^, are, in our opinion, in all material respects fairly stated.

Responsibilities of directors and independent assurance provider **BAE Systems' responsibilities**

- The directors are responsible for the preparation of the Annual Report, and for the information and statements contained in connection with it. They are responsible for determining BAE Systems' objectives in respect of CR performance, and for establishing and maintaining appropriate performance management and internal control systems from which the reported information is derived.

Deloitte's responsibilities

- Our responsibility is to independently express conclusions on the reliability of management's assertions on the selected subject matters as defined within the scope of work above.
- This report is made solely to BAE Systems plc in accordance with our letter of engagement for the purpose of the directors' governance and stewardship. Our work has been undertaken so that we might state to the Company those matters we are required to state to them in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than BAE Systems plc for our work, for this report, or for the conclusions we have formed.
- Our multi-disciplinary team of CR and business ethics assurance specialists performed the engagement in accordance with Deloitte's independence policies, which cover all of the requirements of the International Federation of Accountants (IFAC) Code of Ethics and in some areas are more restrictive. We confirm to BAE Systems that we have maintained our independence and objectivity throughout the year, including the fact that there were no events or prohibited services provided which could impair that independence and objectivity in the provision of this engagement.

Deloitte LLP

London, United Kingdom

18 February 2011

Scope and data

The data and performance measures in this report cover the period January to December 2010 with the exception of environment data which covers the period January to December 2009. Qualitative information and quantitative data for the report are provided by individuals across our business. Quantitative data is recorded on centralised systems, and content and data are reviewed at head office.

Unless otherwise explained, the data in this report cover the Group's major operations globally, excluding those acquired or divested during the year.

Risk management

HOW BAE SYSTEMS MANAGES RISK

Effective management of risks and opportunities is essential to the delivery of the Group's objectives, achievement of sustainable shareholder value, protection of its reputation and meeting the requirements of good corporate governance.

The Group's approach to risk management is aimed at the early identification of key risks, and then to remove or reduce the likelihood and effect of those risks before they occur, and deal effectively with actual problems if they crystallise.

The Group 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 Group is also committed to the effective management of material non-financial and reputational risks, including those arising in connection with business conduct, the environment, and health and safety.

The Board has overall responsibility for ensuring that risk is effectively managed across the Group.

Reporting within the Group is structured so that key issues are escalated through the management team, ultimately to the Board if appropriate. The underlying principles of the Group's risk management policy are that risks are continuously monitored, associated action plans reviewed, appropriate contingencies provisioned and this information reported through established management control procedures.

The Board has delegated:

- to the Audit Committee, the responsibility for reviewing in detail the effectiveness of the Group's system of internal control policies and procedures for the identification, assessment and reporting of risk; and
- to the Corporate Responsibility Committee, the responsibility for monitoring and reviewing the Group's performance in managing business conduct, environmental, and health and safety risks.

Both the Audit and Corporate Responsibility committees report the findings of their reviews to the Board.

Business risk management

The responsibility for risk identification, analysis, evaluation, mitigation, reporting and monitoring rests with line management. Guidance for managers is given in the Group's Risk Management Policy in the Operational Framework and, in respect of projects, in the Lifecycle Management (LCM) Framework and a Risk Management Maturity self-assessment tool.

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

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

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

The output from the risk assessment processes are collated and reviewed by the Executive Committee to identify those issues where the cumulative risk, or possible reputational impacts, could be significant. The Executive Committee's risk workshops allocate management responsibility for the management of the Group's most significant non-financial risks. The non-financial risk register is reviewed regularly by the Executive Committee to monitor the ongoing status and progression of mitigation plans. In addition, it is reviewed on a regular basis by the Board and Corporate Responsibility Committee.

BUSINESS RISK IDENTIFICATION

Business risks are identified on a continuous basis, through robust, mandated processes, from monthly Contract Reviews through to the annual five-year Integrated Business Plan.

Board-approved long-term strategy and five-year plan for each operating group

Management self-assessment of compliance with the Operational Framework and summary of key business risks

Management review of the performance of each of the Group's businesses against their objectives, measures and milestones

Management review of project performance and issues to ensure that appropriate decisions and actions are taken

Integrated Business Plan
Core Business Process

Operational Assurance Statement
Mandated Policy

Quarterly Business Review
Core Business Process

Lifecycle Management Contract Review
Core Business Process

Annually

Six-monthly

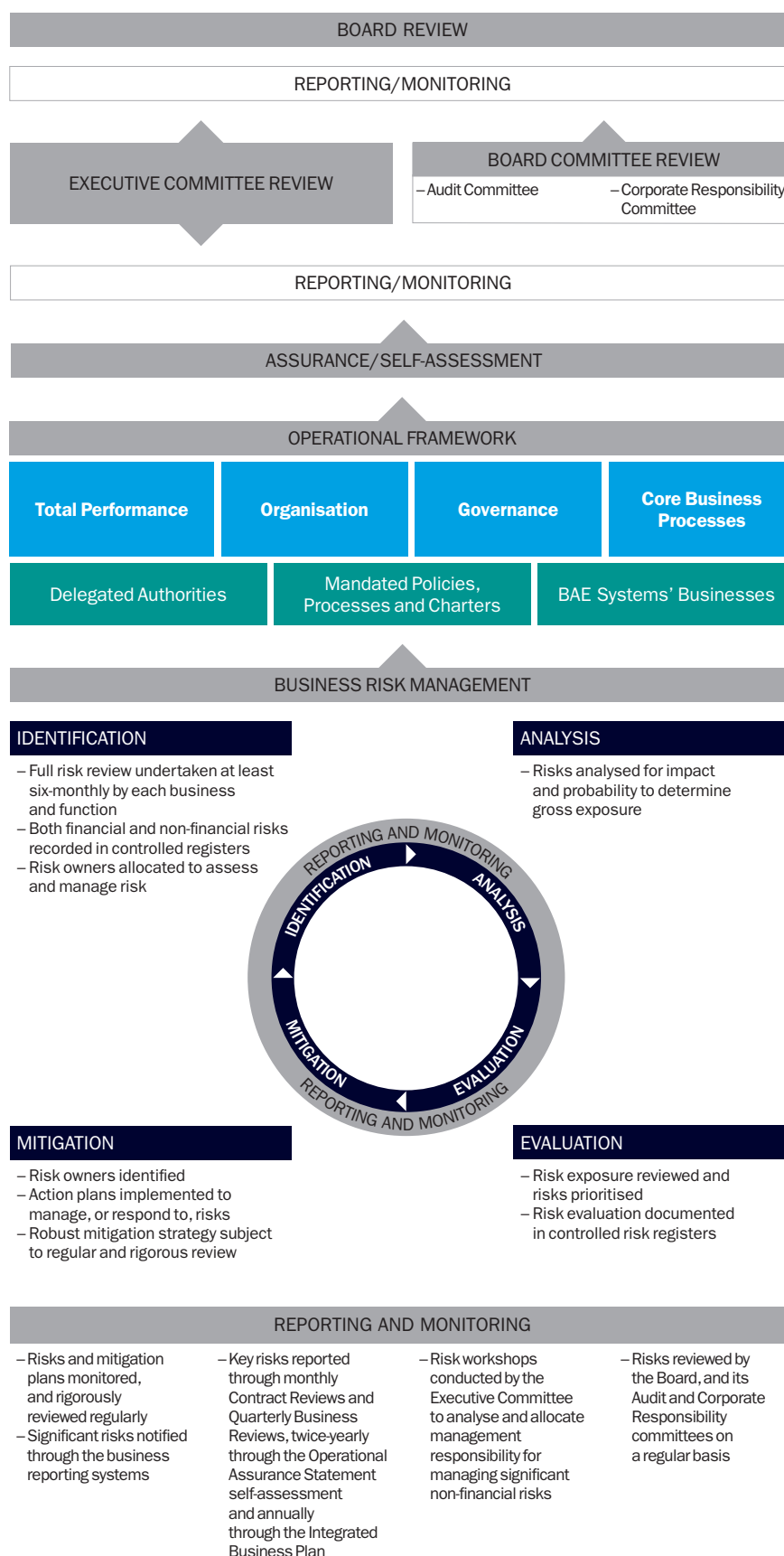
Quarterly

Monthly

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

Principal risks

The principal risks identified by the Group, which are consistent with the prior year, are shown on pages 58 to 63.



p78–99 For more information on the activities of the Board and its committees

p87–88 For more information on the Group's business processes and mandated policies

Principal risks

SUMMARY OF PRINCIPAL RISKS

The Group's principal risks are identified below, together with an estimate of the size of their potential impact on the Group were they to crystallise.

Link to Total Performance	Financial Performance			
	Customer Focus	Programme Execution	Responsible Behaviour	Other
High impact	<p>p58 Defence spending</p> <p>p59 Government customers</p> <p>p59 Global market</p>	<p>p60 Large contracts</p> <p>p60 Fixed-price contracts</p>	<p>p61 Laws and regulations</p>	<p>p61 Competition</p> <p>p62 Pension funding</p> <p>p62 Export controls and other restrictions</p> <p>p62 Acquisitions</p>
Medium impact	<p>p59 Contract award timing</p>	<p>p60 Component availability, subcontractor performance and key suppliers</p>		<p>p63 Consortia and joint ventures</p> <p>p63 Exchange rates</p>

DEFENCE SPENDING

The Group is dependent on defence spending and reductions in such spending could adversely affect the Group.

Description

The Group's core businesses are primarily defence and security related, selling products and services directly and indirectly, primarily to the US, UK, Saudi Arabian, and other national governments. Defence spending depends on a complex mix of political considerations, budgetary constraints, and the ability of the armed forces to meet specific threats and perform certain missions. Because of these factors, defence spending may be subject to significant fluctuations from year to year.

Despite budgetary pressures, the US defence market continues to generate a substantial number of business opportunities. In the UK, pressure to reduce government expenditure has been reflected in the Strategic Defence and Security Review (SDSR), which identified a number of changes in priorities, with consequent implications for certain of the Group's programmes. Saudi Arabia is expected to remain one of the largest defence spenders in the world, with defence expenditure of 10.9% of GDP in 2009.

Impact

A decrease in defence purchases by the Group's major customers could have a material adverse effect on the Group's future results of operations and financial condition.

Mitigation

The Group's business is geographically spread across five key home markets, and its products are marketed across a range of sectors within the defence and security arenas. The Group has a highly sustainable Services business, which represented 48% of sales in 2010. This is an area for growth as customers' operations and maintenance budgets come under pressure. The Group has already made significant cost reductions in anticipation of the increased budgetary pressure. The Group continues to use realistic assumptions to underpin its financial and operational planning.

p20 For more information on the Group's five key home markets

p24 For more information on the SDSR

GOVERNMENT CUSTOMERS

The Group's largest customer contracts are government contracts.

Description

The governments of the US, UK and Kingdom of Saudi Arabia are the Group's three largest end customers. Any significant disruption or deterioration in the relationship with these governments and a corresponding reduction in government contracts would significantly reduce the Group's revenues. Companies engaged in the supply of defence and security related equipment and services to government agencies are subject to certain business risks particular to the defence and security industries. These governments could modify contracts or terminate them at short notice and at their convenience. For example, long-term US government contracts are normally funded annually and are subject to cancellation or delay if funding appropriations for subsequent performance periods are not made. Terms and risk sharing agreements can also be amended. In addition, the Group, as a government contractor, is subject to financial audits and other reviews by some of its governmental customers with respect to the performance of, and the accounting and general practices relating to, government contracts. As a result of these audits and reviews, costs and prices under these contracts may be subject to adjustment.

Impact

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

Mitigation

The Board regularly reviews the Group's performance in these home markets, and the Executive Committee continues to work closely with these customers to ensure the Group strategy is aligned with theirs. In the event of a customer termination for convenience, the Group would typically be paid for work done and commitments made at the time of termination. Having sovereign governments as major customers offers the benefits of dealing with mature procurement organisations with which the Group can have long-standing business relationships, and well established and understood terms of trade.

p14 For more information on the Group's strategy

p32 For more information on the Group's customers

GLOBAL MARKET

The Group is exposed to risks inherent in operating in a global market.

Description

BAE Systems is a global company which conducts business in a number of regions, including the Middle East, and, as a result, assumes certain risks associated with businesses with a broad geographical reach. In some countries, these risks include, and are not limited to, the following: government regulations and administrative policies could change quickly and restraints on the movement of capital could be imposed; governments could expropriate the Group's assets; burdensome taxes or tariffs could be introduced; political changes could lead to changes in the business environment in which the Group operates; and economic downturns, political instability and civil disturbances could disrupt the Group's business activities.

Impact

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

Mitigation

The Group has a balanced portfolio of businesses with five key home markets.

p20 For more information on the Group's five key home markets

CONTRACT AWARD TIMING

The timing of contract awards could materially affect the Group's future results of operations and financial condition.

Description

The Group's operating performance and cash flows are dependent, to a significant extent, on the award of defence contracts.

Impact

Because the amounts payable under these contracts can be substantial, the timing of award or failure to receive anticipated orders could materially affect the Group's operating results and cash flow for the periods affected.

Mitigation

The Board regularly reviews the Group's performance with regard to contract awards, and the Executive Committee actively manages the assets and resources of the Group in line with the timing of awards.

p32 For more information on Lifecycle Management (LCM) which mandates project management processes from business winning to contract execution

LARGE CONTRACTS

Certain parts of the Group's business are dependent on a small number of large contracts.

Description

A significant proportion of the Group's revenue comes from a small number of large contracts. Each of these contracts, which are primarily in the Programmes & Support and International operating groups, is typically worth or potentially worth over £1bn.

Impact

The loss, expiration, suspension, cancellation or termination of any one of these contracts, for any reason, could have a material adverse effect on the Group's future results of operations and financial condition.

Mitigation

The Group has a large forward order book and a well-balanced spread of programmes, which provides long-term visibility. An analysis of the Group's order book by major programme and operating group is presented on the inside front cover of this report. The Board regularly reviews the Group's performance on these contracts, and the Executive Committee continues to work closely with these customers to ensure the Group's strategy is aligned with theirs.

p14 For more information on the Group's strategy

FIXED-PRICE CONTRACTS

The Group has fixed-price contracts.

Description

A significant portion of the Group's revenue is derived from fixed-price contracts. An inherent risk in these fixed-price contracts is that actual performance costs may exceed the projected costs on which the fixed prices for such contracts are agreed. These contracts can extend over many years and it can be difficult to predict the ultimate outturn costs associated with the terms on which they are based.

Impact

The Group's failure to anticipate technical problems, estimate costs accurately or control costs during performance of a fixed-price contract may reduce the profitability of such a contract or result in a loss.

Mitigation

The Group has reduced its exposure to fixed-price design and development activity which is in general more risk intensive than fixed-price production activity. To manage contract-related risks and uncertainties, contracts are managed through the application of the Lifecycle Management (LCM) business process mandated by the Operational Framework at the operational level. Robust bid preparation and approvals processes are well established throughout the Group, with decisions required to be taken at the appropriate level in line with clear delegations of authority. The consistent application of metrics is used to support the review of individual contract performance.

p32 For more information on LCM

COMPONENT AVAILABILITY, SUBCONTRACTOR PERFORMANCE AND KEY SUPPLIERS

The Group is dependent upon component availability, subcontractor performance and key suppliers.

Description

The Group is dependent upon the delivery of materials by suppliers and the assembly of components and subsystems by subcontractors used in its products in a timely and satisfactory manner, and in full compliance with applicable terms and conditions.

Impact

Some of the Group's suppliers or subcontractors may be impacted by the economic environment and constraints on available financing, which could impair their ability to meet their obligations to the Group. In some instances, the Group is dependent on one or a limited number of suppliers. If any of these suppliers or subcontractors fails to meet the Group's needs, the Group may not, in the short term, have readily available alternatives, thereby impacting its ability to complete its customer obligations satisfactorily and in a timely manner. These events could have a negative impact on the Group's future results of operations and financial condition.

Mitigation

The Group's procurement function is responsible for establishing and managing end-to-end integrated supplier arrangements. It is led by a member of the Executive Committee. The Executive Committee continues to monitor this risk and the Group has experienced no material negative impact to date. The Group reviews the financial health of strategically important suppliers globally on an ongoing basis.

p33 For more information on the Group's subcontractors and other suppliers

LAWS AND REGULATIONS

The Group is subject to risk from a failure to comply with laws and regulations.

Description

The Group has contracts and operations in many parts of the world, operates in a highly regulated environment and is subject to applicable laws and regulations of many jurisdictions. These include, without limitation, regulations relating to import-export controls, money-laundering, false accounting, anti-bribery and anti-boycott provisions. Non-compliance could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group. From time to time, the Group is subject to government investigations relating to its operations.

Impact

Failure by the Group or its sales representatives, marketing advisers or others acting on its behalf to comply with these laws and regulations could result in administrative, civil or criminal liabilities resulting in significant fines and penalties and/or result in the suspension or debarment of the Group from government contracts for some period of time or suspension of the Group's export privileges.

Mitigation

During the year, the Group has continued to add resources dedicated to legal and regulatory compliance in order to further enhance its capability to identify and manage the risk of compliance failure. Internal and external market risk assessments form an important element of the ongoing corporate development process. A uniform global policy and process for the appointment of advisers engaged in business development is in effect. Pursuant to its commitments concerning ongoing regulatory compliance made in the course of the settlement reached with the US Department of Justice (DoJ) in February 2010, the Group has appointed an independent monitor for a period of up to three years to monitor the Group's compliance with such commitments.

p48 For more information on the Group's approach to business conduct

COMPETITION

The Group's business is subject to significant competition.

Description

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

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

Impact

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

Mitigation

The Group's global, multi-home market presence, balanced portfolio of businesses, leading capabilities and performance continue to address this risk.

p20 For more information on the Group's five key home markets

PENSION FUNDING

The Group is exposed to funding risks in relation to the defined benefits under its pension schemes.

Description

The Group operates certain defined benefit pension schemes. At present, in aggregate, there is an actuarial deficit between the value of the projected liabilities of these schemes and the value of the assets they hold. The Group continues to implement the deficit recovery plans agreed with the respective scheme trustees based on actuarial advice and funding valuation results.

Impact

The amount of the deficits may be adversely affected by changes in a number of factors, including investment returns, long-term interest rate and price inflation expectations, and anticipated members' longevity. Further increases in pension scheme deficits may require the Group to increase the amount of cash contributions payable to these schemes, thereby reducing cash available to meet the Group's other operating, investing and financing requirements.

Mitigation

The performance of the Group's pension schemes and deficit recovery plans are regularly reviewed by both the Group and the trustees of the schemes taking actuarial and investment advice as applicable. The results of these reviews are discussed with the Board and appropriate action taken.

p40 For more information on the Group's pension accounting and funding valuations, and deficit recovery plans

EXPORT CONTROLS AND OTHER RESTRICTIONS

The Group is subject to export controls and other restrictions.

Description

A portion of the Group's sales is derived from the export of its products. The export of defence and security products outside the jurisdictions in which they are produced is subject to licensing and export controls, and other restrictions. No assurance can be given that the export controls to which the Group is subject will not become more restrictive, that new generations of the Group's products will not also be subject to similar or more stringent controls, or that political factors or changing international circumstances will not result in the Group being unable to obtain necessary export licences.

Impact

Reduced access to export markets could have a material adverse effect on the Group's future results of operations and financial condition. Failure to comply with export controls and wider regulations could expose the Group to fines, penalties, suspension or debarment, which could have a material adverse effect on the Group.

Mitigation

The Group has formal systems and policies in place which are mandated under the Operational Framework to ensure adherence to regulatory requirements and identify any restrictions that could adversely impact the Group's future activities.

p21 For more information on exports

ACQUISITIONS

The Group has experienced growth through acquisitions. Anticipated benefits of acquisitions may not be realised.

Description

The Group has experienced growth through acquisitions and continues to pursue acquisitions in order to meet its strategic objectives. Whether the Group realises the anticipated benefits from these transactions depends upon the integration of the acquired businesses and their performance relative to the Group's acquisition expectations.

Impact

The diversion of management attention to integration efforts, difficulties in combining operations and the performance of the acquired businesses below expectations could adversely affect the Group's business, and create the risk of impairments arising on goodwill and other intangible assets.

Mitigation

The Group has established policies in place to manage the acquisition process, integrate acquired businesses, and monitor performance and potential impairments.

p9 For more information on M&A activity during the year

p132 For more information on impairment testing

CONSORTIA AND JOINT VENTURES

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

Description

The Group participates in various consortia, joint ventures and equity holdings, exercising varying and evolving degrees of control. While the Group seeks to participate only in ventures in which its interests are aligned with those of its partners, the risk of disagreement is inherent in any jointly controlled entity, and particularly in those entities that require the unanimous consent of all members with regard to major decisions and that specify restricted rights.

Impact

In the event of disagreement within a consortium, joint venture or equity holding and the business arrangement failing to meet its strategic objectives or expected benefits, the Group's business and results of operations may be adversely affected.

Mitigation

The Group has formal systems and procedures in place to monitor the performance of such business arrangements, and identify and manage any adverse scenario arising.

p155 For more information on the Group's principal joint ventures

EXCHANGE RATES

The Group is exposed to volatility in currency exchange rates.

Description

The global nature of the Group's business means it is exposed to volatility in currency exchange rates in respect of foreign currency denominated transactions, and the translation of net assets and income statements of foreign subsidiaries and equity accounted investments. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.

Impact

Significant fluctuations in exchange rates to which the Group is exposed could have a material adverse effect on the Group's future results of operations and financial condition.

Mitigation

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures, unless otherwise approved as an exception by the Treasury Review Management Committee, and to manage anticipated economic cash flow exposures. The Group does not hedge the translation effect of exchange rate movements on the income statement or balance sheet of overseas subsidiaries and equity accounted investments it regards as long-term investments. Hedges are, however, undertaken in respect of investments that are not considered long term or core to the Group.

p42 For more information on the Group's treasury policies

Additional risks and uncertainties currently unknown to the Group, or which the Group currently deems immaterial, may also have an adverse effect on the financial condition or business of the Group.

Operating group overview

BAE Systems has four principal operating groups each with different characteristics resulting from the nature and phase in the lifecycle of programmes, products and services provided, procurement philosophies of their principal customers, and geographical areas in which they operate.

OPERATING GROUP FINANCIAL PERFORMANCE SUMMARY – CONTINUING OPERATIONS

	KPI Order intake ¹ £m	Order book ¹ £bn	KPI Sales ¹ £m	KPI Underlying EBITA ² £m	Return on sales %	KPI Cash flow ³ £m
2010						
Electronics, Intelligence & Support	5,823	4.8	5,653	668	11.8	568
Land & Armaments	3,707	5.9	5,930	604	10.2	858
Programmes & Support	4,139	21.1	6,680	529	7.9	227
International	2,908	9.1	4,534	478	10.5	195
HQ & Other Businesses	207	0.3	278	(65)		(665)
Discontinued operations	–	–	–	–		4
	16,784	41.2	23,075	2,214		1,187
Less: intra-group	(400)	(1.5)	(683)	–		–
	16,384	39.7	22,392	2,214	9.9	1,187
2009 (restated⁴)						
Electronics, Intelligence & Support	5,416	4.5	5,637	575	10.2	380
Land & Armaments	3,934	7.8	6,738	604	9.0	480
Programmes & Support	8,789	24.3	6,298	670	10.6	285
International	4,564	11.0	3,828	419	10.9	813
HQ & Other Businesses	175	0.4	254	(71)		(366)
Discontinued operations	–	–	–	–		3
	22,878	48.0	22,755	2,197		1,595
Less: intra-group	(1,170)	(1.7)	(765)	–		–
	21,708	46.3	21,990	2,197	10.0	1,595

p36 For more information on the Group's financial performance

- 1 Including share of equity accounted investments.
- 2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).
- 3 Net cash inflow/(outflow) from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.
- 4 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation.

BAE Systems, Inc.

Electronics, Intelligence & Support (EI&S)

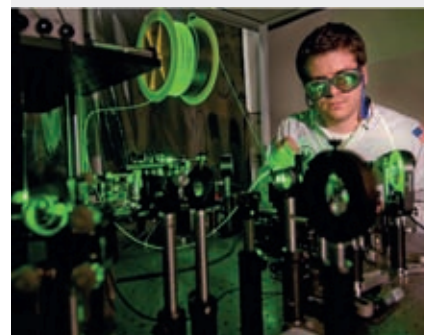
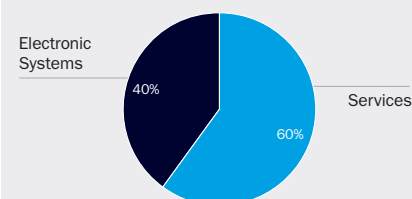
Description of activities

Electronic Systems business comprises many relatively small, short-cycle contracts, applying high technology solutions to complex problems.

Services activities include Readiness & Sustainment, such as the support business, which includes US ship repair and modernisation activities, and Cyber & Intelligence, which supports US and international governments in their national security missions.

Contracting structures include Indefinite Delivery, Indefinite Quantity (IDIQ) contracts, where orders are made against an overall budget spend, and Multi-Ship, Multi-Option (MSMO) contracts, which enable work to be undertaken during successive US Navy ship dockings. The order book is typically one year's sales or less reflecting the value of business drawn against IDIQ or MSMO contracts, and the annual budget appropriation methodology for procurement in the US.

Sales by market segment¹



Land & Armaments

Description of activities

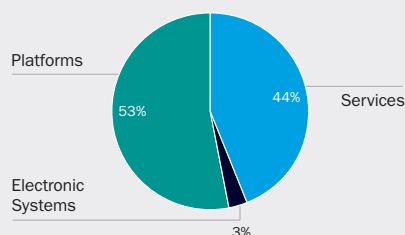
The business typically comprises medium to long-term contracts or IDIQ contracts for design, development, production, support and upgrade of armoured combat vehicles, tactical wheeled vehicles, missile launchers, artillery systems and munitions.

Significant vehicle Platforms include Mine Resistant Ambush Protected (MRAP), the final deliveries on the Family of Medium Tactical Vehicles (FMTV) contract, and sales of CV90 vehicles. Other Platforms business includes the manufacture of artillery systems, such as the M777 howitzer, and naval guns.

Services activities include the 15-year munitions supply contract with the UK Ministry of Defence, and contracts for the reset and remanufacture of Bradley Fighting Vehicles for the US Army.

The business is in the process of restructuring to match the lower sales volume and cost base as the FMTV programme concludes and Bradley reset activity reduces.

Sales by market segment¹



Programmes & Support

Description of activities

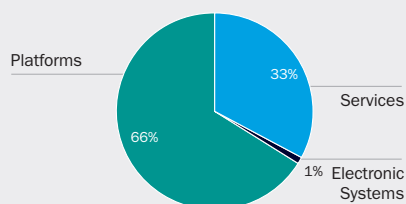
This operating group has a small number of large Platforms contracts. Most of the business is with the UK government. Contracts are typically awarded as multi-year programmes.

Development programmes are contracted such that appropriate levels of risk are initially held by the customer. Subsequent production programmes are priced when a system's development has reached sufficient maturity for specifications to be stabilised and costs known. Production contracts may be awarded on a fixed-price basis, often with indices to adjust prices where they extend over long periods. Contracts may also have incentive arrangements whereby the customer and contractor share cost savings against agreed target prices.

The significant Services business for air and maritime programmes is also usually contracted over multi-year periods, and includes business where the Group provides an overall capability. These contracts may also have incentivised profitability, the customer and contractor sharing cost savings.

The Detica business operates in the Cyber & Intelligence domain.

Sales by market segment¹



International

Description of activities

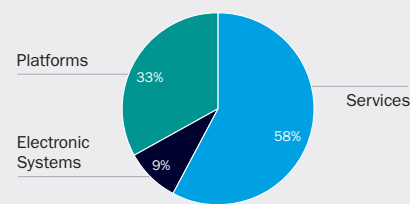
International has businesses in Saudi Arabia and Australia, as well as shareholdings in MBDA, Air Astana, and Indian land systems and software businesses.

The business provides operational capability support to Saudi Arabia's air and naval forces on UK/Saudi government-to-government contracts. Services contracts, such as the Saudi British Defence Co-operation Programme and Typhoon support, tend to be multi-year, including fixed price elements. Platforms business includes multi-year, fixed price contracts, often with price variation formula, such as the Salam Typhoon contract.

In Australia, the business delivers production and support/upgrade programmes for the Australian government across air, maritime, land and security. Services contracts include the provision of support and upgrades. Contracts for Platforms include naval ships and land vehicles. Contracts are often multi-year and fixed price, but with price variation formula.

The business is developing its position in Oman and an order for Typhoon aircraft is actively being pursued.

Sales by market segment¹



Operating group reviews

Electronics, Intelligence & Support

OVERVIEW

Electronics, Intelligence & Support, with 30,800 employees¹, provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for US national security and federal markets, and ship repair and modernisation services.

KEY POINTS – FINANCIAL

- Order intake¹ growth of 7.5%
- Return on sales increased to 11.8%
- Cash flow³ conversion of underlying EBITA² at 85%

PERFORMANCE

		2010	2009	2008
Financial				
Order intake ¹	KPI	£5,823m	£5,416m	£4,904m
Order book ¹		£4.8bn	£4.5bn	£5.2bn
Sales ¹	KPI	£5,653m	£5,637m	£4,459m
Underlying EBITA ²	KPI	£668m	£575m	£506m
Return on sales		11.8%	10.2%	11.3%
Cash inflow ³	KPI	£568m	£380m	£380m
Safety				
Lost Work Day Case Rate (per 100,000 employees)	KPI	262	315	472

KEY POINTS – OPERATIONAL

- Acquisitions of Atlantic Marine and OASYS Technology completed
- Central operating group headquarters closed as part of the restructuring of BAE Systems, Inc.
- Continued to perform on legacy programmes and secured several strategic contract awards in new markets
- US Army qualified IMX-101 as a safer and effective alternative for the potential replacement of TNT in artillery
- Strong ship repair performance continued, with order intake totalling \$1bn (£0.6bn) in 2010

In 2010, Electronics, Intelligence & Support sales¹ were £5,653m (2009 £5,637m). On a like-for-like basis, sales¹ decreased by 2.4% over 2009 primarily reflecting the impact of contracting delays caused by the extended Continuing Resolution funding at the end of 2009.

Return on sales increased to 11.8% (2009 10.2%) reflecting good programme execution on certain maturing programmes, and ongoing cost reduction and efficiency programmes.

Operating cash inflow³ was £568m (2009 £380m) reflecting good working capital management.

The business reduced its Lost Work Day Case Rate by 17% in 2010, driven by good performance in high risk areas. Although the overall target of a 20% reduction was not achieved, the safety performance of the businesses has continued to demonstrate a year-on-year improvement. With the exception of Atlantic Marine sites acquired in 2010, all sites with more than 150 personnel progressed to Level 4 on the Group's Safety Maturity Matrix.

Electronic Solutions

Electronic Solutions completed the \$53m (£33m) acquisition of OASYS Technology, an electro-optical systems manufacturer, which strengthens BAE Systems' Electronic Systems capabilities, providing a wide range of night vision, soldier-borne imaging systems.

The business maintained its leadership position in electronic warfare, with strong performance on Low-Rate Initial Production (LRIP) of electronic warfare suites for F-35. The initial countermeasures system was delivered, with significant improvements made to its mission systems flight testing software.

The F-22 electronic warfare programme completed its required deliveries, retired all risk items as planned and exceeded its cost reduction expectations.

The US Army continues to order the Common Missile Warning System, a helicopter missile warning system, with contract awards of \$34m (£22m) in 2010. The business also unveiled its directable, infrared countermeasures suite, Boldstroke™, an integrated aircraft survivability system for protecting aircraft from infrared-guided missiles and other threats.

A \$46m (£29m) LRIP contract was signed with the US Navy for the Advanced Precision Kill Weapon System. BAE Systems designed the laser guidance and controls on this cost-effective guidance kit that transforms standard unguided rockets into highly precise laser-guided missiles.

2010 Executive Committee objective

Grow our EI&S business both organically and via acquisitions, and improve efficiency

Support Solutions

BAE Systems received a Multi-Ship, Multi-Option (MSMO) contract, with a potential value of \$365m (£233m), for executing planning, modernisation, maintenance and repair work on 11 Arleigh Burke DDG-51 class destroyers at its Norfolk, Virginia, facility. This contract, and existing contracts for CG-47 class cruisers and amphibious ships, support work at the Group's Norfolk, San Diego and Hawaii shipyards, and positions BAE Systems as a major supplier of support services to the US Navy.



¹ Including share of equity accounted investments.
² Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

³ Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

The business continues to invest in research and development. As part of a three-year, \$70m (£45m) investment in the development of state-of-the-art manufacturing and systems engineering facilities for integrated aircraft survivability equipment, the Worrell/Weeks Aircrew Protection Center, a new testing and equipment evaluation laboratory, was dedicated during the year.

Following strong performance by the business on legacy contracts, US Army demand for thermal weapon sights continued in 2010 with the award of an additional \$123m (£79m) contract under a five-year, Indefinite-Delivery, Indefinite-Quantity contract. The order increases the total thermal weapon sight contract value to more than \$1bn (£0.6bn) since 2004.

In 2010, the Driver's Vision Enhancer Family of Systems completed the hardware qualification phase and began production deliveries, with orders totalling more than \$92m (£59m). The combat-proven Check-6® thermal camera system received additional contracts worth more than \$120m (£77m) and deliveries exceeded 21,000 units.

In an emerging market related to unmanned aerial vehicle opportunities, BAE Systems was awarded several wide-area persistent surveillance contracts totalling over \$100m (£64m).

In export markets, the business secured a \$67m (£43m) contract with the Slovak Ministry of Defence for a newly designed mobile military communications system (MOKYS). The system supports secure transfer of information in the form of voice, data and images at both operational and tactical levels of command.

Intelligence & Security

In February 2011, BAE Systems completed the acquisition of L-1 Identity Solutions, Inc.'s Intelligence Services Group, which expands its existing presence in the US intelligence community, for a cash consideration of approximately \$297m (£190m).

Within the Services market segment, Intelligence & Security continues to support US and international government and commercial clients in the collection and management of information to gather intelligence, maintain security, manage risks and strengthen resilience in today's complex operating environments. Key focus areas are intelligence and counterintelligence, homeland security, law enforcement, and support of military operations.

With sustained intelligence and security operations around the world, the business captured significant, indefinite-quantity contract vehicles to provide knowledge management, cyber, information technology, and analysis support to defence and intelligence agencies, and the US Federal Bureau of Investigation (FBI).

Other key contract awards included: Next Generation Desktop for up to \$300m (£192m) that will deploy over 12,000 analyst workstations across the intelligence community; a \$40m (£26m) contract for the FBI supporting enterprise network operations and information assurance; and a command and control system contract for the US Navy with an estimated value of \$100m (£64m) that leverages BAE Systems' market-leading capabilities in full-motion video analysis, geospatial imagery analysis and mission planning.

Platform Solutions

In the air domain, the business extended a long-term agreement with Boeing, securing its exclusive position for Boeing original

equipment and aftermarket work through to 2019. The contract covers commercial electronics for the Boeing 737, 747, 767 and 777 aircraft, with a potential value of \$800m (£511m).

In the UK, the business delivered the first order of new helmet-mounted optical sighting systems to the Royal Navy, addressing a mission-critical need for increased air door gunner situational awareness.

BAE Systems began production deliveries of its HybriDrive® propulsion system to British bus builder Alexander Dennis under the UK Green Bus Fund initiative, with over 100 systems in service to date. The business began the development of a hydrogen fuel cell system for SunLine Transit, delivered its first production bus to the Seattle Transit System, and was selected to power New Flyer hybrid buses in Atlanta, Georgia and Everett, Washington. Transit buses powered by BAE Systems' HybriDrive® green propulsion systems surpassed 200 million miles of clean, reliable revenue service.

Support Solutions

Consistent with the Group's strategy to grow its Readiness & Sustainment activities, Atlantic Marine was acquired in July for \$372m (£245m). The acquisition enhances the Group's ability to meet ongoing demand for ship maintenance, repair, overhaul and conversion services; marine fabrication; and construction. Integration of the business is largely complete.

A five-year, \$400m (£256m) MSMO contract was secured to repair and modernise eight combatant ships for the US Navy. The contract includes docking and non-docking work on four CG-47 Ticonderoga class cruisers and four DDG-51 Arleigh Burke class destroyers.

In another Services market, the US Army awarded the business a contract worth up to \$95m (£61m) to install and maintain automated access control systems at US Army bases and other installations. This award expands BAE Systems' support of physical security at US government sites.

BAE Systems has been approved to provide engineering and technical services to the US Army and other federal customers under the Rapid Response – 3rd Generation \$16.4bn (£10.5bn) government-wide contract, making it eligible to bid on a range of task orders during the ten-year life of the contract.

OUTLOOK

Pressures continue on the US defence budget. The US Secretary of Defense recently announced a directive aimed at reducing funding for multiple programmes and services. Whilst these funding reductions and expected slowing or ultimate cancellations of new programmes could impact the business, BAE Systems remains well positioned to support its US customers with a balance of products, technologies and services. In recognition of the growing importance of affordability and efficiencies, BAE Systems streamlined the organisation of its US business in 2010 to reduce costs and improve flexibility. BAE Systems expects to benefit from its presence in markets that are forecast to grow despite general market pressures, such as Cyber & Intelligence and ship repair services. The business will continue to focus its investment in market areas where growth is expected.

p12 For more information on the Group's 2010 Executive Committee objectives

Land & Armaments

OVERVIEW

Land & Armaments, with 16,100 employees¹, designs, develops, produces, supports and upgrades armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products.

KEY POINTS – FINANCIAL

- Return on sales increased to 10.2% (2009 9.0%)
- Cash flow³ conversion of underlying EBITA² at 142.1%

PERFORMANCE

		2010	2009	2008
Financial				
Order intake ¹	KPI	£3,707m	£3,934m	£8,568m
Order book ¹		£5.9bn	£7.8bn	£11.5bn
Sales ¹	KPI	£5,930m	£6,738m	£6,407m
Underlying EBITA ²	KPI	£604m	£604m	£566m
Return on sales		10.2%	9.0%	8.8%
Cash inflow ³	KPI	£858m	£480m	£467m
Safety				
Lost Work Day Case Rate (per 100,000 employees)	KPI	277	500	737

KEY POINTS – OPERATIONAL

- Restructured to create a leaner, more responsive business to meet customers' needs
- Net headcount reduced by 5,500 (including contractors)
- Demand continues for land vehicle Readiness & Sustainment
- Continued progress in pursuit of supply chain efficiencies
- Continued Mine Resistant Ambush Protected vehicle activity

In 2010, Land & Armaments sales¹ were £5,930m (2009 £6,738m). On a like-for-like basis, and as expected, sales¹ were 13.7% below 2009 reflecting the lower level of land vehicle activity, primarily Bradley and Family of Medium Tactical Vehicles (FMTV).

Underlying EBITA² was £604m (2009 £604m). Return on sales increased to 10.2% (2009 9.0%) benefiting from both performance on the FMTV and Bradley programmes, and continuing rationalisation and efficiency activities. Underlying EBITA² in the prior year included £42m of costs associated with the unsuccessful Mine Resistant Ambush Protected (MRAP) All-Terrain Vehicle (ATV) bid.

Operating cash inflow³ was £858m (2009 £480m) reflecting strong working capital management.

The business reduced its Lost Work Day Case Rate by 45%, exceeding the 2010 objective of a 20% improvement on 2009. All sites with more than 150 personnel progressed to Level 4 on the Group's Safety Maturity Matrix.

In 2010, Land & Armaments restructured its operations to reflect the expected lower demand for new vehicles. As a result of the rationalisation programmes, total headcount (including contractors) was reduced by 5,500.

United States

BAE Systems has reset and upgraded more than 3,390 Bradley vehicles to support its customers since 2007. The business is extending the lives of 552 Bradley Fighting Vehicles by replacing old and damaged components under a \$91m (£58m) contract modification from the US Army Tank-automotive and Armaments Command Life Cycle Management Command. This is in addition to contracts totalling \$440m (£281m) awarded on other Bradley and HERCULES upgrades. The January statements by the US Secretary of Defense included the need to continue to upgrade the Bradley family of vehicles.

Early in 2010, following a rapid design and development process, BAE Systems introduced the Caiman Multi-Terrain Vehicle to provide an effective combination of interior capacity, tactical mobility, operator comfort and survivability. The business was awarded a \$629m (£402m) contract from the US MRAP Joint Program Office to upgrade 1,700 Caiman MRAP vehicles.

2010 Executive Committee objective

Implement our global land systems strategy, and deliver on our efficiency and rationalisation plans

Caiman MRAP Upgrade Programme

BAE Systems has been awarded a \$629m (£402m) contract from the US Mine Resistant Ambush Protected (MRAP) Joint Program Office to upgrade 1,700 Caiman MRAP vehicles. The upgraded vehicle, called the Caiman Multi-Terrain Vehicle, includes a refurbished and improved armoured capsule, a new high power automotive power train, chassis and independent suspension. This award demonstrates BAE Systems' support of the customer's current and future requirements by rapidly improving product performance to protect troops during combat missions.



¹ Including share of equity accounted investments.
² Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

³ Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

BAE Systems is on schedule to deliver seven Paladin Integrated Management prototype vehicles to the US Army under the existing research and development contract. The upgraded vehicles use combat-proven technologies from the Bradley vehicle family and feature the Group's enhanced on-board power management capability.

BAE Systems received orders from the US Marine Corps Systems Command worth \$170m (£109m) to produce 32 US Special Operations Command (SOCOM) Armored Utility Vehicles (AUV) and provide major upgrades to existing vehicles. The US SOCOM AUV is one of several MRAP variants based on the RG33 family of vehicles. To date, nearly 350 SOCOM MRAP vehicles have been produced and, in total, the business has delivered more than 6,400 MRAP vehicles to support urgent needs in Iraq and Afghanistan, with nearly \$5bn (£3.2bn) in contract awards for the production and service of MRAPs.

Two new Services facilities were opened to provide the US Army with work areas to maintain the RG33 SOCOM vehicles in theatre. These facilities provide complete maintenance and service capabilities in support of the Group's products in the field, training classrooms to assist soldiers, and living quarters for workers. Expansion plans include support of all the Group's products in service with the US armed forces in the region.

During the year, the US business was awarded over \$30m (£19m) in orders to deliver armour protection kits for Armored Security Vehicles (ASV), demonstrating BAE Systems' position as a leader in innovative armouring technologies. BAE Systems has produced more than 2,500 armour kits for the highly manoeuvrable, four-wheel drive ASV.

BAE Systems opened a new state-of-the-art design and prototyping centre in Sterling Heights, Michigan, housing facilities for vehicle and subsystem modifications, integration and testing, electrical assembly fabrication, software development, and system integration of vehicle control and crew station electronics.

The business continues to deliver ahead of schedule and to cost under its existing FMTV contract, producing over 7,000 vehicles at a record high quality level, with sales of some \$2bn (£1.3bn) in 2010. This contract is expected to complete in the first quarter of 2011.

Following the submission of a bid for the development phase of the US Army's new Ground Combat Vehicle programme in May, the business was notified of a change in the customer's requirements and re-submitted its bid. The technology demonstration phase of the programme is expected to be awarded late in 2011.

United Kingdom

The munitions business has seen significant investment and transformation activity during the year, with work on new facilities at Radway Green and Washington. Throughout this period, the business has continued to perform under its 15-year partnership with the UK Ministry of Defence (MoD) to deliver small arms ammunition, achieving cumulative schedule adherence of 99% and sales of £302m in 2010.

The vehicles business received Readiness & Sustainment contracts from the UK MoD, valued at £30m, for the design, production and embodiment of upgrade kits for 78 British Army Warrior infantry fighting vehicles. In March, the business delivered the last of the latest tranche of BVs10 Viking Mk2 vehicles.

In March, the UK government announced that it had not selected BAE Systems' proposal for the Future Rapid Effect System (FRES) Specialist Vehicles requirement.

The weapons business received an order for 93 additional M777 howitzers, taking total cumulative orders since product launch to 955 systems, worth in excess of £1bn.

Sweden

The weapons business was awarded a £135m contract for the production of 48 Archer 155mm self-propelled artillery gun systems for the Swedish and Norwegian armed forces.

The vehicles business was awarded a long-term contract from the Dutch MoD to supply spares for their CV9035 infantry fighting vehicles.

In June, BAE Systems launched the latest member of the CV90 family, the CV90 Armadillo, which has been modified to provide a higher degree of payload and flexibility to address new threats, and adapt to rapidly changing operational environments, thereby introducing a new build standard.

Despite its upheld legal appeal against the decision of the Swedish Defence Materiel Administration, the Group's proposed modular 8x8 vehicle, named Alligator, was not selected for the Armoured Wheeled Vehicle programme.

South Africa

Through a partnership with General Dynamics Land Systems Canada, the business received a \$160m (£102m) follow-on contract award to build 250 RG31 Mk5E vehicles in support of the MRAP vehicle programme for use in Afghanistan.

In December, the business received a contract for \$130m (£83m) for the upgrade of approximately 700 MRAP RG31 vehicles. The upgrade includes new engines, and new independent suspension and tyre inflation systems.

Joint ventures

FNSS, a 49% owned joint venture with Nurol Group of Turkey, signed a letter of intent for approximately \$500m (£320m) with DEFTECH of Malaysia for the design and manufacture of 250 armoured wheeled vehicles for the Malaysian armed forces.

OUTLOOK

Land & Armaments faces a challenging market environment. It is expected that pressures on defence budgets, particularly in the US and UK, will continue. Recent statements by the US Secretary of Defense indicated that the 2011 US defence budget is likely to include anticipated cost efficiencies, programme reductions and potential cancellations. However, the business is well positioned to compete for sustainment and upgrade work on its existing platforms in the event of new vehicle programme terminations.

Sales in 2011 will be impacted by approximately \$1.6bn (£1.0bn) on completion of the current FMTV contract and by approximately \$1.0bn (£0.6bn) for the lower level of Bradley reset/remanufacture activity.

Going forward, the focus will be on securing key new programmes, pursuing export opportunities, and sustaining the margin improvement from the business's ongoing restructuring and efficiency initiatives.

p12 For more information on the Group's 2010 Executive Committee objectives

Programmes & Support

OVERVIEW

Programmes & Support, with 31,600 employees¹, primarily comprises the Group's UK-based air, maritime and Cyber & Intelligence activities.

KEY POINTS – FINANCIAL

- **Underlying EBITA² includes a charge of £100m on the terminated Trinidad and Tobago Offshore Patrol Vessel (OPV) programme**

PERFORMANCE

		2010	2009	2008
Financial				
Order intake ¹	KPI	£4,139m	£8,789m	£4,195m
Order book ¹		£21.1bn	£24.3bn	£19.8bn
Sales ¹	KPI	£6,680m	£6,298m	£4,638m
Underlying EBITA ²	KPI	£529m	£670m	£491m
Return on sales		7.9%	10.6%	10.6%
Cash inflow ³	KPI	£227m	£285m	£651m
Safety				
Lost Work Day Case Rate (per 100,000 employees)	KPI	426	812	992

KEY POINTS – OPERATIONAL

- **£537m Hawk India contract secured**
- **Third Type 45 destroyer accepted off contract and sixth launched**
- **HMS Astute acceptance completed and second boat, Ambush, launched**
- **Nimrod MRA4 programme terminated and Harrier to be taken out of service in 2011 following Strategic Defence and Security Review (SDSR)**
- **Continued rationalisation and efficiency activity across the operating group and alignment of cost base post SDSR**

Order intake¹ in the year was £4.1bn (2009 £8.8bn).

The prior year intake included long-term orders for production of Typhoon Tranche 3A aircraft, and support for Typhoon, Harrier, Type 45, and Spearfish and Sting Ray torpedoes.

Sales¹ in 2010 were £6.7bn, which, on a like-for-like basis, were broadly unchanged from 2009.

Underlying EBITA² was £529m (2009 £670m) with a return on sales of 7.9% (2009 10.6%). Underlying EBITA² in 2010 includes a £100m charge on the terminated Trinidad and Tobago OPV programme. As expected, margins were impacted by higher pension service costs arising from a fall in the discount rates applied to pension liabilities.

The business reduced its Lost Work Day Case Rate by 48%, exceeding the 2010 objective of a 20% improvement on 2009. There were particular improvements in safety in the Surface Ships business. All sites with more than 150 personnel progressed to Level 4 on the Group's Safety Maturity Matrix.

In addition to approximately 1,750 redundancies announced in 2009, a further 2,900 were announced across the operating group in 2010 to continue to deliver efficiencies and align the cost base following the SDSR.

Military Air Solutions

Delivery of Typhoon Tranche 2 aircraft to the four partner nations continued with 41 aircraft delivered in the year. Deliveries to the Royal Saudi Air Force (RSAF) were made in accordance with the programme, with 18 of the 72 contracted aircraft delivered to date.

A £111m, four and a half-year Services contract was awarded on the Hawk Advanced Jet Trainer (AJT) fleet at RAF Valley. Twenty-five of the 28 Hawk AJT aircraft for the RAF have now been accepted.

BAE Systems has secured a £537m contract from Hindustan Aeronautics Limited to supply products and services to enable an additional 57 Hawk AJT aircraft to be built under licence in India.

On F-35, major unit deliveries to Lockheed Martin have been completed for the development programme and the first two production contract lots. Production continues to schedule on Lot 3, which includes the first two UK operational test and evaluation aircraft. The SDSR decision to acquire the F-35 Carrier variant instead of the F-35 Short Take Off and Vertical Landing variant will not change BAE Systems' role on the programme. BAE Systems' workshare arrangements are

2010 Executive Committee objective

Establish in the UK sustainably profitable through-life business in air, land and sea

BAE Systems wins pan-European Readiness & Sustainment contract

In May 2010, a five-year, £150m contract was awarded for the delivery of Typhoon Avionics Equipment Repair to the Air Forces of Germany, Spain and the UK. Combined with the £400m Radar and Defensive Aids Sub-System (DASS) contract awarded in 2009, the contracts offer a range of repair services, halving the customer's avionic repair costs for Typhoon and improving availability.



¹ Including share of equity accounted investments.
² Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

³ Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

not matched against the UK government's decisions on aircraft type or quantities.

On the Tornado and Harrier programmes, operational requirements continued to be met through the delivery of contractual milestones and Urgent Operational Requirements.

BAE Systems continues to show good progress in its Unmanned Aircraft Systems activities, with the roll out of the joint MoD and industry Taranis Unmanned Combat Aircraft System demonstrator in July.

Surface Ships

Programmes for the Royal Navy have progressed to plan, with construction well advanced on sections of the first Queen Elizabeth Class aircraft carrier in Portsmouth and Glasgow.

The Type 45 build programme continues, with delivery of third of class, Diamond, sea trials for fourth of class, Dragon, and launch of the sixth and final ship, Duncan, during 2010. The Type 45 support solution has been contracted for and established in Portsmouth.

Considerable achievements have been made to transform the business and drive cost savings under the Terms of Business Agreement (ToBA) with the MoD, including efficiency savings generated in the year to March 2010 for the MoD of £66m.

BAE Systems was awarded a four-year, £127m contract by the MoD to develop a highly flexible, multi-role frigate for the Royal Navy, the Type 26.

The export contracts for Oman, and Trinidad and Tobago have encountered significant difficulties during construction that have led to further delays and losses of £163m. The fair values of these contracts have been updated accordingly (see note 29 to the Group accounts).

In September, BAE Systems received written notice from the Government of the Republic of Trinidad and Tobago (GORTT) of its intention to cancel the contract for three OPVs. The Group has challenged GORTT's entitlement to cancel and has itself issued a termination for default notice on GORTT. The parties are now proceeding in accordance with the contract's dispute resolution provisions and a charge of £100m has been taken.

Submarine Solutions

HMS Astute, the first of class attack submarine for the Royal Navy, was accepted by the MoD in November. Ambush, the second of class, was launched in January 2011 and will now undertake commissioning activities prior to commencing sea trials. Construction continues on the third and fourth boats. A £360m order, which includes commencement of construction of the fifth boat and long lead procurement for the sixth boat, has been received.

The concept phase for the successor to the Vanguard class submarine is scheduled to complete in March 2011, with the assessment, design and development phases then to follow.

Detica

Detica's Cyber & Intelligence activity, which focuses on cyber security and information assurance, countering terrorism and organised crime, and border security, has maintained sales growth despite reduced UK government spending. Growth opportunities in other BAE Systems home markets, and elsewhere in the Middle East and Europe, have secured sales into the law enforcement, telecommunications and financial services sectors.

In the UK, cyber security has been highlighted as a significant threat in the National Security Strategy. Detica continues to be well placed as a strategic partner to UK government. In 2010, Detica launched a new cyber security service, Detica Treidan™, and is advising commercial and government customers on preventing and responding to attacks on their networks.

The Detica NetReveal® solution continues to show global sales growth with some key wins, particularly in the financial services sector.

In July 2010, the Home Office terminated the e-Borders contract. Detica was a subcontractor to Raytheon on that programme and has submitted a claim in connection with the termination for convenience of its subcontract.

In December 2010 and January 2011, respectively, the Group announced the proposed acquisitions of ETI A/S and Norkom Group plc in the Cyber & Intelligence domain.

Integrated System Technologies (Insyte)

The FALCON secure deployable broadband communication system for the British Army and RAF completed Technical Field Evaluation in July. The contract provides for the initial operational capability to be accepted in 2011. The business is in discussions with the customer with regard to a revision to the programme schedule.

A re-baselined programme on the Maritime Composite Training System has been agreed with the customer. A revised ready for training date is planned for September 2011.

The ARTISAN 3D radar successfully completed Customer Critical Design Review in June, allowing the programme to progress towards full production.

The Sting Ray lightweight torpedo main production order for the Royal Navy completed production deliveries in May. The delivery contract for the government of Norway is on schedule, with initial deliveries achieved in December.

OUTLOOK

Anticipating the impact of pressure on government spending and the SDSR, the business has worked closely with the MoD to align objectives and transformation plans. Programmes & Support was re-organised with effect from 1 January 2011. A new Maritime business has been created, encompassing all UK maritime activities, and the new Military Air & Information line of business integrates the military air and information systems activities.

Maritime is underpinned by the Type 45, Queen Elizabeth carrier and Astute class submarine manufacturing programmes, the 15-year ToBA, and the concept design of the successor submarine.

In Military Air & Information, growth is linked to increasing combat aircraft production. The business is underpinned by the Typhoon and F-35 programmes.

Detica's position in the UK market, and its development as a solutions integrator and provider of cyber security services, means that it is well positioned to support the UK government's National Security Strategy, the increased focus on intelligence and security in the UK and overseas, and growing commercial markets.

p12 For more information on the Group's 2010 Executive Committee objectives

International

OVERVIEW

International, with 17,200 employees¹, comprises the Group's businesses in Australia, India and Saudi Arabia, together with interests in the pan-European MBDA joint venture and Air Astana.

KEY POINTS – FINANCIAL

- Like-for-like sales¹ growth of 15.3% over 2009
- Settlement achieved with the former owners of Tenix Defence

PERFORMANCE

		2010	Restated ⁴ 2009	Restated ⁴ 2008
Financial				
Order intake ¹	KPI	£2,908m	£4,564m	£3,559m
Order book ¹		£9.1bn	£11.0bn	£10.2bn
Sales ¹	KPI	£4,534m	£3,828m	£2,926m
Underlying EBITA ²	KPI	£478m	£419m	£417m
Return on sales		10.5%	10.9%	14.3%
Cash inflow ³	KPI	£195m	£813m	£163m
Safety				
Lost Work Day Case Rate (per 100,000 employees)	KPI	896	746	1,393

KEY POINTS – OPERATIONAL

- A further ten Typhoon aircraft delivered under the Salam programme
- Typhoon operational capability being provided under the support contract
- 157 Tactical vehicles accepted by the Saudi Arabia National Guard
- BAE Systems Australia selected as Lockheed Martin's partner for maintenance and upgrade support on the Australian F-35 programme
- Defence Land Systems India Private Limited joint venture became operational

During 2010, International sales¹ were £4,534m (2009 £3,828m). The increase in sales was predominantly a result of increased activity on the Saudi British Defence Co-operation Programme (SBDGP) in the Kingdom of Saudi Arabia and progress on the Landing Helicopter Dock programme in Australia.

Underlying EBITA² of £478m (2009 £419m) generated a return on sales of 10.5% (2009 10.9%). The reduction in return on sales is due to the low margin being traded on increased activity on the early stages of the Salam and Landing Helicopter Dock programmes.

Operating cash inflow³ was £195m (2009 £813m) reflecting the expected utilisation of advance funding on the Salam programme.

The Lost Work Day Case Rate increased by 20% compared with 2009. The overall trend in safety performance has been improving since 2007, but this level of improvement was not maintained in 2010. Senior management are reviewing safety processes in order to put in place an improvement plan. All sites with more than 150 personnel progressed to Level 4 on the Group's Safety Maturity Matrix.

Saudi Arabia

The business continues to develop its presence in Saudi Arabia and remains committed to developing a greater indigenous capability in the Kingdom. This strategy is being enhanced by the entry into service of Typhoon aircraft and subsequent development of the Typhoon in-country industrial base. Of the 72 Typhoon aircraft contracted under the Salam programme, 18 have been delivered to the customer. Six of the ten aircraft delivered this year are the twin-seat variant which will allow the Royal Saudi Air Force (RSAF) to conduct their own training missions.

Whilst deliveries on the Salam programme remain on schedule, the programme is likely to be adjusted to accommodate some customer changes. These may include relocating final assembly of the last 48 of the 72 aircraft, the creation of a maintenance and upgrade facility in the Kingdom of Saudi Arabia and, in addition, the last 24 of the 72 aircraft might be delivered with modifications to allow future incorporation of Tranche 3 capability.

The business continues to provide support to the operational capability of both the RSAF and Royal Saudi Naval Force through the SBDGP. Customer discussions are ongoing for the next phases of SBDGP and the Salam programme. The Group expects the customer to place a greater emphasis on performance-based contracting and use of the Saudi industrial base.

2010 Executive Committee objective

Grow our home markets in the Kingdom of Saudi Arabia, Australia and India

BAE Systems Australia – F-35

BAE Systems Australia has been selected as a key Australian partner for Readiness & Sustainment support for the F-35 combat aircraft. BAE Systems is ideally placed to provide support for the F-35 through its established capabilities at Williamtown where its 400-strong workforce already provides maintenance and through-life support to the F/A-18 Hornet and Hawk Lead-In Fighter fleets.



1 Including share of equity accounted investments.
2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

3 Net cash inflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.

4 Restated following the sale of half of the Group's 20.5% shareholding in Saab AB and subsequent classification as a discontinued operation.

5 Command, Control, Communications, Computers and Intelligence.

All 200 Tactica land vehicles have been delivered to the Saudi Arabia National Guard. In 2010, 157 vehicles were accepted by the customer and entered into service. The remaining 43 vehicles are expected to be accepted in the first quarter of 2011. The business continues to support these vehicles in accordance with a separate contract.

The C4I⁵ programme remains challenging, but good progress continues towards design completion.

Australia

In 2010, BAE Systems consolidated its position as a strategic support provider to the Australian Defence Force (ADF). The Australian government's parallel commitments to maintain defence funding in real terms until 2018 and achieve A\$20bn (£13.1bn) of savings through its ten-year Strategic Reform Programme represent both an opportunity and a challenge to the business.

The business has formally presented a proposal to the customer that is expected to deliver savings of at least 20% on the support contract for the Royal Australian Air Force's (RAAF) Hawk Lead-In Fighter fleet without impacting aircraft availability.

A Memorandum of Understanding was signed with Lockheed Martin to establish BAE Systems as the preferred Australian partner for maintenance and upgrade support for the F-35 that will form the mainstay of the RAAF's air combat capability later this decade.

The business is a sub-contractor to Boeing on the Wedgetail Early Warning and Control aircraft programme. During the year, the business completed delivery of the airborne components of the Electronic Support Measures package under the programme.

The maritime business achieved on-schedule performance for the Landing Helicopter Dock project. On the Air Warfare Destroyer programme, work continues to recover the schedule for the construction of hull blocks following initial fabrication difficulties.

The business was not down-selected as a preferred tenderer for the Land 121 Phase 3 project to supply medium and heavy tactical vehicles to the ADF.

Outstanding issues concerning the acquisition of the Tenix Defence business in 2008 have been resolved. Payments totalling A\$127.5m (£74m, net of legal fees) are to be made to us by the former owners of the business.

MBDA

MBDA has delivered increased sales and increased return on sales compared to 2009.

Order intake in 2010 was below the level achieved in 2009 as global budgetary constraints meant certain export contracts were delayed. Order intake with domestic customers was good with new production orders received for additional Mistral surface-to-air missiles in France, the development and early manufacture contract for Fire Shadow loitering munitions, and the assessment phase, development and early manufacture for SPEAR (Selectable Precision Effects At Range) weapons under the Complex Weapons contract in the UK.

Key deliveries included Aster surface-to-air missiles, Mica air-to-air missiles, Eryx anti-armour missiles, Taurus stand-off

missiles, Milan anti-armour missiles and Exocet anti-ship missiles.

Development programmes continue to progress well, with key milestones being passed on the MEADS air-defence programme, SCALP Naval stand-off missile programme, Meteor beyond visual range air-to-air missile, and all assessment and development phases of the UK Complex Weapons Programmes.

The issues arising during last year's Sea Viper firings have been resolved, culminating in a number of successful trial test firings of the Aster missile. A successful system firing involving an Aster 30 missile was also made in October, to achieve Europe's first ever intercept of a tactical ballistic missile.

India

In 2010, Defence Land Systems India Private Limited, the Group's 26% joint venture with Mahindra & Mahindra Limited, became operational, giving BAE Systems a domestic capability in the land sector. The first new product, Mine Protected Vehicle India, was unveiled in Delhi in February.

BAeHAL Software Limited, the Group's 40% joint venture with Hindustan Aeronautics Limited, has undertaken a series of initiatives to expand its scope of operations and provide IT solutions to a wider range of customers.

Air Astana

Air Astana achieved another year of strong performance. The Group's share of revenue increased by 18% to \$321m (£208m), with an improvement in profit driven by rising passenger demand and strong cost base control across its portfolio of international and domestic routes.

Oman

The business has strengthened its presence in Oman during the year and significant activity is ongoing to agree an order for the supply of Typhoon aircraft to the Royal Air Force of Oman. A number of other longer-term prospects are being pursued, and the business is also developing strategies to improve its Services offerings across the significant installed and anticipated future product base.

OUTLOOK

The Group seeks to sustain its long-term presence in the Kingdom of Saudi Arabia through delivering current programmes and industrialisation, and developing new business in support of all Saudi military and paramilitary forces.

The Salam programme changes referred to will necessitate contract and pricing revisions that will need to be concluded in 2011. These will bias both sales and profits to the second half of 2011.

In Australia, BAE Systems aims to capture its share of the growth in defence spending through delivery of innovative, value for money solutions across both new and existing programmes in close co-operation with its major customer, the Australian Defence Materiel Organisation.

In India, BAE Systems plans to develop its home market strategy through existing and, if appropriate, additional joint ventures and partnerships to address the future requirements of the Indian armed forces, in new product and support activities.

p12 For more information on the Group's 2010 Executive Committee objectives

HQ & Other Businesses

OVERVIEW

HQ & Other Businesses, with 2,500 employees¹, comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

KEY POINTS – FINANCIAL

- **Regional Aircraft underlying EBITA² of £35m in the year**
- **Payment of the regulatory penalty to the US Department of Justice**

PERFORMANCE

		2010	2009	2008
Financial				
Order intake ¹	KPI	£207m	£175m	£212m
Order book ¹		£0.3bn	£0.4bn	£0.4bn
Sales ¹	KPI	£278m	£254m	£235m
Underlying EBITA ²	KPI	£(65)m	£(71)m	£(101)m
Cash outflow ³	KPI	£(665)m	£(366)m	£(66)m

KEY POINTS – OPERATIONAL

- **52 aircraft placements contracted**
- **Long-term lease of six RJ100 aircraft with Swiss International Airlines**

In 2010, HQ & Other Businesses reported a loss² of £65m (2009 £71m) on sales¹ of £278m (2009 £254m).

Operating cash outflow³ in 2010 was £665m (2009 £366m). This includes the payment of the regulatory penalty to the US Department of Justice (£266m) and additional contributions in respect of UK pension schemes totalling £326m (2009 £310m).

Regional Aircraft

Conditions in the commercial aviation sector remain challenging. Despite this, the business has secured 52 aircraft placements to new and existing customers in the year, including a long-term lease of six RJ100 aircraft with Swiss International Airlines.

Lease and sale discussions continue with operators with regard to both current and future fleet requirements and support needs. Marketing activity continues to focus on both uncontracted idle aircraft and those returning off lease.

Whilst market conditions have continued to impact airline profitability, the portfolio customer base remains relatively robust and the business continues to closely monitor operator performance against default risk.

Support revenues have remained under pressure reflecting the current trading conditions. This has been partially offset by good performance within the engineering business.

The balance sheet carrying value of aircraft in the Regional Aircraft business (£166m) is based on the net present value of forecast net leasing or disposal income.

OUTLOOK

Trading conditions for the commercial aircraft market are anticipated to remain challenging given the restricted availability of credit to smaller operators and competition from surplus used aircraft.

Advanced Technology Centre

BAE Systems' Advanced Technology Centre provides research and development, consultancy, specialist manufacturing and technology brokering services into defence, aerospace and commercial markets. With 400 scientists and engineers, the Advanced Technology Centre works in collaboration and partnership with academia and innovative organisations throughout the supply chain, identifying, pulling through, and integrating technologies and capabilities to deliver discriminating solutions to its customers.



¹ Including share of equity accounted investments.
² Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

³ Net cash outflow from operating activities after capital expenditure (net) and financial investment, dividends from equity accounted investments, and assets contributed to Trust.



5. Governance

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Armadillo unveiled

In June 2010, BAE Systems unveiled a new build standard of the CV90 tracked armoured vehicle, named Armadillo. The BAE Systems advanced laboratory in Örnköldsvik, Sweden incorporates an engine test cell in which both upgrade and platform build projects can be carried out.

Board of directors



1. Dick Olver



3. Linda Hudson



5. Paul Anderson



2. Ian King



4. George Rose



6. Harriet Green OBE

Key: ■ Chairman ■ Executive directors ■ Non-executive directors

1. Dick Olver

Chairman

Appointed to the Board: 2004

Nationality: British

Skills and experience: A chartered civil engineer with extensive experience of managing complex international engineering projects, he held a variety of senior management positions in the oil industry culminating in his appointment to the board of BP p.l.c. as CEO of Exploration and Production in 1998. Subsequently appointed Deputy Group Chief Executive of BP in 2003, stepping down from that role when he assumed the chairmanship of BAE Systems.

Other appointments: Business Ambassador for UK Trade & Investment, and member of the Prime Minister's Business Advisory Group and Prime Minister's India/UK CEO Forum. Also a member of the Multinational Chairman's Group and the Trilateral Commission, a Fellow of the Royal Academy of Engineering and Chairman of the Education for Engineering (E4E) Policy Group.

Past appointments: Non-executive director of Thomson Reuters plc.

Committee membership: Chairman of the Nominations Committee and the Non-Executive Directors' Fees Committee

2. Ian King

Chief Executive

Appointed to the Board: 2007

Nationality: British

Skills and experience: Appointed as Chief Executive in 2007 having been originally appointed to the Board as Chief Operating Officer, UK and Rest of the World. He was previously Group Managing Director of the Company's Customer Solutions & Support business and, prior to that, Group Strategy and Planning Director. Prior to the BAe/MES merger he was Chief Executive of Alenia Marconi Systems, having previously served as Finance Director of Marconi Electronic Systems.

Other appointments: Non-executive director and Senior Independent Director of Rotork plc.

Committee membership: Non-Executive Directors' Fees Committee

3. Linda Hudson

President and Chief Executive Officer of BAE Systems, Inc.

Appointed to the Board: 2009

Nationality: US

Skills and experience: Appointed to the Board as President and Chief Executive Officer of the Company's US-based Land & Armaments operating group. She joined the Company in 2006 from General Dynamics where she had worked since 1992 in a variety of roles culminating in her appointment as Corporate Vice President and President, Armament and Technical Products.

Other appointments: Member of the United Service Organizations Worldwide Board of Governors, the Association of the United States Army Council of Trustees, and engineering advisory boards for engineering programmes at the universities of Maryland and Florida.

Committee membership: Non-Executive Directors' Fees Committee

4. George Rose

Group Finance Director

Appointed to the Board: 1998

Nationality: British

Skills and experience: Appointed Group Finance Director in 1998, he is a Fellow of the Chartered Institute of Management Accountants. Prior to joining the Company in 1992 he gained substantial experience in the engineering and manufacturing sectors, having held senior finance positions in the Rover Group and Leyland DAF.

Other appointments: Non-executive director of Saab AB and National Grid plc, and a member of the Industrial Development Advisory Board.

5. Paul Anderson

Non-executive director

Appointed to the Board: 2009

Nationality: US

Skills and experience: Paul Anderson has extensive global business experience in the energy and mining sectors. He spent more than 20 years in two spells at Duke Energy Corporation and its predecessor companies, culminating in his appointment as Chairman, President and Chief Executive Officer. He was subsequently Chairman of Spectra Energy Corporation until 2009 and in the intervening period he served as Managing Director and Chief Executive Officer of BHP and, subsequently, of the newly merged BHP Billiton.

Other appointments: Non-executive director of Spectra Energy Corporation and BP p.l.c.

Past appointments: Non-executive director of BHP Billiton plc and Qantas Airways Limited.

Committee membership: Chairman of the Corporate Responsibility Committee and member of the Nominations Committee

6. Harriet Green OBE

Non-executive director

Appointed to the Board: 2010

Nationality: British

Skills and experience: Currently Chief Executive Officer and executive director of Premier Farnell plc, a leading, high service, multi-channel technology distribution group, Harriet Green has significant global business experience having run volume distribution businesses in four continents including Asia Pacific for Arrow Electronics as well as having functional responsibility for worldwide marketing, suppliers and strategy.

Other appointments: Non-executive director of Emerson Electric Co.

Committee membership: Corporate Responsibility Committee


7. Michael Hartnall

9. Roberto Quarta

11. Carl Symon

8. Sir Peter Mason KBE

10. Nick Rose

12. Ravi Uppal
7. Michael Hartnall

Non-executive director

Appointed to the Board: 2003

Nationality: British

Skills and experience: A Fellow of the Institute of Chartered Accountants in England and Wales, Michael Hartnall is a former Finance Director of Rexam PLC where, in addition to his finance responsibilities, he gained considerable exposure to mergers and acquisitions activity. Prior to that he held senior finance and operational positions with a number of manufacturing companies.

Other appointments: Non-executive director of Lonmin plc.

Past appointments: Non-executive director of Elementis plc.

Committee membership: Chairman of the Audit Committee

9. Roberto Quarta

Non-executive director

Appointed to the Board: 2005

Nationality: US/Italian

Skills and experience: Roberto Quarta's management experience spans a broad range of manufacturing and service businesses with global operations. A partner in the private equity firm Clayton, Dubilier & Rice, he also serves as Chairman of Rexel SA, one of the world's largest electrical products distributors, which is one of the firm's portfolio businesses.

Past appointments: Chairman of Italtel, Chairman and Chief Executive of BBA Group plc, executive director of BTR plc, and a non-executive director of PowerGen plc and Equant NV.

Committee membership: Audit Committee and Remuneration Committee

11. Carl Symon

Non-executive director

Appointed to the Board: 2008

Nationality: US/British

Skills and experience: Carl Symon has an extensive background in global business operations and management, retiring in 2001 after a long career at IBM during which he held senior executive positions in the US, Canada, Latin America, Asia and Europe, including that of Chairman and Chief Executive Officer of IBM UK.

Other appointments: Non-executive director of BT Group plc and Rexam PLC.

Past appointments: Non-executive director of Rolls-Royce Group plc and former Chairman of HMV Group plc.

Committee membership: Chairman of the Remuneration Committee

8. Sir Peter Mason KBE

Non-executive director and Senior Independent Director

Appointed to the Board: 2003

Nationality: British

Skills and experience: Chairman of Thames Water and Senior Independent Director of Subsea 7 S.A., an international offshore engineering, construction and services contractor. Formerly Chairman and Chief Executive of Balfour Beatty Limited, and Chief Executive of AMEC plc, Sir Peter has extensive experience in engineering, construction and long-term contracting.

Past appointments: Executive director of BICC plc and chief executive of Norwest Holst Group PLC.

Committee membership: Audit Committee, Corporate Responsibility Committee and Nominations Committee

10. Nick Rose

Non-executive director

Appointed to the Board: 2010

Nationality: British

Skills and experience: Nick Rose was until recently Chief Financial Officer of Diageo plc. He held the position for over ten years and, in addition to his finance responsibilities, he was also responsible for supply, procurement, strategy and IT on a global basis. His financial experience has encompassed a number of roles since joining Diageo's predecessor company, Grand Metropolitan, in 1992, including group treasurer and group controller, having spent his earlier career with Ford Finance.

Other appointments: Non-executive director of BT Group plc.

Past appointments: Non-executive director of Môtet Hennessy SNC and Scottish Power plc.

Committee membership: Audit Committee and Remuneration Committee

12. Ravi Uppal

Non-executive director

Appointed to the Board: 2008

Nationality: Indian

Skills and experience: Ravi Uppal's business experience encompasses both operational management and business development in India and globally. Currently Managing Director and Chief Executive of L&T Power Limited, a member of the Larsen & Toubro group which operates in the technical, engineering, construction and manufacturing sector. He was previously President, Global Markets, for the power and automation technology group ABB Limited where he was responsible for ABB's marketing and business development on a worldwide basis.

Past appointments: Managing Director of Volvo India.

Committee membership: Audit Committee

Each of the eight non-executive directors listed above is considered to be independent for the purposes of the Combined Code.

David Parkes

Company Secretary

Corporate governance

“A year in which we have continued to evaluate our governance arrangements against our own experiences and changes in best practice.”

Dick Oliver
Chairman



Dear Shareholders,

Change is inevitable and desirable, and this is as applicable to companies as it is to most things in life. Managing change as part of an ongoing process of improvement is a fundamental part of good governance; driven as it is by the demands of the business environment and wider social and political influences. Boards need to look forward and put their companies in the best position possible, not just reacting to change but managing it for the benefit of our various stakeholders. Last year, I mentioned the reports produced by Sir David Walker and the Financial Reporting Council reviewing corporate governance in the UK, and the changes that they recommended. In 2010, a number of important changes were made to the UK's Corporate Governance Code. We welcome the new Code as a statement of the evolving nature of good corporate governance practice – and one that must continue to change if we are to learn lessons from the past and go on to build the successful, robust commercial enterprises that are fundamental to our economic and social well being.

The Board has reviewed the new UK Corporate Governance Code during the year, and has taken action to ensure that what we do reflects fully its principles and that we comply with its provisions. As I have said before in these reports, the Code principles, embodying as they do the essence of good governance practice, are the most important part of the Code. In the next few pages, we seek to explain how they have been applied by the BAE Systems Board. I will begin by highlighting a number of important areas that have been the subject of further development during the year.

Board membership

Too often we talk of boards in the abstract and overlook the obvious point that a board is essentially a group of individuals. The quality of those individuals largely determines the quality of the board, so consequently, through the Nominations Committee, we pay a good deal of attention to the composition of the Board and succession planning. We look at composition from a number of different angles, including:

- Knowledge and experience
- Diversity
- Key skills
- Executive/non-executive mix
- BAE Systems' Board experience

We seek to achieve the right balance across these different dimensions. However, I believe that to be effective a board needs a core of business people who have deep knowledge and experience in running companies. In particular, as BAE Systems' business is characterised primarily by its complex long-term contracting nature, we seek to retain core non-executive knowledge and competence gained in similar industries. In addition, we look for individuals with board level experience with international and global companies.

Diversity

BAE Systems places particular emphasis on diversity and inclusion, and this is reflected in the objectives that the Board has set for management – and is one of the factors influencing annual executive reward. This is an area in which the Board needs to show leadership and gender diversity is a factor we consider when appointing new directors. With the assistance of our recruitment consultants, we have taken steps to ensure that there are no obstacles to the Nominations Committee having visibility of suitable candidates for possible appointment to the

Board, regardless of gender. Companies such as BAE Systems have to accept that performance to date in achieving a more equitable representation for women at the highest levels has been poor and that this is something we have to address. When women make up half of the population, those companies that fail to have diverse leaders at the highest levels risk putting themselves at a competitive disadvantage.

Developing the quality of the senior management 'pipe-line' – which ultimately leads to the Board – is an area that chairmen and boards do get involved in. As part of this activity, the Board and our Nominations and Corporate Responsibility committees have been monitoring how we manage diversity and inclusion across the Group, and it is good to see progress being made, particularly in developing the behaviours and culture that in the long term will be the main determinants of success in this area. Quotas and tokenism could superficially solve the diversity issue – at least at board level. However, that would not be good for companies and equally would not be good for women. I believe that the best way forward is to set the right behavioural expectations at the very top of the company and encourage management to develop appropriate solutions to meet that challenge. In terms of Board governance, the Corporate Responsibility Committee undertakes a specific role in monitoring progress against our diversity and inclusion objectives (as it does with other non-financial performance measures), and makes recommendations to the Remuneration Committee for reward purposes based on actual achievement.

As chairman of both the Board and the Nominations Committee, I recognise that I have particular responsibilities for leading the work in developing the Board, and its composition is a very important element of board effectiveness. Reflecting on the gender diversity issue, progress has been made – both within the executive and non-executive areas. Linda Hudson, one of our three executive directors, is the President and Chief Executive Officer of our US-managed businesses, which account for more than half of our sales. Together with strong operational management experience, she brings a deep understanding of the US defence market. I am also pleased that in 2010 Harriet Green joined the Board as a non-executive director. She is Chief Executive Officer of a UK-listed international electronics distribution company, and brings international and operational experience to the Board. Progress, but more to do, particularly in respect of long-term executive development work from which many of our future executive directors will be found, and importantly, will provide candidates for non-executive director positions in other companies.

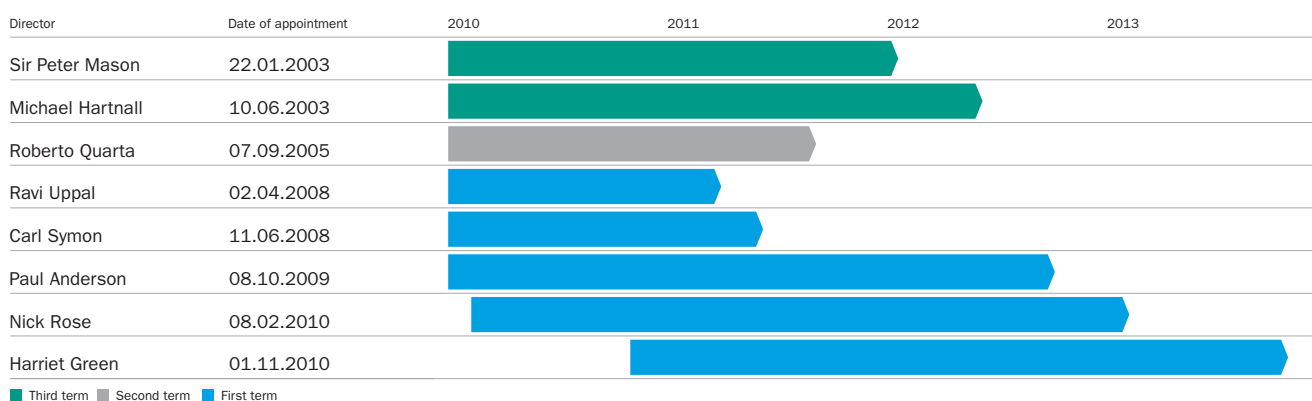
Succession planning and directors' induction

Returning to the opening theme, change is inevitable but it is also risky. Good succession planning recognises that you can mitigate succession risk through well informed and timely decisions being made by experienced and knowledgeable people. The table below details the non-executive members of the Board and their terms of office. The Nominations Committee regularly reviews this information to help plan the membership of the Board. This includes having people on the Board's committees with the right skills and experience. For example, in 2009, the committee identified a need for an individual with appropriate skills and financial experience to sit on our Audit Committee, and provide expertise and long-term cover for Michael Hartnall, who has done an excellent job in chairing the committee since 2003. I am pleased that we were able to appoint Nick Rose to the Board in February 2010, and he brings the experience and skills gained in his role as Chief Financial Officer of Diageo plc to our Audit Committee, and also to our Remuneration Committee. Also, when we recruited Paul Anderson in October 2009 we recognised he had the background and qualities required for a future chairman of the Corporate Responsibility Committee, and he was appointed to that role in September last year.

With regards to the executive directors on the Board, the most significant event during the year was the search for the right candidate to succeed George Rose as Group Finance Director. This was undertaken by the Nominations Committee and for this purpose it co-opted an additional independent non-executive, Nick Rose. The search process is detailed in the Nominations Committee report on page 94.

Too much change around the board table can be a risk in itself. No matter how experienced and knowledgeable an incoming non-executive director is it will always take time for that individual to develop a detailed understanding of the Company. For this reason a properly tailored induction programme is very important. Done well, it should reduce the time taken for a new member of the Board to become fully effective. Over the last few years, we have worked at improving the induction programme we offer new directors, combining a mixture of subject specific one-to-one meetings with senior management covering matters such as core control processes and investor relations, through to site visits to various Company locations around the world. For information, an example of a typical induction programme is shown on page 84. Maintaining the right level of experience and company knowledge within a board, whilst at the same time introducing new people who bring a new perspective and a 'fresh pair of eyes', is a necessary but difficult balance to maintain. We recognise it as such and remain diligent in trying to get the balance right.

BOARD SUCCESSION – NON-EXECUTIVE DIRECTORS



Roles and responsibilities

The revisions to the Combined Code made in 2010 provided more definition to the roles of both the Chairman and the Senior Independent Director. As a result, the Board has amended the requirements of the roles as detailed in our Board Charter (see page 83). The changes to the Senior Independent Director's role and responsibilities reflect the need for one of the non-executive Board members to act as a sounding board for the Chairman and, in the normal course of events, facilitate an annual review of the Chairman's performance. If events do not run such a normal course, he will also act as an intermediary for the other directors if they have specific concerns regarding the Chairman and how the Board is being run. Having a robust senior director on the Board who is both the natural person to turn to when I need to discuss Board matters, and is open and frank in giving feedback on my performance, is invaluable to me as Chairman, and an important part of board governance.

The relationship between a chairman and the chief executive is probably the key personal dynamic within a board. Again it is a matter of balance, this time between being supportive of a chief executive in delivering the agreed strategy and the need to have the right level of challenge. Within BAE Systems, it is for others to say whether I get this balance right, and here the Board's annual performance evaluation provides all directors with the opportunity to speak to our external facilitator about my performance – we specifically ask directors for their views on the chairman/chief executive relationship – and for any issues to be fed back to me via the Senior Independent Director. Likewise, the Chief Executive is subject to the same evaluation process, receiving formal feedback once a year from the Board but having the opportunity to engage with members of the Board, both formally and informally, throughout the year.

Managing risk

The management of risk in major companies is an issue to which directors and those responsible for public policy have given a good deal of thought in recent years. When reviewing the changes to the Combined Code last year, the Board noted the change to the Main Principle in the Risk Management and Internal Control section of the Code, regarding a board being responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The Board has agreed that this should be an integral part of the process we use to develop and agree strategy, which is based on strategy review sessions, separate from our formal board meetings.

The Risk Management and Internal Control principle also requires that boards maintain sound risk management and internal control systems. There has been some debate regarding the need for all listed company boards to have risk committees. Whilst the detailed monitoring of the quality of our risk management and internal control systems forms part of the regular work undertaken by the Audit and Corporate Responsibility committees, importantly the Board as a whole is ultimately responsible for the management of risk. We ensure that risk is a regular agenda item for the Board and this provides all directors with the opportunity to evaluate the quality of our risk management processes, to challenge the quality of the judgements made on risk and the quality of risk mitigation planning.

In addition to the specific inclusion of risk management within the UK Corporate Governance Code's principles, provisions concerning remuneration have also been amended to require that remuneration incentives are compatible with risk policies and systems. In relation to this, it should be noted that within BAE Systems, risk management is embedded into the recognition of profit on long-term contracts.

In the accounting policy notes on page 134 you will find the following words:

"No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved."

For us, the management of risk on our programmes is a core management discipline and, therefore, management reward for profit performance is inextricably linked to managing risk, with reward and profit not recognised until outcomes can be reliably estimated.

Board performance evaluation

One of the other key changes to the Combined Code in 2010 was the change to the evaluation section, with the addition of a requirement that, at least every three years, the annual board evaluation should be externally facilitated. During my time as Chairman, we have undertaken an externally facilitated performance evaluation exercise annually, covering the performance of the Board, its committees and individual directors (including myself). This is now a core process that we have refined over the past six years and one that I believe adds real value to the work of the Board. We have used the same facilitator throughout this period, which has helped to build trust in the process and an appreciation of its value in improving the effectiveness of the Board.

For us, the use of an external facilitator has been a positive one. I certainly don't see the exercise as an audit or inspection that is undertaken by an outsider with the aim of telling us what we are doing wrong. Rather, it is more about providing a process through which directors can speak candidly at length to our facilitator and in doing so analyse our performance over the past year. She then presents what she has heard, and collectively the directors discuss this and agree any actions required to improve our effectiveness. Feedback on the performance of the Board's committees is provided separately to committee chairmen so that this can be discussed with committee members, and I meet with the facilitator to discuss feedback on individual performance before holding one-to-one meetings with directors. Similarly, the Senior Independent Director, following discussions with the facilitator and the other non-executive directors, provides me with feedback on my performance.

For the last few years we have provided details of the annual objectives the Board has set following the evaluation process and information on how we think we did in addressing the prior year's objectives. We report on the evaluation we have just completed opposite.

Shareholder engagement

As Chairman, I am responsible for ensuring that all directors are aware of any issues and concerns that major shareholders may have. The Company has a comprehensive investor relations programme, through which the Chief Executive and Group Finance Director engage regularly with our larger shareholders on a one-to-one basis. The Board receives reports on these meetings covering the general nature of matters communicated and discussed. However, it is important that the Board has a number of channels providing access to shareholder views. These additional channels include an annual survey that our investor relations consultants undertake of the views of our largest shareholders, and which are reported directly to the Board. Also, I write to major shareholders each year updating them on matters concerning the Company and inviting them to meet with me if they wish to discuss any particular matter. The Chairman of our Remuneration Committee undertakes a similar exercise on the subject of remuneration policy.

BOARD PERFORMANCE – 2010 OBJECTIVES AND ACHIEVEMENTS

2010 objectives	2010 summary of achievements
– Maintain focus on developing the Company's strategy and progress in achieving the Strategic Actions agreed by the Board in 2009.	– Through a number of different forums the Board undertook a wide-ranging review of Group strategy in 2010. At the strategy review sessions in June and November, the Board reviewed progress against the Strategic Actions agreed in 2009, and at the end of 2010, updated the Group Strategic Framework (see page 14) to recognise progress in achieving prior year actions.
– The Board and the Corporate Responsibility Committee to continue to monitor the development of a Total Performance culture, including implementation of the Woolf Committee recommendations.	– During 2010, performance against the responsible business conduct objectives was integrated into the Company's regular management reporting requirements, and consequently was reported at all scheduled Board meetings. – At regular meetings held throughout the year, the Corporate Responsibility Committee monitored performance against the CR-related objectives set for the development of a Total Performance culture. In addition, the Committee agreed the approach (including external assessments) that will be used to determine progress in meeting the Company's three-year commitment to addressing the 23 recommendations made by the Woolf Committee (see page 48).
– Focus on monitoring operational performance, including cost and efficiency metrics.	– Operational performance targets were integrated into the 2010 Integrated Business Plan (IBP). Performance against this plan was monitored by the Board throughout the year. In particular, as part of the development of the 2010 IBP, the Board reviewed the efficient management of the Group's cost base, and the contribution that such activity is expected to make over the five-year planning period.
– Continue to monitor the development of the competencies and culture required to support the growth of our home markets.	– The Board reviewed with senior operational managers progress in developing our home markets. This has been reviewed both in terms of performance in individual markets and also in terms of the long-term management resource required to support our global business.
– The Chairman to facilitate continuing development for the non-executive directors, including their understanding and familiarity with the Company's businesses and core processes and markets.	– To assist in developing an understanding of the Company's businesses, the Board visited sites in the US and UK during the year. For example, it took the opportunity whilst visiting part of our US ship repair business to gain a deeper understanding of the development and dynamics of the US support services market. – Facilitated by the Chairman, directors participated in a Responsible Business Conduct Awareness Training session, utilising the materials used across the Group to discuss responsible business behaviour and to focus on the importance of ethical conduct to the Company.

BOARD PERFORMANCE – 2011 OBJECTIVES

Strategy	Develop further the process by which the Board engages in the development of strategy.
Succession planning and implementation	Prioritise support for new Board members and long-term succession planning for key executive roles.
Operational performance monitoring	Develop the programme of 'Deep Dives' to complement and validate KPIs and deepen directors' understanding of the Group's operations and performance.
Risk and risk management	Monitor the development of crisis management planning and the role of the Board in such plans. Establish future milestones after completion of the Woolf Report three-year implementation review.
Stewardship and UK Corporate Governance codes	Engage with shareholders as they implement the Stewardship Code and find ways to expose non-executive directors more directly to shareholders' views.
Brand	Think about 'Brand' in the context of the evolving nature of the business.

I believe that regular dialogue with shareholders is important to good governance. Establishing reliable lines of communication – even when there are no particular issues of concern for shareholders – is another of the valuable ‘safety valves’ that we need to firmly establish as part of our governance processes. Obviously, this requires engagement on the part of the investor community and I welcome the Stewardship Code which was launched last year in the UK with the aim of enhancing, “...the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities”.

During 2011, we will be looking to continue to improve the quality of our engagement with shareholders and explore with investors the practical means by which we can give effect to the requirements of the Stewardship Code and UK Corporate Governance Code.

Stewardship is a word that sits equally comfortably with the directors of a company as it does with shareholders – maybe even more so for directors as the duty is more immediate and all embracing in its scope. Therefore, we naturally support the aims of this new code and look forward to developing its application.

At the centre of a company's engagement with its shareholders is the Annual General Meeting (AGM), and we should not lose sight of the importance of this meeting as it provides a forum for engagement with all shareholders. BAE Systems has thousands of shareholders, most of whom do not wish or are unable to attend the actual meeting. However, all shareholders have the opportunity to ensure that their shares are voted on. To help facilitate this we provide the following:

- Electronic and postal voting – shareholders can vote on all the resolutions either electronically via our website or by post.
- Questions & Answers – all shareholders have the opportunity to submit questions by e-mail or post and we address the issues that arise most frequently in these questions in answers provided on our website.
- Polls – all the resolutions detailed in the Notice of Meeting are voted on by way of a poll. This ensures that all votes are counted on the basis of one vote for every share held, as against voting on a show of hands, which results in only attendees at the meeting deciding on the resolutions.
- Results – we publish the results of the voting on all resolutions on our website.

Those who are able to attend our AGM have the opportunity to ask questions and hear the views of other shareholders before deciding how to cast their votes. One of the main changes to the provisions in the Combined Code is the change to require that all directors are subject to annual election by shareholders. Consequently, all members of the BAE Systems Board shall be standing for re-election this year and in future years.

This year's AGM is on 4 May 2011. I look forward to meeting those shareholders who are able to attend, and answering any questions they may have on these governance reports and other matters covered by the resolutions to be put to the meeting.



Dick Oliver
Chairman

Corporate governance report

Applying the principles of the UK's Corporate Governance Code

The following report details how the Board has applied the principles in the Financial Reporting Council's Combined Code (the “Code”), as required by the UK Listing Rules. In June 2010, a revised code, the UK Corporate Governance Code, was published. Whilst reporting against the additional and revised principles contained within this revised code is not required for regulatory purposes until next year, the Board accepts that it represents an authoritative statement of best practice, and as such it has reviewed its practices relative to it. Consequently, the following report includes information on the application of the additions and revisions to the Code.

Leadership

Principles – An effective board collectively responsible for the long-term success of the company • A clear division of responsibilities at the head of the company between the running of the board and the executive • No one individual should have unfettered powers of decision • The chairman is responsible for the leadership of the board and ensuring its effectiveness on all aspects of its role • Non-executive directors should constructively challenge and help develop proposals on strategy.

The Company's governance structure is based on the leadership principles in the new UK Corporate Governance Code. The core activities of the Board and its committees are documented and planned on an annual basis, and this forms the basic structure within which the Board operates. The Board has adopted a document, the Board Charter, in which there is a statement of governance principles that reflect the principles contained in the Code, and cover the following:

- Strategy – reviewing and agreeing strategy;
- Performance – monitoring the performance of the Group and also evaluating its own performance;
- Standards and values – setting standards and values to guide the affairs of the Group;
- Oversight – ensuring an effective system of internal controls is in place, ensuring that the Board receives timely and accurate information on the performance of the Group and the proper delegation of authority; and
- People – ensuring the Group is managed by individuals with the necessary skills and experience, and that appointments to the Board are managed effectively.

The Board Charter also details the separate and distinct roles of the Chairman and the Chief Executive, and also those of the Senior Independent Director and Company Secretary. These are detailed opposite, and have been reviewed and amended in light of changes made to the Code in 2010.

Whilst the Board is ultimately responsible for the success of the Company, given the size and complexity of its operations, all but the most important matters are managed on a delegated basis by the Chief Executive and the executives working for him. The Board appoints the Chief Executive and monitors his performance in leading the Company, and providing operational and performance management in delivering the agreed strategy. Specifically, he is responsible for developing, for the Board's approval, appropriate values and standards to guide all activities undertaken by the Company and also making recommendations on appropriate delegated responsibilities.

ROLES AND RESPONSIBILITIES

The role of the Chairman

The Chairman is responsible for creating the conditions for the effective working of the Board and is specifically responsible for the following:

- Chairing Board meetings and setting the agenda for such meetings, taking full account of the issues and concerns of all directors and encouraging their active engagement in Board discussion.
- Promoting the highest standards of corporate governance, including compliance with the UK Corporate Governance Code wherever possible.
- Promoting the requirement that all Board members are exemplars of the Company's values, principles and standards.
- Through the Nominations Committee, ensuring that the Board comprises individuals with an appropriate mixture of skills, experience and knowledge.
- Ensuring that the Company maintains effective communication with shareholders, and that their views and any concerns are understood by the Board.
- Working with the Chief Executive to ensure that the Board receives accurate and timely information on the performance of the Company.
- Representing the Company at the highest level and, in conjunction with the Chief Executive, developing strategic relationships with major customers and political leaders worldwide.
- Leading the evaluation of the performance of the Board, its committees and individual directors.
- Establishing an effective working relationship with the Chief Executive, providing support and advice whilst respecting executive responsibility.
- Ensuring that a well constructed induction programme is provided for new directors, that all directors have the opportunity to develop their understanding of the Company and that they are kept informed of matters affecting the Company.

The role of the Senior Independent Director

The Senior Independent Director is responsible for the following:

- Being available to shareholders if they have concerns which contact through the normal channels of Chairman, Chief Executive or other executive directors has failed to resolve or for which such contact is inappropriate.
- Providing a sounding board for the Chairman and serving as an intermediary for the other directors when necessary.
- Chairing the Nominations Committee when it is considering the Chairman's succession.
- Providing feedback on the Chairman's performance as derived from the evaluation exercise undertaken by the Board.

The role of the Chief Executive

The Chief Executive is responsible for the leadership, and the operational and performance management of the Company within the strategy and business plan agreed by the Board.

The Chief Executive is specifically responsible for the following in respect of his/her relationship with the Board:

- Developing a business strategy for the Company to be approved by the Board on an annual basis.
- Producing business plans for the Company to be approved by the Board on an annual basis.
- Overseeing the management of the executive resource and succession planning processes, and presenting annually the output from these to the Board and Nominations Committee.
- Ensuring that effective business and financial controls, and risk management processes are in place across the Company, and that all relevant laws and regulations are complied with.
- Making recommendations to the Board on the appropriate delegation of authority within the Group.
- Keeping the Board informed regularly as to the performance of the Company and bringing promptly to the Board's attention all matters that materially affect, or are capable of materially affecting, the performance of the Company and the achievement of its strategy.
- Developing for the Board's approval appropriate values and standards to guide all activities undertaken by the Company.
- Providing clear and visible leadership in business conduct.
- Promoting the requirement that all Senior Leaders are exemplars of the Company's values, principles and standards.
- Owning the Company's commitment to all aspects of corporate responsibility.

The role of the Company Secretary

The Company Secretary is specifically responsible for the following:

- Under the direction of the Chairman, ensuring good information flows within the Board and its committees, and between senior management and non-executive directors, as well as facilitating induction activities for directors and assisting with their development as required.
- Advising the Board through the Chairman on all governance matters.

The Operational Framework is the output from this process. It is a document that has evolved over time, subject to a formal six-monthly review process that culminates in the Board's review and approval. In approving it the Board has agreed the following:

- Performance requirements and values – i.e. Total Performance and the Values underpinning it.
- Organisation structure – the roles and accountabilities of the Board and certain senior individuals.
- Governance standards – the Group's trading principles, internal controls, operational assurance framework and risk management framework.
- Core business processes – covering business planning, project management, mergers and acquisitions, individual executive performance, and management of performance against business objectives, measures and milestones.
- Delegated responsibilities – dealing with the Board's delegation of authority concerning financial, commercial and legal matters.

The Board and its committees monitor the application of values, standards and processes. This includes a range of activities such as the formal review of the effectiveness of internal controls (see page 89).

To ensure that non-executive directors can constructively challenge and help develop proposals on strategy, the Board has adopted a process of reviewing the development of strategy and formally approving the agreed strategy for the Company on an annual basis. In 2010, the Board members were provided with opportunities to engage in strategy development through informal meetings and workshops as well as formal Board meetings.

Effectiveness

Principles – Board and committees having an appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively • A formal, rigorous and transparent procedure for the appointment of new directors • All directors to be able to allocate sufficient time to the company to discharge their responsibilities effectively • All directors to receive induction on joining and should regularly update and refresh skills and knowledge • The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties • The board should undertake a formal and rigorous annual evaluation of its performance, and that of its committees and individual directors • All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

Succession planning is used by the Board to deliver two key responsibilities, firstly to ensure that the Group is managed by executives with the necessary skills, experience and knowledge, and secondly to ensure that the Board itself has the right balance of individuals to be able to effectively discharge its responsibilities. The Nominations Committee has specific responsibilities in this area but the Board as a whole is also involved in overseeing the development of management resources in the Group with the aim of ensuring the Company has the individuals with the right skills to meet the needs of an increasingly complex and global business. The process adopted for the appointment of non-executive and executive directors is detailed in the Nominations Committee report.

All non-executive directors are advised of the likely time commitments at appointment and are asked to seek approval

Typical non-executive director induction programme

HEAD OFFICE FUNCTIONS (APPROXIMATELY TEN HOURS)

Matters covered	Facilitated by
Duties of a director, Board procedures, corporate governance, Code of Conduct	Company Secretary
Business planning and control, and risk management processes	Director Financial Control, Reporting and Treasury
Strategy and planning processes	Group Strategy Director
Enterprise Metrics – the measures used by the Board and management to measure and monitor performance	Managing Director, Performance Excellence
Investor Relations	Investor Relations Director
Corporate Responsibility	Managing Director, Corporate Responsibility
Internal Audit	Head of Internal Audit
Business Development	Group Business Development Director

MEETINGS WITH SENIOR EXECUTIVES (APPROXIMATELY SIX HOURS)

Matters covered	Facilitated by
UK and International (London-based)	
Programmes & Support (UK defence and security businesses)	Group Managing Director, Programmes & Support
International (Saudi Arabia, Australia, India, Oman)	Group Managing Director, International
US (Washington, DC)	
BAE Systems, Inc.	President and Chief Executive Officer of BAE Systems, Inc. Executive Vice Presidents, BAE Systems, Inc.

OPERATIONAL SITE VISITS (APPROXIMATELY FIVE DAYS)

UK	US
Military Air Solutions – Warton and Samlesbury, Lancashire	Electronic Solutions – Nashua, NH
Surface Ships – Portsmouth	US Combat Systems – York, PA

from the Nominations Committee if they wish to take on additional external appointments. The ability of individual directors to allocate sufficient time to the discharge of their responsibilities is considered as part of the directors' annual evaluation process overseen by the Chairman. Any issues concerning the Chairman's time commitment are dealt with by the Nominations Committee, chaired for this purpose by the Senior Independent Director.

An induction programme is agreed for all new directors aimed at ensuring that they are able to develop an understanding and awareness of the Company's core processes, its people and businesses. A typical induction programme is shown opposite.

The Chairman, with the assistance of the Chief Executive and Company Secretary, is responsible for ensuring that directors are supplied with information in a timely manner that is in a form and of a quality appropriate to enable them to discharge their duties. In the normal course of business, such information is provided by the Chief Executive in a regular report to the Board that includes information on operational matters, strategic developments, reports on the performance of Group operations, financial performance relative to the business plan, business development, corporate responsibility and investor relations.

In addition to the induction programme that all directors undertake on joining the Board, an ongoing programme of director development and Company awareness has been developed. For example, as part of the annual programme of Board meetings, directors will typically visit the Group's principal operations to meet employees and gain an understanding of the Group's products and services. In 2010, the Board visited the Company's Support Solutions and Information Solutions businesses in San Diego, and the Surface Ships business in Portsmouth. Also, the Board undertakes training sessions on particular matters, and last year directors participated in Responsible Business Awareness Training sessions facilitated by the Chairman. As part of the recently completed evaluation process, the Chairman is meeting with all directors individually, and agreeing training and development.

For the last six years the Board's annual effectiveness evaluations have been undertaken by Sheena Crane, an experienced consultant, whose only interest with BAE Systems is with regards to her work with the Board and undertaking similar performance evaluation work for the Executive Committee. She was appointed to perform this work in consultation with the Nominations Committee. The evaluation process is based on the facilitator interviewing each of the directors, and recording their views on the effectiveness of the Board and its committees' work, and on the performance of individual directors. Feedback on Board performance is presented to a meeting of the Board, which agrees actions and objectives for the following year based on the information the facilitator provides and the conclusions that the Board derived from this.

Individual directors are also subject to annual performance evaluation, and the Chairman meets with each director and provides feedback on a one-to-one basis – committee chairmen also get feedback on committee performance. Feedback on the Chairman's performance is provided by the facilitator directly to the Board's Senior Independent Director, who discusses this with the other non-executive directors before discussing this with the Chairman on a one-to-one basis. Subject to continued satisfactory performance, directors seek re-election on an annual basis.

Accountability

Principles – The board to present a balanced and understandable assessment of the company's position and prospects • The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives • The board should maintain sound risk management and internal control systems • The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor.

Through this report and, as required, through other periodic financial statements, the Board is committed to providing shareholders with a clear assessment of the Company's position and prospects.

The arrangements established by the Board for the application of risk management and internal control principles are detailed on page 87. The Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors, further details of which can be found in the Audit Committee report on page 89.

Remuneration

Principles – Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose • A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance • There should be a formal and transparent procedure for developing policy on executive remuneration, and for fixing the remuneration packages of individual directors • No director should be involved in deciding his or her own remuneration.

The Board has delegated to the Remuneration Committee responsibility for agreeing remuneration policy and the individual remuneration of the executive directors, the Chairman, members of the Executive Committee and the Company Secretary (see Remuneration report on pages 96 to 119). The Committee is formed exclusively of independent non-executive directors.

Relations with shareholders

Principles – There should be a dialogue with shareholders based on the mutual understanding of objectives • The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place • The board should use the AGM to communicate with investors and to encourage their participation.

The Company has a well-developed investor relations programme managed by the Chief Executive, Group Finance Director and Investor Relations Director. In addition, the Chairman is in regular contact with major shareholders and looks to keep them informed of progress on corporate governance matters. In order to assist in developing an understanding of the views of major shareholders, each year the Company commissions a survey of investors undertaken by external consultants. The results of the survey are presented to the Board.

The Company maintains a comprehensive Investor Relations website that provides, amongst other things, information on investing in BAE Systems and copies of the presentation materials used for key shareholder presentations. This can be accessed via the Company's website, www.baesystems.com

The Company's AGM provides all shareholders with the opportunity to vote on the resolutions put to shareholders either electronically via the Company's website or by post. All resolutions detailed in the Notice of Meeting are voted on by way of a poll so as to ensure that all votes are counted on the basis of one vote for every share held. The result of the voting on all resolutions is published on the Company's website.

Compliance with the provisions of the Combined Code

The Company was compliant with the provisions of the Combined Code on Corporate Governance throughout 2010, except that between 1 January 2010 and 8 February the membership of the Remuneration Committee consisted of two independent non-executive directors and the Chairman of the Company (who had been independent on appointment to the position of Chairman). The Committee met once during this period and the only decision made concerning directors' remuneration was to introduce clawback provisions into the Company's executive share plans.

The Board

The Board comprises a non-executive chairman, eight non-executive directors and three executive directors.

The attendance by individual directors at meetings of the Board and its committees in 2010 is shown in the table below.

The Board considers all of the non-executive directors, with the exception of the Chairman, to be independent for the purposes of the Combined Code. Each of these directors has been identified on pages 76 and 77 of this report.

Mr Quarta is a partner in Clayton, Dubilier & Rice (CDR) and Mr Olver is an adviser to that firm. The Board has considered Mr Quarta's independence in light of the provisions in paragraph A.3.1 of the Combined Code (paragraph B.1.1 of the UK Corporate Governance Code) concerning significant links with other directors through involvement with other companies or bodies. Following review, the Board considers that, for the purposes of the Code, their relationship through CDR does

not constitute a significant link. In reaching this determination the following matters were taken into consideration:

- as an adviser to CDR, Mr Olver has no management responsibilities or oversight obligations in respect of CDR or any of its investments; and
- Mr Olver has no involvement with the companies that Mr Quarta is a director of, or has management responsibility for, within CDR.

Mr Olver has undertaken to advise the Board should there be any material change in his relationship with CDR whilst Mr Quarta has an involvement with that firm.

Mr Symon and Mr Rose are both non-executive directors of BT Group plc and the Board has determined that, as they both serve in a non-executive capacity, both are independent for the purposes of paragraph A.3.1 of the Combined Code (paragraph B.1.1 of the UK Corporate Governance Code).

In 2010, the Board was scheduled to meet seven times and in addition two days were spent reviewing strategy. Additional Board meetings are called as required and in total the Board met 11 times during the year.

The Board has appointed Sir Peter Mason as the Senior Independent Director. Amongst the duties undertaken by Sir Peter during the year was to meet with the non-executive directors without the Chairman present to discuss the Chairman's performance.

The Company's Articles of Association require that all new directors seek re-election to the Board at the following AGM. In addition, the Board has agreed that in compliance with the UK Corporate Governance Code all directors shall seek re-election on an annual basis. The Board has set out in the Notice of Annual General Meeting their reasons for supporting the re-election of those directors seeking re-election at the forthcoming AGM.

ATTENDANCE BY INDIVIDUAL DIRECTORS AT MEETINGS OF THE BOARD AND ITS COMMITTEES IN 2010

Director	Board	Audit Committee	Corporate Responsibility Committee	Nominations Committee	Remuneration Committee	Non-Executive Directors' Fees Committee
Mr P M Anderson	10 (11)	–	3 (3)	6 (6)	–	–
Mr P J Carroll ¹	5 (5)	–	–	2 (2)	–	–
Ms H Green ²	1 (2)	–	0 (1)	–	–	–
Mr M J Hartnall	10 (11)	6 (6)	–	–	–	–
Ms L P Hudson	10 (11)	–	–	–	–	1 (1)
Mr A G Inglis ³	3 (6)	–	1 (2)	–	–	–
Mr I G King	11 (11)	–	–	–	–	1 (1)
Sir Peter Mason	11 (11)	5 (6)	4 (4)	8 (8)	–	–
Mr R L Olver	10 (11)	–	–	7 (8)	2 (2)	1 (1)
Mr R Quarta ⁴	6 (11)	5 (6)	–	–	7 (7)	–
Mr G W Rose	11 (11)	–	–	–	–	–
Mr N C Rose ⁵	7 (9)	5 (6)	–	–	3 (5)	–
Mr C G Symon	10 (11)	–	–	–	7 (7)	–
Mr R K Uppal	8 (11)	2 (5)	1 (1)	–	–	–

Figures in brackets denote the maximum number of meetings that could have been attended.

1 Retired from the Board on 5 May 2010.

2 Appointed to the Board on 1 November 2010.

3 Retired from the Board on 9 July 2010.

4 Attended six of the seven scheduled Board meetings held during the year.

5 Appointed to the Board on 8 February 2010.

Risk management and internal control

As reported in the Company's 2009 Annual Report, the Board has reviewed the historical control failures associated with the global settlement agreement with the UK Serious Fraud Office and the US Department of Justice announced in February 2010, and believes that the Company has systematically enhanced relevant compliance policies and processes since the behaviour referred to in the settlements occurred.

The Board has conducted a review of the effectiveness of the Group's system of risk management and internal control processes, including financial, operational and compliance controls and risk management systems, in accordance with the Code and the Turnbull guidance (as revised).

BAE Systems has developed a system of internal control that was in place throughout 2010 and to the date of this report, that encompasses, amongst other things, the policies, processes, tasks and behaviours that, taken together, seek to:

- facilitate the effective and efficient operation of the Company;
- enable it to respond appropriately to significant operational, financial, compliance and other risks that it faces in carrying out its business;

- assist in ensuring that internal and external reporting is accurate and timely, and based on the maintenance of proper records supported by robust information-gathering processes; and
- assist in ensuring that the Company complies with applicable laws and regulations at all times, and also internal policies in respect of the standards of behaviour and conduct mandated by the Board.

Details of the processes the Company has put in place to manage risk can be found on pages 56 and 57 of this report.

The Board has delegated to the Audit Committee responsibility for reviewing in detail the effectiveness of the Company's system of internal controls. Having undertaken such reviews, the Committee reports to the Board on its findings so that the Board as a whole can take a view on this matter. In order to assist the Audit Committee and the Board in this review, the Company has developed the Operational Assurance Statement (OAS) process (see below). This has been subject to regular review over a number of years, which has resulted in a number of refinements being made.

OPERATIONAL ASSURANCE STATEMENT (OAS) – KEY CHARACTERISTICS

A half-yearly review process to provide assurance that mandated policies and processes are being complied with, and a formal assessment of business risk.

All senior executives with specific profit or loss accountability for a line of business (Line Leaders) and functional directors are required to implement robust local processes to determine how their OAS should be completed. OAS returns are submitted to the Chief Executive and reviewed by the Audit Director and Director Financial Control, Reporting and Treasury. Results from the OAS are presented to the Audit and Corporate Responsibility committees, and form part of the Board's regular review of risk. All returns are made available to the Group's auditors for use in their audit activities.

The OAS is formed of the following two parts:

1. Assessment of compliance with the Operational Framework

- Line Leaders of all businesses and relevant functional directors are required to complete and sign off an OAS recording their formal review of compliance against the Company's Operational Framework covering, amongst other things, the following:

<ul style="list-style-type: none"> – Health and safety – Environment – Product safety – Sponsorship and charitable giving – Product trading policy and pursuit of exports – Lobbying and political support 	<ul style="list-style-type: none"> – Advisers – Engineering – Business planning – Lifecycle Management (a core Group project management process) – Mergers, acquisitions and disposals 	<ul style="list-style-type: none"> – General compliance with the Operational Framework – Effectiveness of internal controls in joint ventures and associated undertakings – Ethical business conduct – Compliance with law, regulation and codes of practice 	<ul style="list-style-type: none"> – Delegated authorities – Financial controls – Risk management – People – Gifts and hospitality – Conflicts of interest – Security – Use of IT
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- Where simple yes/no answers are not appropriate, an assessment of compliance is required to be made against structured qualitative guidance.

- Minimum satisfactory levels of compliance are set by policy. If not compliant, a robust plan to achieve compliance is mandated and monitored through the Group's performance management processes and at the relevant audit review board.

2. Identification and management of key risks

- Line Leaders of all businesses and functional directors are required to identify their key risks (nominally 20), and analyse them in terms of size of impact and probability. An owner is required to be assigned to each risk, and mitigation plans produced and managed by the relevant business.
- The Executive Committee conducts risk workshops to analyse and allocate management responsibility for the management of the Group's most significant non-financial risks.

Risks are identified on a 'bottom-up' basis as part of the OAS process. This process is mandated across the Group and requires that the heads of all businesses and functions identify their key risks. As part of this process, an assessment is made of the probability of the risk arising and its potential impact on the Group's business plan. All risks have an owner who is responsible for production and implementation of plans aimed at mitigating the risk. The output from the Group's risk processes is reviewed on a regular basis by the Executive Committee and it produces a register of non-financial risks. As with risks identified through the OAS process, all risks on the non-financial risks register have owners who are responsible for mitigating them.

The Audit Committee is responsible for reviewing the ongoing effectiveness of the Company's risk management processes as part of its review of the effectiveness of internal controls. Also, twice a year, the Audit Committee receives reports on the output from the OAS process, details of the changes in the risks identified by it and the status of mitigation plans. The Corporate Responsibility Committee undertakes a similar role in respect of the non-financial risk register. The Board receives reports from the chairmen of these two committees, providing details of the work they have undertaken. Once a year, the Audit and Corporate Responsibility committees hold a joint meeting to agree the annual programme for the Group's Internal Audit function.

Each year the Board specifically reviews the risks identified in the risk management processes. This is aimed at providing the Board with an appreciation of the key risks within the business and oversight of how they are being managed.

Reporting within the Company is structured so that key issues are escalated through the management team ultimately to the Board if appropriate. The Operational Framework provides a common framework across the Company for operational and financial controls, and is reviewed on a regular basis by the Board. The business policies and processes detailed within the Operational Framework draw on global best practice and their application is mandated across the organisation. Lifecycle Management (LCM) is such a process, and promotes the application of best practice programme execution and facilitates continuous improvement across the Group. It considers the whole life of projects from inception to delivery into service and eventual disposal, and its application is critical to our capability in delivering projects to schedule and cost.

Further key processes are Integrated Business Planning (IBP), Quarterly Business Reviews (QBR) and Total Performance Leadership (TPL). The IBP, approved annually by the Board, results in an agreed long-term strategy for each operating group, together with detailed near-term budgets. The QBRs evaluate progress against the IBP, and business performance against objectives, measures and milestones. TPL drives business success by linking individual goals to those of the organisation, enabling employees to understand how their own success contributes to the success of the whole business.

Whilst the quality of the control processes is fundamental to the overall control environment, the consistent application of these processes is equally important. The consistent application of world-class control processes is a key management objective. The Company is committed to the protection of its assets, which include human, property and financial resources, through an effective risk management process, underpinned where appropriate by insurance.

The Internal Audit team independently reviews the risk identification procedures and control processes implemented by management. It provides objective assurance as to the operation and validity of the systems of internal control through a programme of cyclical reviews making recommendations for business and control improvements as required.

The overall responsibility for the system of internal control within BAE Systems rests with the directors of the Company. Responsibility for establishing and operating detailed control procedures lies with the Line Leaders of each operating business.

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

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

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position, are set out in the operating group reviews on pages 66 to 74. The financial position of the Group, including information on order intake, cash flow, treasury policy and liquidity, can be found in the review of financial performance on pages 36 to 44. Principal risks are detailed on pages 58 to 63. In addition, the financial statements include, amongst other things, notes on finance costs (page 142), loans and overdrafts (page 158), and financial risk management (page 176).

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

On behalf of the Board



Dick Oliver
Chairman

Audit Committee report

Members

Michael Hartnall (Chairman)
Sir Peter Mason
Roberto Quarta
Nick Rose
Ravi Uppal

Responsibilities

- Reviewing the effectiveness of the Group's financial reporting, internal control policies and procedures for the identification, assessment and reporting of risk.
- Monitoring the integrity of the Group's financial statements.
- Reviewing significant financial reporting issues and judgements.
- Monitoring the role and effectiveness of the Internal Audit function including approving the appointment or removal of the head of Internal Audit.
- Approving, in conjunction with the Corporate Responsibility Committee, an annual programme of internal audit work.
- Considering and making recommendations to the Board on the appointment of the Auditors.
- Agreeing the scope of the Auditors' annual audit programme and reviewing the output.
- Keeping the relationship with the Auditors under review, including the terms of their engagement and fees, their independence and expertise, resources and qualification, and assessing the effectiveness of the audit process.
- Developing and implementing policy on the engagement of the Auditors to supply non-audit services.

The full terms of reference of the Audit Committee can be found on the Company's website or can be obtained from the Company Secretary. The terms of reference are reviewed on an annual basis.



Michael Hartnall
Audit Committee Chairman

Governance

The Audit Committee was in place throughout 2010. Nick Rose and Ravi Uppal joined the Committee on 17 February 2010. All its members are independent in accordance with provision A.3.1 of the Combined Code.

Michael Hartnall has been chairman of the Committee since 2003. He was formerly the finance director of a FTSE 100 company and is a fellow of the Institute of Chartered Accountants in England and Wales. As reported by the Chairman on page 79, the appointment to the Committee of Nick Rose, equipped with the experience and skills gained in his role as Chief Financial Officer of Diageo plc, provides additional expertise and longer-term succession planning. Further biographical details on the individual members is provided on pages 76 and 77.

The Committee has asked that the Chief Executive, Group Finance Director, Director Financial Control, Reporting and Treasury, and the head of Internal Audit normally attend its meetings.

During the year, the Committee held individual meetings without Group executives present, without the head of Internal Audit present, solely with the head of Internal Audit present, and also solely with the external auditors present.

The Auditors and head of Internal Audit have direct access to the Chairman of the Committee.

The Committee may obtain at the Company's expense independent professional advice on any matters covered by its terms of reference.

The Committee accepts that certain work of a non-audit nature is best undertaken by the external auditors. The Committee reviews regularly the amount and nature of non-audit work they perform. It believes that it is not appropriate to limit the level of such work by reference to a set percentage of the audit fee, as this does not take into account important judgements that need to be made concerning the nature of work undertaken to help safeguard the Auditors' independence.

During the year the Committee reviewed its policy in relation to the undertaking of non-audit work by the external auditors and implemented a revised policy as reported on page 90.

On an annual basis the Committee's effectiveness is reviewed as part of the Board's externally facilitated evaluation process.

Meetings

The Committee met six times in 2010.

Activities

The principal activities undertaken by the Committee in the period under review are set out below.

Internal controls and risk

- The Committee received and considered reports during the year from the Group's auditors, KPMG Audit Plc, and the Group's Internal Audit function on the work they had undertaken in reviewing and auditing the control environment, in order to assess the quality and effectiveness of the internal control system.
- The Group's internal controls framework, which is based on a set of core processes that have been developed over a number of years, is documented in the Operational Framework (further information on which is provided on page 84). Twice during the year, the Committee reviewed the results of the Group's Operational Assurance Statement (OAS) process, through which senior managers across the Group report on the quality of their businesses' implementation and

compliance with the policies mandated in the Operational Framework. Further information on the OAS is provided on page 87.

- The Committee reviewed the output from the OAS process that requires managers to evaluate, identify and report on significant risks to the delivery of their business plans, and to report on the status of plans to mitigate such risks.
- The Committee assessed the effectiveness of the Group's internal controls and reviewed the related disclosures in the Annual Report.
- As part of the Committee's programme to gain a greater awareness of the Group's operations and to understand in more detail the implementation of core control processes, it met with:
 - senior executives from the Combat Systems business in the US; and
 - Detica senior management at Detica's UK offices.

As well as giving the Committee the opportunity to meet and discuss issues direct with operational management, these sessions provide a practical demonstration of the Group's risk identification and risk mitigation processes within the context of its wider internal control system.

The Committee also met with:

- the Chairman of the Information Technology & Management Functional Council to receive a report on the governance, management and security of IT;
- the Group Taxation Director to receive a report on taxation matters; and
- the Pensions Director to receive an update on pension scheme matters.

Financial reporting

The Committee:

- reviewed the financial statements and, as part of this process, the significant financial reporting judgements contained within them;
- reviewed liquidity risk and the basis for preparing the Group accounts on a going concern basis, including the analysis supporting the going concern judgement and disclosures in the financial statements;
- reviewed the financial statements in the 2009 and 2010 Annual Reports, and the 2010 Half-yearly Report, and received a report from the Auditors on the statements; and
- reviewed the two Interim Management Statements prior to their publication in May and October 2010.

Internal Audit

The Committee:

- reviewed output from the internal audit programme twice during the year and considered progress against the programme;

- met with the Corporate Responsibility Committee to consider a programme of internal audit work aimed at assessing the effectiveness of policies and processes relating to key areas of ethical and reputational risk;
- agreed the internal audit programme for 2010; and
- reviewed the effectiveness of the Group's Internal Audit function. In addition to the Committee's own consideration, this included discussion of the assessment and input from key stakeholders within the Group.

The Committee also met with the new head of US Internal Audit following her appointment.

The Auditors

The Committee:

- agreed the approach and scope of the audit work to be undertaken by the Auditors;
- reviewed with the Auditors the findings of their work;
- reviewed the Group's processes for disclosing information to the Auditors and the statement concerning such disclosure in the Annual Report;
- agreed the fees payable in respect of the 2010 audit work;
- undertook an annual review of the effectiveness and performance of the Auditors which included, in addition to the Committee's own consideration, assessment and input from key stakeholders within the Group, and was discussed by the Committee. It also received assurances from the Auditors regarding their independence. On the basis of this review the Committee recommended to the Board that it recommend that shareholders support the re-appointment of the Auditors at the 2011 Annual General Meeting; and
- developed and implemented a revised policy in respect of the provision of Non-Audit Services by the Auditors. Under the policy:
 - certain Non-Audit Services listed in the table on page 91 are prohibited from being provided by the Auditors.
 - Audit-Related Services and Permitted Non-Audit Services listed in the table on page 91 are pre-approved by the Committee up to £250,000 (subject to senior finance approval at business level up to £100,000 and subject additionally to the approval of the Director Financial Control, Reporting and Treasury up to £250,000). Work to be undertaken beyond this threshold requires consent from the Group Finance Director and the Audit Committee Chairman (up to £500,000) or the full Committee (over £500,000).
 - any other Non-Audit Services, which are neither prohibited nor defined as Permitted Non-Audit Services as set out on page 91, are subject to approval up to £100,000 by the Group Finance Director and the Audit Committee Chairman, and beyond that threshold by the full Committee.

On behalf of the Audit Committee

Michael Hartnall

Audit Committee Chairman

POLICY ON NON-AUDIT SERVICES PROVIDED BY THE AUDITORS

Prohibited Non-Audit Services

- Book-keeping and work relating to the preparation of accounting records and financial statements that will ultimately be subject to external audit;
- Financial information system design and implementation;
- Appraisal or valuation services in respect of material assets;
- Actuarial services;
- Internal auditing;
- Investment adviser or broking;
- Advocacy services;
- Secondments to management positions that include decision-making; and
- Any work where a mutuality of interest is created that could compromise the independence of the Auditors.

Audit-Related Services

- Reporting required by law or regulation to be provided by the Auditors;
- Reviews of interim financial information;
- Reporting on regulatory returns;
- Reporting to a regulator on client assets;
- Reporting on government grants;
- Reporting on internal financial controls when required by law or regulation; and
- Extended work undertaken at the request of those charged with governance on financial information (this does not include accounting services) and/or financial controls performed where this work is integrated with the audit work, and is performed on the same principal terms and conditions.

Permitted Non-Audit Services, subject to approval under the policy

- Tax compliance services;
- Tax advisory services;
- Due diligence services relating to acquisitions of new businesses or significant investments in businesses, joint ventures or strategic alliances;
- Public reporting on investment circulars;
- Private reporting to sponsors or similar parties in connection with investment circulars (including comfort letters and reporting on working capital statements);
- Preparing information for third parties relating to acquisitions and disposals, including the conversion of financial statements into other accounting standards;
- Liquidation services in respect of redundant subsidiaries or associate companies;
- Participation in the evaluation of Internal Audit; and
- Accounting advice.

Corporate Responsibility Committee report

Members

Paul Anderson (Chairman)
 Harriet Green
 Sir Peter Mason

Responsibilities

- Assisting the Board in overseeing the development of strategy, and policy on social, environmental and ethical matters.
- Keeping under review the effectiveness of the Company's internal control policies and procedures for the identification, assessment, management and reporting of reputational risks, including health and safety, workplace policies, environmental impact and business ethics.
- Monitoring and reviewing the role and effectiveness of the Company's Internal Audit function in relation to Corporate Responsibility (CR) and monitoring the development of the capability and capacity of the function to perform its role with regards to CR assurance and, in particular, ethical business conduct.
- Reviewing audit and assurance reports produced by the CR Assurer (an independent entity appointed to act as an external assurer of the Company's CR reporting) and assessing management responsiveness to recommendations in such reports.
- Overseeing and supporting key stakeholder engagement on social, environmental and ethical issues.
- Making proposals to the Remuneration Committee regarding appropriate CR-related performance objectives for executive directors and, in due course, providing its assessment as to performance against such objectives.
- Reviewing the Company's arrangements for employees to obtain further advice on ethical issues or raise and report concerns, in confidence, where there may be possible improprieties.
- Monitoring the implementation of the Woolf Report and ensuring that the global Code of Conduct is regularly reviewed and reflects best practice for such codes.
- Ensuring the Corporate Responsibility section of the Annual Report includes an examination of ethical business conduct within the Company.

The full terms of reference of the Corporate Responsibility Committee can be found on the Company's website or can be obtained from the Company Secretary.



Paul Anderson
 Corporate Responsibility
 Committee Chairman

Governance

The Corporate Responsibility Committee was in place throughout 2010.

Mr Anderson was appointed to the Committee on 17 February 2010 and succeeded Mr Inglis as Chairman of the Committee on 9 July 2010. Mr Uppal ceased to be a member of the Committee on 17 February 2010. Mr Inglis ceased to be a member of the Committee on 9 July 2010 and Ms Green joined the Committee on 1 November 2010 (Mr Olver attended meetings between these dates).

The Committee has asked that the Chief Executive, Group General Counsel, Group HR Director, Managing Director, Corporate Responsibility and the Head of Internal Audit normally attend its meetings.

The head of the Company's Internal Audit function and managing director of the CR function have direct access to the Chairman of the Committee.

The Committee is responsible for appointing the CR Assurer (presently Deloitte) and keeping under review its fees, independence and objectivity, scope of work, and the expertise and resources available to it.

The Chairman of the Committee reports on the proceedings of all Committee meetings to the Board and all directors receive copies of the Committee's minutes.

The Committee may obtain at the Company's expense independent professional advice on any matters covered by its terms of reference.

On an annual basis the Committee's effectiveness is reviewed as part of the Board's externally facilitated evaluation process.

The Committee held a joint meeting with the Audit Committee during the year to review work undertaken by the Internal Audit function and agree the programme of audit work for the following year.

Meetings

The Committee met four times in 2010.

Activities

The principal activities undertaken by the Committee during 2010 are detailed below.

CR objectives

The Committee agreed with the Chief Executive that the Company should continue to focus on the following areas of corporate responsibility:

- business conduct;
- safety; and
- diversity and inclusion.

At the end of 2009, the Committee agreed management objectives in the areas of business conduct, safety, and diversity and inclusion, and the Remuneration Committee incorporated these into the non-financial objectives against which annual incentive payments for executive directors and other senior managers were to be based. At meetings held during the year, the Committee reviewed progress against these objectives.

Actual performance against the measures agreed for the 2010 objectives was determined by the Committee at the end of the year and a recommendation was made to the Remuneration Committee to assist it in determining the total level of payout under the annual incentive plan.

At the end of last year, the Committee agreed corporate responsibility-related management objectives for 2011.

Risk management

The Committee reviewed the output from the Company's risk management processes as they relate to corporate responsibility-related risks. These processes are as follows:

- Operational Assurance Statement (OAS) process – a half-yearly self-assessment process by which businesses and functional heads identify key risks.
- Non-financial risk register – a top-down analysis of key non-financial and reputational risks reviewed regularly and updated by the Executive Committee.

The Committee was provided with details of the risks reported via the above processes and related mitigation plans. As part of this activity, the Committee reviewed the Company's crisis management arrangements.

Assurance

Assurance as to adherence to corporate responsibility-related policies is provided to the Committee by the Group's Internal Audit function. It also receives a report on the activities undertaken by Deloitte LLP, who have been engaged by the Committee to provide independent assurance on certain corporate responsibility matters.

The Head of Internal Audit attends all of the Committee's meetings and, amongst other things, reports regularly on corporate responsibility-related work undertaken by the Internal Audit function and the key findings from this. The Committee has reviewed with the Head of Internal Audit the development of the skills and capabilities within the Internal Audit function required to effectively undertake corporate responsibility-related audit work. Deloitte provides the Committee with a letter detailing the scope of the work undertaken and the key observations arising from this. The Committee reviewed the letter issued by Deloitte in 2010 following the review of the CR Report and agreed matters to be addressed arising from the observations made.

Business conduct

During the year, the Committee monitored progress against the milestones set for the implementation of the recommendations in the Woolf Report. It also agreed how an assessment would be undertaken in the first half of 2011 of the effectiveness of the implementation of the 23 recommendations contained in the report.

Environment

In 2010, the Committee reviewed progress towards developing the Group's approach to environmental sustainability.

Ethics Helpline

Recognising the importance of having a means by which employees may raise issues or seek guidance on matters in confidence, the Committee reviews the operation of the Ethics Helpline. At two of the Committee's meetings held in 2010 it reviewed the working of the Ethics Helpline, and the nature and number of contacts made.

Corporate Responsibility Report

The Committee reviewed and approved the Company's Corporate Responsibility Report.

Terms of reference

The Committee reviewed its terms of reference.

On behalf of the Corporate Responsibility Committee

Paul Anderson

Corporate Responsibility Committee Chairman

Nominations Committee report

Members

Dick Olver (Chairman)
Paul Anderson
Sir Peter Mason

Responsibilities

- Reviewing regularly the structure, size and composition of the Board and making recommendations to the Board on any appropriate changes.
- Identifying and nominating for the Board's approval suitable candidates to fill any vacancies for non-executive and, with the assistance of the Chief Executive, executive directors.
- Planning for the orderly succession of directors to the Board.
- Recommending to the Board the membership and chairmanship of the Audit, Corporate Responsibility and Remuneration committees.

The full terms of reference of the Nominations Committee can be found on the Company's website or can be obtained from the Company Secretary.



Dick Olver
Nominations Committee
Chairman

Governance

The Nominations Committee was in place throughout 2010. It is chaired by the Chairman of the Company. Whilst he is not deemed to be independent, the other two members of the Committee are independent non-executive directors in accordance with provision A.3.1 of the Combined Code.

When dealing with any matters concerning his membership of the Board the Chairman will absent himself from the meeting as required, and meetings will be chaired by the Board's Senior Independent Director, Sir Peter Mason.

The Committee normally asks the Chief Executive and the Group HR Director to attend its meetings.

During the year, the Committee retained the services of the search consultants Zygos Partners and Spencer Stuart to assist in identifying potential candidates for nomination to the Board.

Nick Rose, an independent non-executive director, attended Committee meetings in the period from June to November 2010.

Meetings

The Committee met eight times in 2010.

Activities

The principal activities undertaken by the Committee in the period under review are set out below.

Executive succession planning

The Committee is responsible for reviewing the plans and processes aimed at ensuring that the Company has a senior executive resource with the necessary skills and experience to meet the Group's future needs, with a particular interest in long-term succession planning for the executive membership of the Board. As in past years, the Committee reviewed the output from the Group's executive development and succession planning processes. This review looked at threats to achieving the desired resource plans, and the overall health of the plans in terms of depth of resource across readiness categories and positions, average age profiles across readiness categories, gender diversity, and attrition rates. In addition, the Committee reviewed individual succession plans for the most senior executive positions in the Company (including existing executive director appointments).

During 2010, the Committee managed the search for a suitable candidate to succeed George Rose as Group Finance Director – Mr Rose having indicated that he was thinking about retiring in 2011. To assist the Committee in this activity, Nick Rose, until recently Chief Financial Officer of Diageo plc, attended meetings and participated fully in the search activity. In addition, the Committee engaged the services of the search consultants Spencer Stuart. The search was undertaken against a detailed job specification and included both internal and external candidates. Having completed the process, the Committee agreed to nominate Peter Lynas, a senior finance executive within the Company, for the position and he was subsequently appointed by the Board with such appointment to be effective from 1 April 2011.

Non-executive succession planning

As explained on page 79, the Committee also undertook a review of the Board's long-term succession requirements in terms of non-executive directors. This review looked at both the Board's skill and experience requirements, and the needs of the committees. This work was undertaken recognising that two non-executive directors, Phil Carroll and Andy Inglis, were looking to stand down from the Board, and also taking into consideration the length of service and skill/experience profile of current non-executive Board members.

Board committee membership

The Committee is responsible for nominating appropriate individuals for membership of the Board's committees. A number of changes were made to committee membership during the year to ensure that they comprised individuals with the necessary skills, knowledge and experience, and that they comply with the requirements of the Company's Articles of Association.

Conflicts of interest

As required by procedures adopted by the Board to deal with the authorisation of potential conflicts of interest (in accordance with UK company law), the Committee reviewed such authorisations previously agreed by the Board and made recommendations regarding their renewal.

On behalf of the Nominations Committee

Dick Olver

Nominations Committee Chairman

Remuneration report

The Remuneration report is structured as follows:

– Remuneration Committee report	Page 96
– Non-Executive Directors' Fees Committee report	Page 99
– Remuneration reporting:	
– Remuneration strategy, policy and service contracts for executive directors	Pages 100 to 112
– Chairman's appointment, term and fees	Page 112
– Non-executive directors' appointment, term and fees	Page 113
– Tabular information on directors' shareholdings, share-based incentives, emoluments and pensions	Pages 114 to 119

Remuneration Committee report

Members

Carl Symon (Chairman)
Roberto Quarta
Nick Rose

Responsibilities

- Agreeing a policy for the remuneration of the Chairman, executive directors, members of the Executive Committee (EC), the Company Secretary and other senior executives.
- Within the agreed policy, determining individual remuneration packages for the Chairman, executive directors and EC members.
- Agreeing the policy on terms and conditions to be included in service agreements for the Chairman, executive directors, EC members, the Company Secretary and other senior executives, including termination payments and compensation commitments, where applicable.
- Approving any employee share-based incentive schemes and any performance conditions to be used for such schemes.
- Determining any share scheme performance targets.

The full terms of reference of the Remuneration Committee can be found on the Company's website or can be obtained from the Company Secretary.



Carl Symon
Remuneration
Committee Chairman

Governance

The members of the Committee are independent non-executive directors.

Dick Oliver, the Company's Chairman (who was deemed to be independent on his appointment as Board Chairman on 1 July 2004), also served as a member of the Committee until 17 February 2010. Nick Rose was appointed to the Committee with effect from 17 February 2010.

The Chief Executive and the Company's Chairman, subsequent to his resignation from the Committee, attend Committee meetings by invitation only. They do not attend where their individual remuneration is discussed and no director is involved in deciding his own remuneration. The Company Secretary acts as secretary to the Committee.

In 2010, the Committee met seven times and details of attendance at these meetings are provided in the Corporate Governance report on page 86.

The Committee appointed Kepler Associates as its Independent Adviser in 2007 to provide advice to the Committee and its individual members on all aspects of the Committee's remit. Kepler Associates will not undertake any work for the Company whilst they are retained as the Committee's Independent Adviser. Representatives from Kepler Associates have attended each of the Committee meetings during 2010 and will be in

attendance at all meetings unless specifically requested otherwise by the Committee.

During the year, the Committee also received material assistance and advice on remuneration policy from the Group's Human Resources Director, Alastair Imrie, and the Human Resources Director, Remuneration and Benefits, Graham Middleton. Dick Oliver, Chairman, and Ian King, Chief Executive, also provided advice that was of material assistance to the Committee.

Legal advice to the Committee has been provided by Linklaters who are appointed by the Company, and who also provided services to the Company during the year. The Committee is satisfied that the services provided to it by Linklaters are of a technical nature and did not create any conflict of interest. If a conflict of interest were to arise in the future, the Committee would appoint separate legal advisers from those used by the Company.

PricewaterhouseCoopers (PwC), who are appointed by the Company and also provided services to the Company during the year, provided detailed information on market trends and the competitive positioning of packages. Hewitt New Bridge Street, who are appointed by the Committee, provided advice on the total shareholder return figures for assessing the performance condition under the Performance Share Plan.

ANNUAL TIMETABLE OF COMMITTEE ACTIVITIES

	Directors' and EC members' remuneration	Annual bonus	Share plans	Miscellaneous
Quarter 1	Shareholder consultation on remuneration review Approve remuneration for EC members	Review prior year performance against financial and non-financial performance. Where applicable, agree bonus amounts payable Set directors' and EC members' performance targets and objectives for current year	Approve Group All-Employee Free Shares Plan payments Grant of Spring awards to directors and executives	Review Remuneration Committee Terms of Reference and output of the Remuneration Committee performance evaluation Review Remuneration Report for recommendation to the Board
Quarter 2				Review pay review for senior executives below the EC
Quarter 3	Review directors' actual pay and bonus for previous year against comparator group actuals Set basis for annual remuneration review	Review progress of directors' and EC members' performance against targets	Grant of Autumn awards to directors and executives	
Quarter 4	Review market position (including pensions) Set bonus levels and share plan grant levels Set directors' salaries		Review share-based reward considering market trends, and review status of performance conditions, dilution levels and usage for following year Agree grant policy for Spring awards Approve Group All-Employee Free Shares Plan for following year	Review market position of package (including pensions) for senior executives below the EC

Activities and highlights

BAE Systems is one of the world's largest and most geographically diverse defence and security companies. We operate with a clearly defined strategy to deliver sustainable growth in value to shareholders, operating in a highly technologically complex market, with a presence in five key home markets. The Group faces a more challenging trading environment as governments look for cost savings to address budgetary pressures.

Our remuneration strategy is intended to recognise this business environment whilst fostering a Total Performance culture at all levels of the Company, taking into account seniority and local market practice. In addition, it reinforces our drive to continue to embed high levels of business conduct and our commitment to safety across the business.

The Committee is sensitive to the levels of the remuneration packages of other employees within the Group. In some areas, our workforce is heavily unionised. Many of our employees work at the very leading edge of technology. We have a diverse workforce operating in many countries. Employee remuneration packages are therefore determined locally to meet local needs, whilst respecting our culture and Values. In 2010, general salary increases for our two largest employee populations in the UK and US typically averaged 2.4% and 2.5%, respectively.

In determining the levels of executive reward, the Remuneration Committee also continues to place considerable emphasis on ensuring a strong link between actual remuneration received, and achievement of our strategic and business objectives.

In 2010, our performance against targets was good. We slightly exceeded our profit target, and exceeded our stretch cash targets. However, our Total Shareholder Return (TSR) performance reflects the sustained under-performance of our share price. Our Earnings per Share (EPS) was 40.5p. We also started to experience significant executive retention issues in North America.

Against this performance background, the main aspects of our remuneration policy and practice for the year were as follows:

- having been unchanged in 2009, the salaries of the Chief Executive and Group Finance Director were increased by 3.9% and 2.5%, respectively;
- the salary of the President and Chief Executive Officer of BAE Systems, Inc., Linda Hudson, has been increased by 12.2% to bring her nearer to market median. She was appointed in October 2009 having been promoted to that position from within the business. In setting her initial salary the Remuneration Committee was aware that she would be operating at a significantly higher level than was previously the case, and, whilst this salary was a clear step-up from her previous position, there was scope for future increases to bring her closer to market median provided her performance merited this. The increase awarded by the Remuneration Committee recognises where her initial salary was set in 2009 and that she is performing on a level which justifies a more market competitive package. This salary change was made with effect from 1 January 2011;
- annual bonus payouts for the executive directors under the annual incentive plan ranged from 69.1% to 89.1% of maximum;

- the growth of EPS over the three-year performance period for the 2008 awards under the long-term incentive plans was approximately 10.6% pa. Consequently:
- the awards of matching shares granted under the Share Matching Plan (SMP) in 2008 vest in full; and
- of the 50% of the awards of shares granted in Spring 2008 under the EPS portion of the Performance Share Plan (PSP), 94.55% vest.
- the Company's TSR for the 50% of awards of shares granted in March 2008 under the TSR portion of the PSP was below the median position when compared against the comparator group of 18 other defence and aerospace companies, and the related awards accordingly lapsed;
- the structure of our annual incentive and long-term incentives were left substantially unchanged (including the 'clawback' arrangements established last year) (see pages 101 and 108 for details);
- we retained the requirement for one-third of executive directors' annual incentives (25% for EC members and other senior executives) to be compulsorily deferred into the SMP;
- our requirement for executive directors to build up a shareholding of 200% of salary over time, remains unchanged. Both the Chief Executive and Group Finance Director comfortably exceed this level; at 31 December 2010, the President and Chief Executive Officer of BAE Systems, Inc. held shares representing approximately 144% of salary, reflecting her more recent appointment; and
- we are seeking shareholder approval to introduce a Restricted Share Plan (see page 102), principally to enable us to address key executive retention issues for US-based executives. The Plan would permit awards to executives in other countries, but specific Remuneration Committee approval will be required on each occasion. The President and Chief Executive Officer of BAE Systems, Inc. will be included in the Plan, but other Board members will not be included without further consultation with shareholders.

The Company's remuneration strategy, policy and details of executive remuneration are set out on pages 100 to 112 of this report.

Following the announcement of the retirement of George Rose as Group Finance Director, effective 31 March 2011, the Committee also agreed the package for Peter Lynas on his appointment as Group Finance Director and an executive director of BAE Systems plc, effective 1 April 2011.

On behalf of the Remuneration Committee

Carl Symon

Remuneration Committee Chairman

Non-Executive Directors' Fees Committee report

Members

Dick Olver (Chairman)
Philip Bramwell
Linda Hudson
Ian King

Responsibilities

- Reviewing the fees payable to non-executive directors (excluding the Chairman) and making changes to such fees as deemed appropriate.



Dick Olver
Non-Executive Directors'
Fees Committee
Chairman

Governance

The Non-Executive Directors' Fees Committee has delegated authority from the Board to agree fees payable to non-executive directors on its behalf.

Activities

The Board has approved the following guidelines to be used by the Committee when discharging its responsibilities:

- fees shall be sufficient to attract and retain individuals with the necessary skills, experience and knowledge required to ensure that the Board is able to discharge its duties effectively;
- in setting fees the Committee shall have regard to the amount of time individual non-executive directors are required to devote to their duties, and also the scale and complexity of the business, and the responsibility involved;
- fees payable to non-executive directors shall be paid in cash and shall not be performance-related; and
- non-executive directors shall not participate in the Company's share-based incentive schemes or pension scheme.

The Committee meets each year to consider the fees paid to the non-executive directors. Having reviewed the increasing time commitments expected of non-executive directors and the market competitive positioning of existing fee levels, the Committee agreed in January 2011 to increase the basic fee from £66,000 to £75,000 per annum. All other fees remain unchanged as detailed on page 113.

On behalf of the Non-Executive Directors' Fees Committee

Dick Olver

Non-Executive Directors' Fees Committee Chairman

Remuneration strategy, policy and packages

Following the annual review in November 2010, the Committee concluded that the current remuneration strategy remains generally appropriate, but the following changes have been introduced:

- to further emphasise the importance of business growth, order intake is being incorporated as one of the financial elements in the annual incentive plan targets (see page 101). Other elements of the Plan remain unchanged; and
- to address retention issues principally in our North American business, shareholder approval is being sought at the AGM to implement a Restricted Share Plan (see page 102).

Other than these changes, the Committee intends to continue with the executive remuneration policy as detailed in this report in 2011 and subsequent years for executive directors and EC members, and this policy will be flowed down to the most senior executives within the Group globally (approximately 280) to create a consistent global approach to reward. The principles of the remuneration strategy are applied consistently across the Group below this level, taking account of seniority and local market practice.

The Committee will continue to consult on material changes with principal shareholders.

The Committee has considered the new UK Corporate Governance Code requirement regarding remuneration incentives being compatible with risk policies and systems, and is satisfied that the Company is well placed to meet this requirement as profit recognition on long-term programmes is intrinsically linked to risk reduction.

REMUNERATION STRATEGY	REMUNERATION POLICY
<p>The Company's remuneration strategy is to provide a remuneration package that:</p> <ul style="list-style-type: none"> – helps to attract, retain and motivate; – is aligned to shareholders' interests; – is competitive against the appropriate market; – encourages and supports a Total Performance culture aligned to the achievement of the Company's strategic objectives; – is fair and transparent; and – can be applied consistently throughout the Group. 	<p>To achieve the strategy, the remuneration policy for executive directors and EC members is to:</p> <ul style="list-style-type: none"> – set base salary at around median of the relevant market competitive level; – reward stretching superior performance with upper quartile reward; – provide an appropriate balance between: <ul style="list-style-type: none"> – short-term and long-term reward; and – fixed and variable reward with the balance becoming more long term and more highly geared with seniority; – directly align short-term and long-term reward through compulsory deferral of annual incentive into the Share Matching Plan; and – provide a competitive package of benefits.
ELEMENTS OF PACKAGE	PURPOSE
Base salary	Recognise market value of role and individual's skills, experience and performance.
Annual incentive	Drive and reward annual performance of individuals, teams and the Company on both financial and non-financial metrics, including behaviours.
Share Matching Plan	Directly align short-term and long-term reward through compulsory deferral of annual incentive into shares, and drive and reward delivery of sustained long-term EPS performance through co-investment aligned to the interests of shareholders.
Performance Share Plan	Drive and reward delivery of sustained long-term EPS and TSR performance aligned to the interests of shareholders.
Restricted Share Plan	Provide long-term reward and address retention issues, through time-vesting awards principally in the Company's US market.
Pension provision	Provide competitive retirement benefits which reward long-term performance through seniority, and loyalty through long service.
Other benefits	Provide competitive cost effective benefits package through leveraging the Company's size and scale.
Global all-employee incentive plan	Reward all employees globally for Group performance, encouraging employee share ownership aligned to the interests of shareholders.

Appointment of new Group Finance Director

The Company announced on 10 December 2010 that George Rose would be retiring as Group Finance Director with effect from 31 March 2011 and that Peter Lynas would be appointed as Group Finance Director with effect from 1 April 2011. The salary packages for both George Rose, the outgoing Group Finance Director, which had been agreed as part of the 2010 remuneration review, and for Peter Lynas, the incoming Group Finance Director, which was agreed by the Committee subsequent to the 2010 remuneration review, are included in this report.

2010 remuneration review

The 2010 review not only considered the Company's executive remuneration packages against the market, but also the Company's performance to date and its corporate strategy for the next five years.

Information on the market for comparable management positions was provided by PwC so that the Committee could form a view as to where to position the various elements of the package relative to comparable companies.

The methodology used was to construct appropriate comparator groups for the individual positions, taking account of company size, scale of operations and breadth of role. The comparator group for the UK executive directors comprised the FTSE 50 companies (excluding financial services and retail) with market capitalisation nearest to that of BAE Systems. The Committee believes that using market capitalisation creates alignment between the value placed on the Company and the value placed on the executives who manage it. The six largest companies were also excluded as were several others to arrive at a comparator group of 20 companies (11 larger and 9 smaller) which the Committee believed appropriate for benchmarking UK executive directors' packages.

For the President and Chief Executive Officer of BAE Systems, Inc., the comparator group was drawn from companies in the US aerospace, defence and general industry sector, adjusted as appropriate, to produce market figures consistent with the size, scale and relative independence of the US business, and adjusting where necessary to reflect the extra responsibility for her plc Board role.

The base salary, total cash reward (base salary plus annual incentive), total direct reward (total cash reward plus long-term incentives) and total reward (total direct reward plus pension) were analysed at the lower quartile, median and upper quartile for the relevant posts in the comparator group companies. This gives the Committee a view on the competitiveness of the individual elements of the package as well as the package as a whole.

The Committee also reviewed market trends around the individual elements of remuneration to ensure that the structure of the package stays in line with market practice. The remuneration structure overall also takes account of the performance of the individual, the Company as a whole, and the pay and conditions of Group employees.

Overall, while the review indicated that the structure is broadly in line with the market, some minor adjustments were deemed necessary to ensure that it remained so. In addition, the base salaries for both the Chief Executive and the President and Chief Executive Officer of BAE Systems, Inc. were behind their respective benchmarks.

Base salary

The Committee reviewed base salaries, taking into account the current economic climate, the challenges facing the business, their respective positions against benchmark, the pay environment for employees in general and that their salaries had been unchanged since 2009. In particular, the salary of the President and Chief Executive Officer of BAE Systems, Inc. has been increased to maintain the competitiveness of the package and bring her salary closer to market median. Further information on the rationale for this increase is provided on page 98.

The annual base salary levels of executive directors with effect from 1 January 2011 are as follows:

Name	2010 salary	2011 salary	Increase
Ian King	£900,000	£935,000	3.9%
George Rose	£622,500	£638,000	2.5%
Linda Hudson	\$900,000	\$1,010,000	12.2%

Incentives

The Group's strategy is set out on page 14 along with the Group Strategic Framework. This explains how the Group's mission is to deliver sustainable growth in shareholder value through its commitment to Total Performance – Customer Focus, Programme Execution, Financial Performance and Responsible Behaviour. Underpinning the drive for Total Performance are the Group's Values – Trusted, Innovative and Bold. The Group's strategy focuses on delivering growth in the three market segments of Services, Electronic Systems and Platforms, in existing and new home markets, and in export markets. The six Strategic Actions, which translate the strategy into operational plans, are underpinned by the Integrated Business Plan (IBP), which sets out a five-year strategic and financial plan.

Each year, the Board agrees the Executive Committee's top ten objectives which are those key to delivering the Group's strategy. For 2011, these are set out on page 13, and are used as the basis to set the individual objectives for the executive directors and EC members which are agreed by the Chairman, Dick Olver, and the Committee. These then flow down to the senior leadership team to ensure that all businesses within the Group are aligned with the overall Group strategy.

The remuneration strategy incentivises and rewards executives to deliver their contribution to the achievement of the Group's strategy through the combination of short-term incentives targeted at business performance, Group performance, personal performance and leadership behaviours, and long-term incentives targeted at Group performance. To directly align short-term and long-term reward, executive directors will be required to invest at least one-third of their net 2011 annual incentive into the SMP when the annual incentive is paid in 2012. Further investment can be made on a voluntary basis up to a maximum investment of half their net annual incentive, except in the case of the US executive director who will participate in the Restricted Share Plan subject to its approval by shareholders at the 2011 AGM (further detail is provided on page 102).

Annual incentive plan

The annual incentives for 2011 continue to focus on a combination of in-year financial performance, and longer-term performance and risk management (both business risk and reputation risk). Two-thirds is driven off in-year financial performance, and one-third based on driving performance and improvement in business conduct and safety (reinforcing the importance of key aspects of the Group's corporate responsibility agenda) combined with the other non-financial objectives supporting the Group's strategy. No changes to this structure are proposed for 2011.

The financial targets are derived from the IBP, and are based on earnings and cash targets and, for 2011, also order intake. The relative proportions of the financial targets for profit, cash and order intake are 40:40:20. These are seen as the key indicators of both short-term and long-term financial performance and value creation, and are supported by the Company's major shareholders. At Group level, EPS is used whereas EBITA¹ is used to measure earnings performance at a business level. To incentivise improved phasing of cash generation throughout the year, a combination of year-end and average quarterly net cash/debt was introduced for 2009 and 2010, and will continue for 2011. Due to the stretching nature of the plan, the Committee introduced for 2010 a threshold paying 20% of maximum for the profit element. This will continue for 2011. The payout for on-target performance is 50% of maximum. Payout for performance between targets is calculated on a straight-line basis.

The table below summarises the overall structure of the annual incentives for executive directors.

Performance measure	Proportion of annual incentive	
	2010	2011
In-year financial	66.6%	66.7%
Business conduct and safety	15.0%	15.0%
Other objectives	18.4%	18.3%

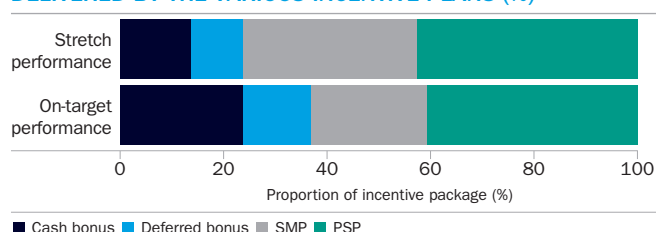
The Committee believes that the annual incentive targets for the executive directors are stretching but achievable. The structure of the 2011 annual incentive plan for executive directors is summarised in their individual sections on pages 103 to 106.

Long-Term Incentive Plans (LTIPs)

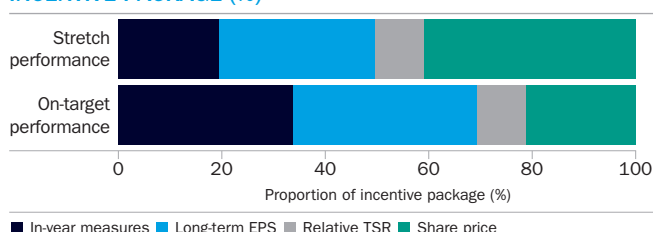
The Company operates two LTIPs (having ceased awards of share options in 2008) – the Performance Share Plan (PSP) and the Share Matching Plan (SMP). The structure of these plans remain unchanged. Full details of the PSP and SMP are contained on pages 108 and 109.

The combination of the annual incentive plan, SMP and PSP provides a balance between short-term cash reward and longer-term share-based reward as shown below. The proportion of the incentive package delivered through longer-term performance is significantly higher at stretch payout than at on-target payout, demonstrating that the package supports the achievement of superior long-term performance and strongly aligns the interests of executives to those of shareholders through long-term reward being delivered in shares. The second graph shows which performance metrics are driving the value of the incentives. This shows that, at on-target performance, the higher influence of the annual incentive means that in-year measures drive almost 40% of the package value, with long-term EPS (which underpins the SMP and half the PSP awards) accounting for a similar proportion. But, at stretch performance, the influence of the annual incentive is reduced, and the SMP and PSP account between them for nearly three-quarters of the value of the incentive package, with the most important drivers of value becoming long-term EPS and share price. This shows that achieving strong performance on the in-year measures is important but, to maximise the value of their incentive package, executives need to drive growth in long-term EPS and share price.

PROPORTION OF CHIEF EXECUTIVE'S INCENTIVE PACKAGE DELIVERED BY THE VARIOUS INCENTIVE PLANS (%)



PERFORMANCE DRIVERS OF CHIEF EXECUTIVE'S INCENTIVE PACKAGE (%)



Restricted Share Plan (RSP)

Within the Company's US peer group, our research indicates that performance-based LTIP awards only typically make up around a third of the overall long-term incentive package for a US executive. In comparison, the BAE Systems LTIP plans are 100% based on performance conditions, which provides much less retention value for senior US executives and can be 'bought out' by a competitor for a small cost.

Our US business is a fundamentally important part of the Group, and it is essential we are able to attract and retain high calibre staff. We do not wish to provide a completely different reward structure in the US compared to our global approach; nor will we increase the overall value of the Inc. reward package. However, the retention issue is sufficiently serious and potentially damaging to the business to require action.

Consequently, the Committee is proposing to introduce a time-vesting LTIP element within the overall US executive package. This will be achieved by introducing a Restricted Share Plan (RSP) without performance conditions other than time vesting. The Restricted Share Plan will provide 35% of the expected value of the total LTIP package, and will vest after three years. This Plan will require the approval of shareholders at the AGM in May 2011.

The expected value of the total LTIP package for US executives including the RSP will be maintained at its current level. Subject to shareholder approval of the RSP, this will be achieved by reducing existing LTIP award levels for participants as follows:

- removing the voluntary matching element of the SMP. This will apply to voluntary investment in the SMP in respect of the 2010 annual incentive plan payment, and onwards; and
- reducing overall PSP award levels.

Subject to shareholder approval, participants' awards of restricted stock will be confirmed after the AGM.

¹ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

Whilst the Plan is primarily aimed at our US executives, the Plan would permit awards to executives in other countries, but specific Remuneration Committee approval will be required on each occasion. The President and Chief Executive Officer of BAE Systems, Inc. will be included in the Plan, but other Board members will not be included without further consultation with shareholders.

Personal shareholding policy

The Committee has agreed a policy whereby all executive directors are required to establish and maintain a minimum personal shareholding equal to 200% of base salary. As a minimum, a holding equal to 100% of base salary must be achieved as quickly as possible using shares vesting or options exercised through the executive share option schemes or long-term incentive schemes, by using 50% of the shares that vest or 50% of the options which are exercised on each occasion. Thereafter, executive directors are required to increase their personal shareholding gradually, on each occasion using 25% of the shares that vest or 25% of the options exercised each year, until a personal shareholding equal to 200% of annual base salary is achieved and maintained. These limits are reviewed periodically. A similar arrangement applies to senior executives eligible for share-based long-term incentives with limits aligned to the levels of awards made under these plans.

Details of the directors' personal shareholdings are shown in Table A on page 114.

Pension provision

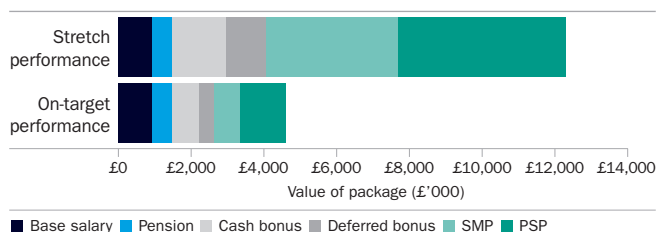
No changes to the pension arrangements for executive directors were made in 2010. A review of UK executive pension arrangements has been undertaken in the light of the changes announced to the taxation of members of UK registered pension arrangements from 6 April 2011. The underlying principles for this review were that the aggregate level of benefits provided to members under the new arrangements should be cost neutral to the Company compared to the existing arrangements. The approach addresses tax inefficiencies arising for existing employees as a consequence of the pensions tax changes, and members will be given the choice to remain in the current arrangements and pay the increased tax. Further detail is provided on page 111.

STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES

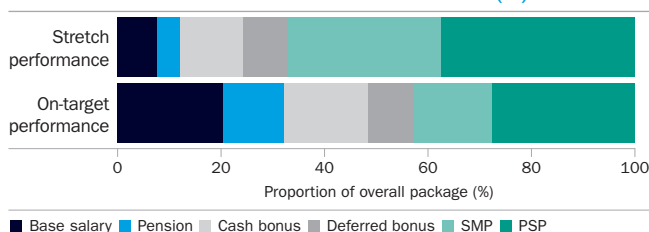
Ian King (Chief Executive)		2011		2010	
Base salary		£935,000 pa		£900,000 pa	
Annual incentive	Maximum/ on-target (% of salary)	225%/112.5%			
	Structure (% of salary)	On-target	Stretch	On-target	Stretch
	Group EPS	30%	60%	36%	90%
	Group cash	30%	60%	24%	60%
	Order intake	15%	30%	Not applicable	
	Safety	Up to 16.875%		Up to 16.875%	
	Business conduct	Up to 16.875%		Up to 16.875%	
	Other objectives	Up to 41.25%		Up to 41.25%	
	Deferral into SMP	1/3 compulsory plus voluntary up to total of 50% of net annual incentive			
SMP	Gross match	2:1			
	Performance condition	EPS growth of 5% – 11% pa			
PSP	Grant (% of salary)	250%			
	Performance condition	1/2 on relative TSR against 18 other global aerospace and defence companies, and 1/2 on EPS growth of 5% – 11% pa			
Pension accrual		1/30th of three-year final average salary from age 62 for 8% member's contributions			

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

VALUE OF PACKAGE (£'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)

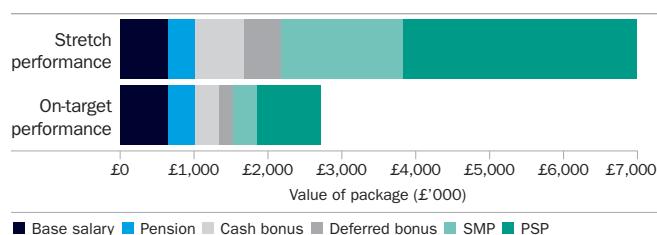


STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES CONTINUED

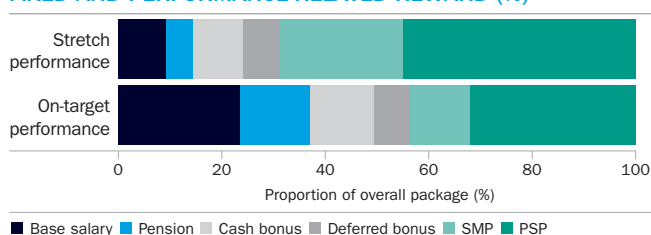
George Rose (Group Finance Director)		2011*		2010	
Base salary		£638,000 pa		£622,500 pa	
Annual incentive	Maximum/on-target (% of salary)	150%/75%			
	Structure (% of salary)	On-target	Stretch	On-target	Stretch
	Group EPS	20%	40%	24%	60%
	Group cash	20%	40%	16%	40%
	Order intake	10%	20%	Not applicable	
	Safety	Up to 11.25%		Up to 11.25%	
	Business conduct	Up to 11.25%		Up to 11.25%	
	Other objectives	Up to 27.5%		Up to 27.5%	
	Deferral into SMP	1/3 compulsory plus voluntary up to total of 50% of net annual incentive			
SMP	Gross match	2:1			
	Performance condition	EPS growth of 5% – 11% pa			
PSP	Grant (% of salary)	250%			
	Performance condition	1/2 on relative TSR against 18 other global aerospace and defence companies, and 1/2 on EPS growth of 5% – 11% pa			
Pension accrual		1/30th of three-year final average salary from age 60 for 9.29% member's contributions			

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

VALUE OF PACKAGE (£'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)



* As announced by the Company on 10 December 2010, George Rose will retire with effect from 31 March 2011. The 2011 salary package details and graphs above set out the position had he continued in his role throughout 2011. Details of his retirement arrangements are provided on page 112.

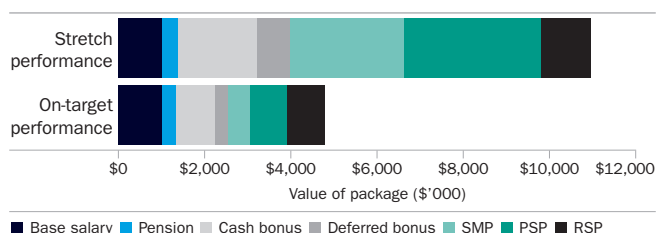
STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES CONTINUED

Linda Hudson (President and Chief Executive Officer of BAE Systems, Inc.)		2011		2010	
Base salary		\$1,010,000 pa		\$900,000 pa	
Annual incentive	Maximum/on-target (% of salary)	225%/112.5%			
	Structure (% of salary)	On-target	Stretch	On-target	Stretch
	Group EPS	10%	20%	12%	30%
	Group cash	10%	20%	8%	20%
	Order intake	5%	10%	Not applicable	
	Business EBITA ¹	20%	40%	24%	60%
	Business cash	20%	40%	16%	40%
	Business order intake	10%	20%	Not applicable	
	Safety	Up to 16.875%		Up to 16.875%	
	Business conduct	Up to 16.875%		Up to 16.875%	
SMP	Other objectives	Up to 41.25%		Up to 41.25%	
	Deferral into SMP	Compulsory $\frac{1}{3}$ of net annual incentive. No voluntary element		$\frac{1}{3}$ compulsory plus voluntary up to total of 50% of net annual incentive*	
PSP	Gross match	2:1			
	Performance condition	EPS growth of 5% – 11% pa			
RSP	Grant (% of salary)	160%		250%	
	Performance condition	$\frac{1}{2}$ on relative TSR against 18 other global aerospace and defence companies, and $\frac{1}{2}$ on EPS growth of 5% – 11% pa			
Pension accrual	% of salary	65%		Not applicable	
		Cash sum at retirement of 14.1% of career pay (salary plus bonus up to maximum of 150% of salary) for a contribution of 1.5% of pay, plus an 85% Company 401(k) match on contributions to a maximum of 6% of salary			

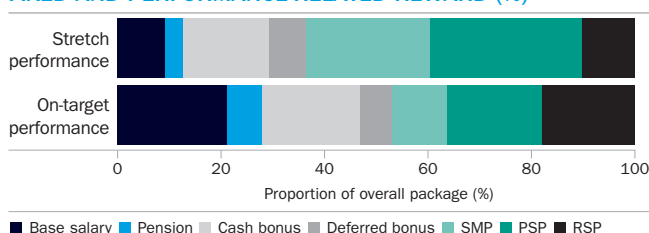
* Linda Hudson will be granted an award under the RSP in 2011, subject to shareholder approval of the RSP at the 2011 AGM, and will thus not be permitted to make any voluntary investment in the SMP in 2011 in relation to her 2010 net annual incentive payment.

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward.

VALUE OF PACKAGE (\$'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)



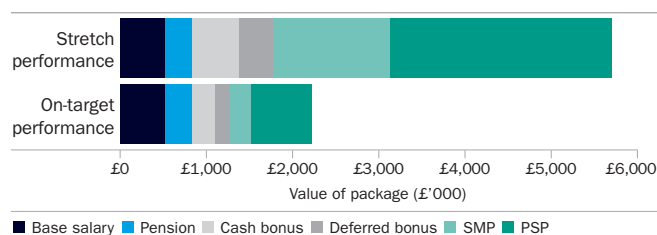
¹ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

STRUCTURE OF INDIVIDUAL EXECUTIVE DIRECTORS' PACKAGES CONTINUED

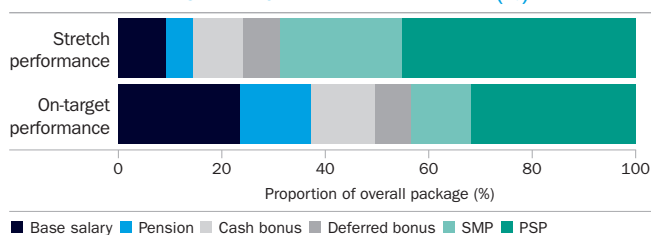
Peter Lynas (Group Finance Director designate)		Effective 1 April 2011	
Base salary		£520,000 pa	
Annual incentive	On-target/maximum (% of salary)	75%/150%	
	Structure (% of salary)	On-target	Stretch
	Group EPS	20%	40%
	Group cash	20%	40%
	Order intake	10%	20%
	Safety	Up to 11.25%	
	Business conduct	Up to 11.25%	
	Other objectives	Up to 27.5%	
	Deferral into SMP	$\frac{1}{3}$ compulsory plus voluntary up to total of 50% of net annual incentive	
SMP	Gross match	2:1	
	Performance condition	EPS growth of 5% – 11% pa	
PSP	Grant (% of salary)	250%	
	Performance condition	$\frac{1}{2}$ on relative TSR against 18 other global aerospace and defence companies, and $\frac{1}{2}$ on EPS growth of 5% – 11% pa	
Pension accrual		$\frac{1}{30}$th of three-year final average salary from age 62 for 8% member's contributions	

The graphs below show the value of the package at on-target and stretch performance together with the proportion of the package delivered through fixed and variable reward as if Peter Lynas had been in post as Group Finance Director with effect from 1 January 2011.

VALUE OF PACKAGE (£'000)



PROPORTION OF PACKAGE VALUE DELIVERED THROUGH FIXED AND PERFORMANCE-RELATED REWARD (%)



Performance in 2010

The structure of the 2010 annual incentive plan was set out in last year's Remuneration report and is summarised in the individual sections for each of the executive directors on pages 103 to 106 of this report.

Financial performance: 2010 was a robust year in terms of financial performance following the Group's strong performance of recent years. At the Group level, EPS performance was above threshold, but well short of stretch performance. Stretch performance was achieved on both cash targets. At the operating group level, Programmes & Support exceeded its profit target but did not hit its stretch target, and achieved its stretch cash targets. International and BAE Systems, Inc. achieved stretch on all their financial targets.

Non-financial performance: Page 12 sets out the Executive Committee's top ten objectives for 2010 and the assessment of performance against these, whilst page 46 provides more detailed information on the performance against the specific objectives relating to business conduct and safety.

Business conduct: The Group targeted the successful implementation of the suite of revised policies and processes which had been updated as part of the Woolf implementation programme. All businesses are on target with their stated plans.

Safety: The Group has continued to drive improvement of safety management, using its Safety Maturity Matrix (SMM) as the mechanism to measure and drive performance. Sites with more than 150 personnel (other than those acquired during 2010) have now progressed to Level 4 on the SMM. In addition, the Group achieved an overall 31% reduction in the Lost Work Day Case Rate, exceeding a target 20% reduction, compared with performance during 2009. Some individual businesses did not achieve this target.

Other objectives: Of the remaining top ten Group objectives most have been successfully achieved, giving a result of 90% of maximum. This sets the starting point with further adjustment, up or down, depending on the assessment of overall performance and leadership behavioural performance of the individual executive.

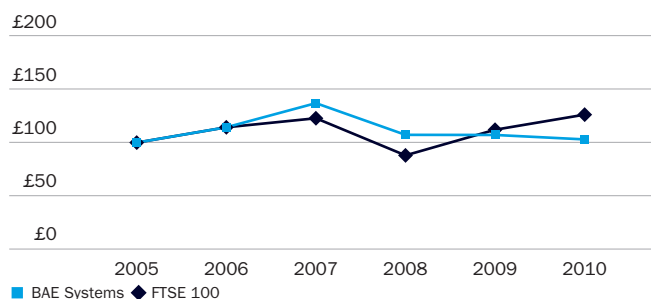
Accordingly, the Committee determined the payout under the 2010 annual incentive plan as follows:

2010 annual incentive payout	Ian King	Linda Hudson	George Rose
% of stretch	71.0%	89.1%	69.1%
% of base salary	159.7%	200.5%	103.7%
Amount	£1,437,075	\$1,804,275	£645,533

In addition:

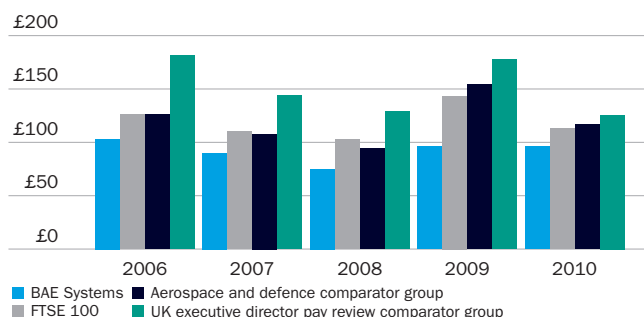
- the growth in EPS over the three years to 2010 was approximately 10.6% pa. Consequently:
 - the awards of matching shares granted under the SMP in 2008 vest in full; and
 - of the 50% of the awards of shares granted in Spring 2008 under the EPS portion of the PSP, 94.55% vest.
- the Company's TSR for the 50% of awards of shares granted in March 2008 under the TSR portion of the PSP was below the median position when compared against the comparator group of 18 other defence and aerospace companies, and the related awards accordingly lapsed.

VALUE AT 31 DECEMBER 2010 OF £100 INVESTMENT AT 31 DECEMBER 2005 (£)



This graph, which has been produced in accordance with the requirements of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, shows the value by 31 December 2010, on a total shareholder return basis, of £100 invested in BAE Systems on 31 December 2005 compared with the value of £100 invested in the FTSE 100 index. The FTSE 100 is considered to be an appropriate comparator for this purpose as it is a broad equity index. As BAE Systems is a constituent member of the FTSE 100, it was deemed to be the most appropriate general UK equity index.

VALUE AT 31 DECEMBER 2010 OF £100 INVESTMENT (£)



The graph above shows the value shareholders have achieved by their investment in BAE Systems over recent years as compared to (i) the FTSE 100 index; (ii) the companies forming the sectoral peer group for the Performance Share Plan; and (iii) the companies forming the comparator pay group for the 2010 executive pay review. The graph depicts the value for BAE Systems and the comparators at the end of 2010 of a single £100 investment made at the beginning of each of the last five years.

Summary of Long-Term Incentive Plans

Plan provisions

Performance conditions for grants of awards to be made under the Performance Share Plan and the Share Matching Plan in 2011 are detailed below. Performance conditions for grants of awards made prior to 2011 are detailed on pages 115 and 116.

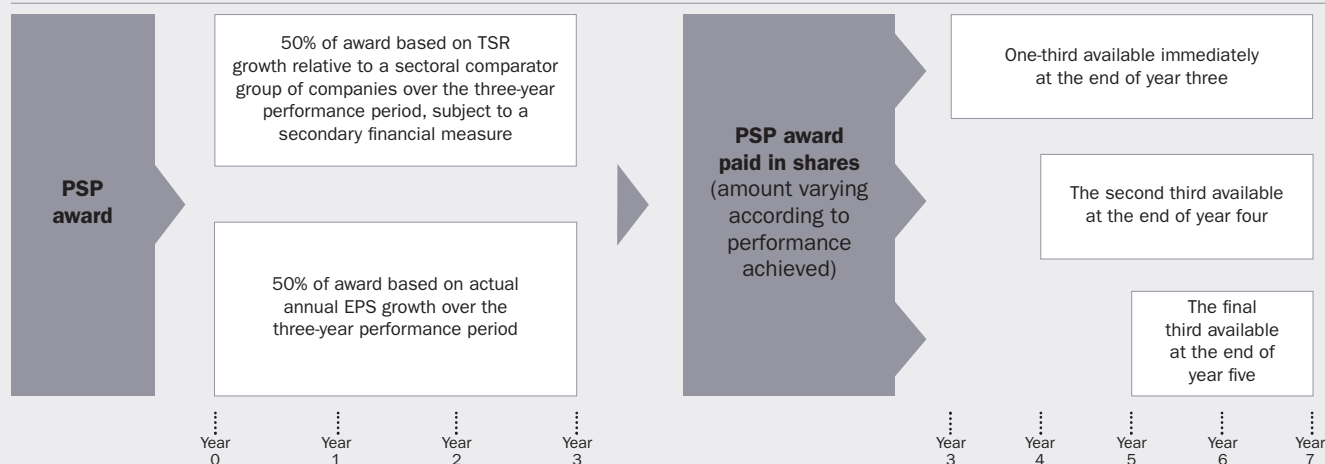
Clawback arrangements operate in respect of these two plans from the 2010 awards onwards. The arrangements are intended to cover situations, for example, where results are restated or otherwise turn out to be materially inaccurate or where the executive's employment can be terminated for cause.

PERFORMANCE SHARE PLAN (PSP)

Key features for PSP awards in 2011:

- awards of shares are granted based on a percentage of salary and share price at the date of grant;
- the shares are subject to satisfaction of three-year performance conditions;
- half the PSP award will be based on a Total Shareholder Return (TSR) performance condition (PSP^{TSR}) and the other half on an Earnings per Share (PSP^{EPS}) performance condition;
- in addition, there is a further test on the PSP^{TSR} element to ensure that the TSR performance is supported by the underlying performance of the Company;
- shares under award after satisfaction of the performance condition vest in three equal tranches at the end of years three, four and five; and
- shares under award attract dividends prior to vesting.

HOW THE PSP OPERATES



For the US executives, the awards are automatically delivered at the end of years three, four and five, subject to the performance condition achieved.

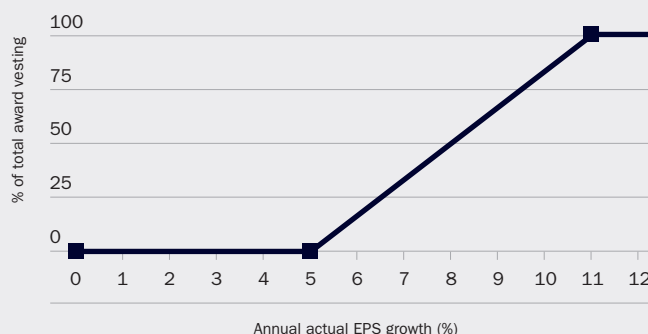
PERFORMANCE CONDITION – PSP^{EPS}

The proportion of the award capable of exercise is determined by the rate of annual actual EPS growth over the three-year performance period, with nil vesting at annual actual EPS growth of 5% and 100% vesting at 11% growth as set out opposite (15% to 33% growth over three years).

The rationale for the EPS performance measure is that major investors consider EPS to be a key indicator of long-term financial performance and value creation.

Summary of EPS performance to 31 December 2010

2010 EPS was 40.5p, and is approximately 10.6% greater (per annum) than the 2007 EPS of 30.7p. This is near the top of the performance range of 5% to 11% growth per annum. Accordingly, 94.55% of the EPS portion of the Spring 2008 PSP awards vest.



PERFORMANCE CONDITION – PSP^{TSR}

The proportion of the award capable of exercise determined by:

- the Company's TSR (share price growth plus dividends) ranking relative to a comparator group of 18 other international defence and aerospace companies as shown in the table opposite. There has been no change to the comparator group. None of the shares vest if the Company's TSR is outside the top 50% of TSRs achieved by the sectoral comparator group and 100% vest if it is in the top quintile (i.e. top 20%) as set out opposite; and
- whether there has been a sustained improvement in the Company's underlying financial performance and whether it is appropriate to release some or all of the awards. In taking such a view, the Committee may consider (but not exclusively) the following financial metrics: net cash/debt; EBITA¹; order book; turnover; risk; and underlying project performance.

The rationale for TSR performance measures is that major investors regard TSR as an important indication of both earnings and capital growth relative to other major companies in the same sector and to ensure that awards only vest if there has been a clear improvement in the Company's performance over the relevant period.

SUMMARY OF TSR PERFORMANCE TO 31 DECEMBER 2010

The chart opposite summarises the position on the TSR element for all outstanding awards under the PSP as at 31 December 2010.

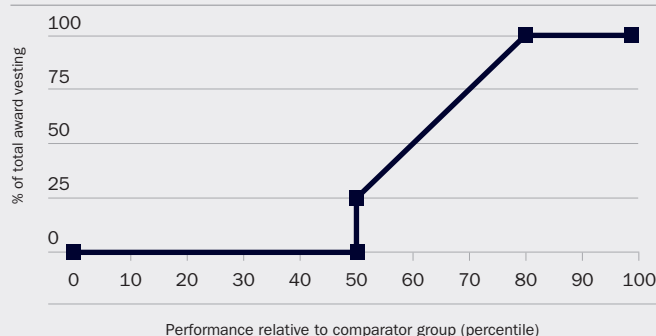
The coloured box shows the range of TSR required for 25% vesting to full vesting, and the diamond shows BAE Systems' TSR. The proportion that would vest is shown in the boxes at the top of the chart.

This shows that the TSR portion of the 2008 PSP award lapsed as the Company's TSR return was below that of the comparator group.

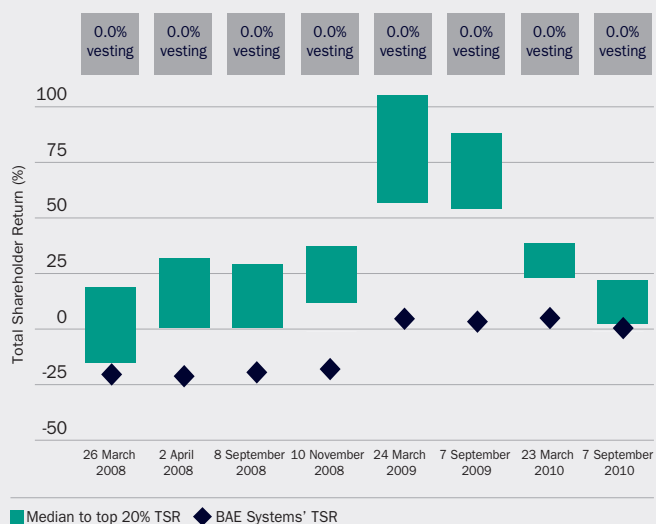
PSP^{TSR} – sectoral peer group

Boeing	General Dynamics	Raytheon
Cobham	GKN	Rockwell Collins
Dassault Aviation	Goodrich	Rolls-Royce
EADS	Honeywell International	Smiths Group
Embraer PN	Lockheed Martin	Thales
Finmeccanica	Northrop Grumman	United Technologies

PERFORMANCE CONDITION – PSP^{TSR}



TSR PERFORMANCE UNDER THE PERFORMANCE SHARE PLAN



SHARE MATCHING PLAN (SMP)

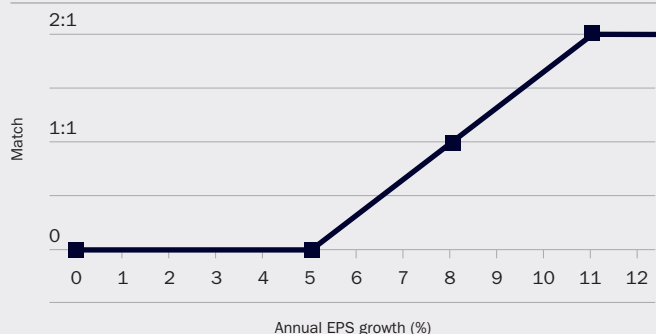
Key features for grants of awards in 2011:

- stand-alone share investment plan with the investment linked to the award under the annual incentive plan;
- participants are granted a conditional award of matching shares against the gross value of the annual incentive invested;
- matching shares attract dividends during the three-year deferral period, released on vesting of any matching shares;
- executive directors are required to invest one-third of their 2010 net annual incentive into the SMP; and
- maximum level of investment will be 50% of the net annual incentive.

Match and performance condition

- Nil match for actual EPS growth of 5% per annum (with nil vesting below that level) increasing uniformly to a 2:1 match at 11% per annum growth (15% to 33% growth over three years).
- Rationale for performance measure: major investors consider EPS to be a key indicator of long-term financial performance and value creation.

PERFORMANCE CONDITION – SMP 2011



2008 SMP award

The 2008 SMP awards were based on nil match for actual EPS growth of 5% per annum increasing uniformly to a 1:1 match at 8% per annum growth. 2010 EPS was 40.5p, and is approximately 10.6% greater (per annum) than the 2007 EPS of 30.7p. Accordingly, the 2008 SMP award vests in full.

Restricted Share Plan (RSP) *

Key features of awards in 2011:

- conditional awards of shares are granted based on a percentage of salary and share price at the date of grant;
- the shares are subject only to the condition that the participant remains employed by the Group at the end of the vesting date (three years after the award date); and
- shares under award attract dividends prior to vesting.

The RSP is not subject to a performance condition as it is designed to address retention issues principally in the US, as detailed on page 102. Clawback arrangements will operate in respect of this Plan.

* Introduction of the RSP is subject to shareholder approval at the 2011 AGM.

Share Incentive Plan (SIP)

During 2010, the UK executive directors were eligible to participate in the all-employee free shares element of the Share Incentive Plan. As a result of the Company's performance in 2010, all eligible employees (including the UK executive directors) will be entitled to receive shares worth £391.50. A similar arrangement operates for non-UK employees on a cash or shares basis depending on local tax and security laws.

The Company operates a share purchase arrangement (Partnership Shares) under the Share Incentive Plan. Under this arrangement, UK-based employees (including executive directors) may purchase ordinary shares in BAE Systems by either monthly investments of between £10 and £125 a month, or lump sum investments of between £10 and £1,500 in a tax year, both limited to 10% of salary if less. The Partnership Shares attract matching shares. As the plan is an all-employee plan, the matching shares are not subject to performance conditions in accordance with legislation. One free matching share is awarded for each Partnership Share up to a maximum of £63 per month.

Dividends paid in respect of the shares in the Share Incentive Plan for UK-based employees are reinvested as Dividend Shares.

Share usage for employee share schemes

The Committee has agreed that, in respect of new issue or treasury shares, shares representing no more than 1% (and no more than 0.5% for the executive schemes) of the Company's issued share capital will be used in any one financial year for the grant of incentives under all of the Company's employee share schemes. The table opposite sets out the available dilution capacity for the Company's employee share schemes on this basis.

The Company currently intends to use new issue shares to satisfy future share awards under the executive long-term incentive plans up to the 0.5% annual dilution limit, and to use treasury shares to satisfy awards of free shares and matching shares under the all-employee Share Incentive Plan. For outstanding options it is intended that new issue shares will be utilised for the Executive Share Option Plan.

	Number of shares
Total issued share capital as at 31 December 2010	3,587m
All schemes:	
10% in any consecutive years	358.7m
Remaining headroom	212.8m
Executive schemes:	
5% in any consecutive ten years	179.4m
Remaining headroom	90.6m

Post-retirement benefits

UK pension benefits

UK executive directors are members of the BAE Systems Executive Pension Scheme (the ExPS) and members of the underlying employee pension plans. As such, they are subject to the same contribution rates payable by employees of the underlying plans, and the benefit changes introduced in 2006 for post-April 2006 service including the introduction of the Longevity Adjustment Factor, a reduction in the maximum level of pension increases and a change in the definition of Pensionable Pay.

The ExPS tops up the underlying employee plan to provide a target benefit for executive directors payable from normal retirement age of 1/30th of Final Pensionable Pay (FPP) for each year of ExPS pensionable service (subject to a maximum of two-thirds of FPP). FPP is defined as annual base salary averaged over the last 12 months prior to leaving service in respect of service accrued to 5 April 2006 and 36 months prior to leaving in respect of service from 6 April 2006. The ExPS also provides a lump sum death-in-service benefit equal to four times base salary at date of death, and a spouse's death-in-service pension equal to two-thirds of the prospective pension at normal retirement age. Children's allowances are also payable, usually up to the age of 18. Spouses' pensions and children's allowances are also payable upon death in retirement and death after leaving the Company's employment with a deferred pension. Once in payment, pensions are increased annually by the rise in the Retail Price Index subject to a maximum increase of 5% per year in respect of pre-6 April 2006 service and 2.5% per year in respect of service from 6 April 2006.

As a result of the 2006 age discrimination legislation, executive directors' default retirement age is 65 but they retain any previous rights they had to retire and draw their pensions without actuarial reduction for early payment at an earlier age.

Following the changes made to take account of the Pensions Simplification tax changes which came into effect from April 2006, UK executives reaching the Lifetime Allowance (LTA) were given a number of choices as previously reported. These were:

- remain in the pension scheme and pay any additional tax charge; or
- opt out of the pension scheme (and so earn no further pension benefits in respect of future service) and instead receive a taxable salary supplement. This supplement will be 30% of salary and 20% of salary for those senior executives with a two-thirds salary target after at least 20 years' and 30 years' service, respectively; or

- restrict scheme benefits to the value of the LTA with the remainder being provided directly from the Company as an unfunded promise. At retirement, the unfunded Company benefits can be either taken as pension or commuted in full for a taxable lump sum.

The Committee reviews these arrangements each year in the light of developing market practice, and believes they remain appropriate as they provide executives with competitive pension benefits and choices for dealing with the LTA which may better suit their needs whilst being broadly cost neutral to the Company, are in line with market practice and do not compensate executives for changes in taxation.

During the year, an additional review of UK executive pension arrangements has been undertaken in the light of the changes announced to the taxation of members of UK registered pension arrangements from 6 April 2011. The underlying principles for this review were that the aggregate level of benefits provided to members should continue to be cost neutral to the Company.

The review concluded that the new arrangements should be based on the Company's registered pension schemes and that, in appropriate circumstances, the Company will continue to have the option to offer an unfunded pension promise so as to mitigate the impact of the Lifetime Allowance (introduced in 2006) and the impact of the reduced Annual Allowance with effect from 6 April 2011. This new arrangement addresses tax-inefficiencies arising for existing employees as a consequence of the pension tax changes although members will be given the choice to remain in the current arrangement and pay the increased tax. The Committee has decided that in cases where the Company is to pay an unfunded promise, executives will be given the choice to commute some or all of the benefit for a taxable lump sum, or take it as pension.

Ian King, George Rose (who retires from the Company on 31 March 2011) and Peter Lynas already have an unfunded promise from the Company arising from the 2006 changes; for Ian King and Peter Lynas, this will be extended to cover the reduced Annual Allowance at no additional cost to the Company.

Ian King and Peter Lynas (Group Finance Director designate) are both members of the BAE Systems 2000 Pension Plan (the 2000 Plan), applicable to former employees of Marconi Electronic Systems (MES), and members of the ExPS with a normal retirement age of 62. The 2000 Plan provides a pension of 1/50th of Final Pensionable Earnings (FPE) for each year of pensionable service, payable from a normal retirement age of 65 and members pay contributions of 8% of Pensionable Earnings. FPE under the 2000 Plan is the best consecutive three-year average of base salary and bonus in the ten Plan Years prior to leaving, less an offset for State pensions. The Company decided in 2006 to limit pensionable bonuses in the 2000 Plan in the 2006/07 Plan Year to 20% of base salary and to 10% of base salary for the 2007/08 Plan Year and thereafter. However, there is a guarantee that the FPE figure for benefits in respect of service prior to 6 April 2007 will not be less than the FPE figure at 5 April 2007 to ensure that employees do not lose the benefit of contributions paid on past bonuses. Ian King and Peter Lynas joined the ExPS in 1999 following the BAe/MES merger. Therefore their individual total pensions are the sum of their 2000 Plan benefits plus the top up from the ExPS.

George Rose is a member of the BAE Systems Pension Scheme paying contributions of 9.29% of base salary, and is a member of the ExPS with a normal retirement age of 60. George Rose was affected by the previously applicable Inland Revenue earnings cap on approved pensions and has an unapproved (i.e. non-tax qualified) pension arrangement to top up his benefits from the approved schemes. This was designed so that the total pension from all sources would be broadly in line with the pension he would have received from the Group pension schemes had he not been subject to the earnings cap. The Pension Simplification tax changes allowed the flexibility to remove the earnings cap for George Rose in respect of service from April 2006, although some of his benefits will remain to be provided by means of an unfunded promise from the Company. No further contributions will be paid into his funded unapproved top up arrangement.

On leaving the Company, George Rose has been granted consent from the Company to early retirement and his pension benefits will therefore become payable from 1 April 2011, one year early. His pension is subject to the normal actuarial reduction for early payment that would be applied to any other member of the Executive Pension Scheme in these circumstances.

US pension benefits

Linda Hudson is a member of the 2006 Plan and a Non-Qualified Plan which provide a cash sum at retirement equal to a percentage of career average pay (salary plus bonus subject to a maximum bonus of 150% of salary). The cash accrual rate of the combined plans from 1 January 2010 is 14.1% of career average pay. Executive directors pay contributions at the same rates as other employees in the plan, being 1.5% of earnings. Linda Hudson also receives a company match on her contributions to her 401(k) plan up to a maximum contribution of 6% of salary, up to regulatory limits (\$245,000 in 2010). From 1 January 2010, the company match was 85%.

Details of post-retirement benefits for each of the executive directors who served during 2010 are shown in Table D on page 119 and are calculated in accordance with the requirements of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

Other benefits

Other benefits provided to executive directors include a car allowance, the private use of a chauffeur-driven car and a cash allowance for medical examination.

On his appointment as Group Finance Director on 1 April 2011, Peter Lynas will be provided with Company support to establish a second home in London as the Committee believed this to be a more cost-effective option for the Company than requiring full relocation of his principal residence from outside London. This support is in accordance with Company policy, and consists of a lump sum of £22,200, together with a monthly allowance totalling £33,300 in year one declining on a uniform basis to £6,660 in year five (such monthly allowances over the five-year period totalling £99,900), and zero thereafter. Clawback provisions operate during the first two years of this arrangement whereby he would be required to repay these monies on a pro-rata basis should he leave the Company in certain circumstances, e.g. resignation or termination.

Executive directors' service contracts

It is the Committee's policy that executive directors should normally have service contracts that provide for the Company to give the individual 12 months' notice of termination. This policy has been chosen because it provides a reasonable balance between the need to retain the services of key individuals and the need to limit the liabilities of the Company in the event of the termination of a contract. The executive directors have service contracts with Group companies and details of these are shown below.

	Date of contract	Unexpired term	Notice period
Linda Hudson	26 October 2009 (amended 8 January 2010)	31 December 2011*	90 days either party
Ian King	27 June 2008	No fixed term	12 months either party
George Rose	16 November 1998 (amended 3 December 1999, 15 January 2004 and 17 October 2005)	No fixed term – ends 31 March 2011	12 months from the Company, 6 months from the individual
Peter Lynas	16 February 2011 (effective 1 April 2011)	No fixed term	12 months either party

* Subject to automatic renewal for one-year periods each year unless either party gives notice of non-renewal.

In the event of the termination of an executive director's contract it is the Committee's policy to seek to limit any payment made in lieu of notice to a payment equal to the amount of one year's base salary. The service contracts for two of the executive directors (Ian King and George Rose), and that for Peter Lynas which comes into effect on 1 April 2011, contain specific provisions to the effect that the Company has the right to pay a sum equivalent to 12-months' salary in lieu of notice.

Linda Hudson's contract of employment automatically renews for one-year periods from 31 December each year, unless one party gives notice of non-renewal. Separately, there is a 90-day termination provision. If the employment is (a) terminated by the Company (other than for cause as defined in the contract or in the event it is not extended following her 65th birthday) or (b) she resigns for a 'Good Reason' (as defined in her contract), she is entitled to a termination payment equal to (i) one year's base salary, (ii) a pro-rated bonus for the relevant financial year, and (iii) the continuation of 18-months' medical benefits, plus a further 18-months' subsidy of a portion of the premiums (or a cash payment in lieu of this benefit).

George Rose will retire from the Company, and as a director, with effect from 31 March 2011. No termination payments will be made. All outstanding long-term incentive awards and share options will vest in accordance with the rules of the respective share plans, i.e. subject to the attainment of the related performance conditions and pro-rating in accordance with the length of his service against the relevant performance period. He will not be required to defer one-third of his 2010 annual incentive, payable in 2011, into the SMP. He will receive a normal early retirement pension as described on page 111.

No executive director has provisions in his or her service contract that relate to a change of control of the Company (and neither does the Chairman nor the non-executive directors in their letters of appointment).

Policy on external board appointments

The long-standing policy of allowing executive directors to hold external non-BAE Systems-related non-executive directorships with the prior approval of the Committee will continue. The Committee considers that external directorships provide the Company's senior executives with valuable experience that is of benefit to BAE Systems. It is also considered appropriate for BAE Systems to contribute to the pool of non-executive expertise available for the benefit of the wider business community, thereby reciprocating the benefit that it in turn has received from other organisations which have permitted members of their senior management teams to serve on the BAE Systems Board. The Committee believes that it is reasonable for the individual executive director to retain any fees received from such appointments given the additional personal responsibility that this entails. Such fees retained by executive directors in 2010 were as follows: Ian King £43,333 in respect of his non-executive directorship of Rotork plc and George Rose £78,500 in respect of his non-executive directorship of National Grid plc.

Chairman's appointment, term and fees

Dick Olver was appointed Chairman on 1 July 2004. His appointment was for an initial fixed three-year term with effect from 17 May 2004 (the date that he was appointed to the Board as a non-executive director) and was subsequently extended in 2007 for a second term of three years to 16 May 2010. Following the approval of the Board under the chairmanship of Sir Peter Mason, Senior Independent Director, it was extended again in 2009 for a third term to 16 May 2013 unless terminated earlier in accordance with the Articles of Association or with either party giving the other not less than six months' prior written notice. The Chairman's appointment is documented in a letter of appointment which is not a contract of employment and he is required to devote no fewer than two days a week to his duties as Chairman. His appointment as Chairman will automatically terminate if he ceases to be a director of the Company. His fee, which was set by the Committee at £600,000 per annum for the duration of his second three-year term, was reviewed in 2010 and the Committee decided that his fee should remain unchanged at that time. His current fee will be subject to review in 2011.

Non-executive directors' appointment, term and fees

The non-executive directors do not have service contracts but do have letters of appointment detailing the basis of their appointment. The dates of their original appointment were as follows:

Non-executive director	Date of appointment	Expiry of current term*
Paul Anderson	08.10.2009	07.10.2012
Harriet Green	01.11.2010	31.10.2013
Michael Hartnall	10.06.2003	09.06.2012
Sir Peter Mason	22.01.2003	21.01.2012
Roberto Quarta	07.09.2005	06.09.2011
Nick Rose	08.02.2010	07.02.2013
Carl Symon	11.06.2008	10.06.2011
Ravi Uppal	02.04.2008	01.04.2011

* Subject to re-election at the AGM following their appointment and subsequently at intervals of no more than three years in accordance with the Company's Articles of Association.

The non-executive directors are normally appointed for two consecutive three-year terms subject to review after the end of the first three-year period and with any third term of three years being subject to rigorous review and taking into account the need progressively to refresh the Board. They do not have periods of notice and the Company has no obligation to pay compensation when their appointment terminates. Under the Company's Articles of Association, they are subject to re-election at the Annual General Meeting (AGM) following their appointment and subsequently at intervals of no more than three years. Having completed a three-year term of appointment, Andy Inglis retired from the Board on 9 July 2010 having originally been appointed to the Board on 13 June 2007. Phil Carroll, who had originally been appointed to the Board on 7 September 2005, also retired from the Board on 5 May 2010 on the expiry of his term. Ravi Uppal will retire from the Board at the end of his current term on 1 April 2011.

In compliance with the new UK Corporate Governance Code, all members of the Board will submit themselves for re-election on an annual basis from the 2011 AGM onwards.

Non-executive directors are proposed by the Nominations Committee and are appointed by the Board on the basis of their experience to provide independent judgement on issues of strategy, performance, resources and standards of conduct.

Following publication of the new UK Corporate Governance Code in 2010, the time commitment expectations for non-executive directors were reviewed and, with their agreement, their Letters of Appointment were amended to reflect that they need to commit approximately two days for each of the Board meetings scheduled during the year, to cover attendance and preparation for the meeting. Additional time commitments will include attending scheduled Board committee meetings, strategy review meetings and ad hoc meetings of the Board (or sub-committees of the Board) that may be called from time to time. The non-executive directors are aware that it is not possible to be specific as to exact time commitments as this will vary according to the nature of the matters that the Board is required to deal with at any point in time. Newly appointed non-executive directors will also have to dedicate additional time to induction activities. The level of their fees is set by the Non-Executive Directors' Fees Committee to reflect this time commitment and responsibility, and after reviewing practice in other comparable companies. Having undertaken its review in January 2011, the Committee decided that the non-executive directors' fees for 2011 will be as follows:

	2010 fee	2011 fee
Base fee	£66,000	£75,000
Additional fee for chairing committees:		
Audit Committee	£20,000	£20,000
Corporate Responsibility Committee	£20,000	£20,000
Remuneration Committee	£20,000	£20,000
Additional fee for Senior Independent Director	£20,000	£20,000
Travel allowance (per meeting)*	£4,000	£4,000

* The travel allowance of £4,000 per meeting is paid on each occasion that a non-executive director's attendance at a Board meeting necessitates air travel of more than five hours (one-way) to the meeting location, subject to a maximum of six travel allowances per year.

The table below summarises the fee structure for 2010 and 2011:

Non-executive director	2010 fee*	2011 fee*
Chairman Audit Committee	£86,000	£95,000
Chairman Corporate Responsibility Committee	£86,000	£95,000
Chairman Remuneration Committee	£86,000	£95,000
Senior Independent Director	£86,000	£95,000
Other non-executive directors	£66,000	£75,000

* Excludes the travel allowance of £4,000 per meeting referred to above.

On behalf of the Board

Dick Oliver Chairman

16 February 2011

Tabular information on directors' shareholdings, share-based incentives, emoluments and pensions

TABLE A: DIRECTORS' INTERESTS

	As at 1 January 2010*				As at 31 December 2010			
	Ordinary shares	Executive Share Option Plan	Share Matching Plan	Performance Share Plan	Ordinary shares	Executive Share Option Plan	Share Matching Plan	Performance Share Plan
P M Anderson	—	—	—	—	10,000	—	—	—
H Green ¹	—	—	—	—	—	—	—	—
M J Hartnall	20,000	—	—	—	20,000	—	—	—
L P Hudson	224,957	133,740	99,908	390,549	253,390	133,740	196,291	685,355
I G King	678,327	1,132,008	527,437	1,325,953	873,422	1,132,008	912,728	1,712,771
Sir Peter Mason	25,283	—	—	—	25,283	—	—	—
R L Olver	40,000	—	—	—	40,000	—	—	—
R Quarta	—	—	—	—	—	—	—	—
G W Rose	806,114	369,554	227,699	951,739	859,694	369,554	357,099	1,132,368
N C Rose ²	—	—	—	—	55,000	—	—	—
C G Symon	10,000	—	—	—	10,000	—	—	—
R K Uppal	—	—	—	—	—	—	—	—

* or upon appointment.

1 Appointed as a director on 1 November 2010.

2 Appointed as a director on 8 February 2010.

The table above gives details of the interests in ordinary shares in BAE Systems plc held by directors and their connected persons for those individuals who were directors of the Company as at 31 December 2010. There have been no changes in the interests of the current directors listed in the table above between 31 December 2010 and 16 February 2011 with the exception of the interests in the ordinary shares of Ian King and George Rose who have acquired an additional 107 and 106 ordinary shares, respectively, since 31 December 2010 under the partnership and matching shares elements of the Share Incentive Plan so that their beneficial shareholdings at the date of this report stood at 873,529 and 859,800, respectively.

The Company's register of directors' interests (which is open to inspection) contains full details of directors' share interests.

Information subject to audit

The Auditors are required to report on the information contained in Tables B, C and D on pages 115 to 119.

TABLE B: SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – IAN KING

Share options	1 January 2010	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2010	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP ^{TSR}	49,313	–	49,313	–	–	nil	24.03.05	24.03.10	3.81	24.03.10 ^{1,2}	24.03.12
PSP ^{TSR}	53,200	–	26,599	–	26,601	nil	12.04.06	13.04.10	3.72	12.04.10 ^{1,3}	12.04.13
PSP ^{TSR}	115,973	–	–	115,973	–	nil	30.03.07	30.03.10	–	30.03.10 ⁴	30.03.14
PSP ^{TSR}	122,039	–	–	–	122,039	nil	26.03.08	–	–	26.03.11 ⁵	26.03.15
PSP ^{EPS}	122,039	–	–	–	122,039	nil	07.05.08	–	–	26.03.11 ¹	26.03.15
PSP ^{TSR}	103,467	–	–	–	103,467	nil	08.09.08	–	–	08.09.11 ⁶	08.09.15
PSP ^{EPS}	103,467	–	–	–	103,467	nil	08.09.08	–	–	08.09.11 ⁶	08.09.15
PSP ^{TSR}	328,227	–	–	–	328,227	nil	24.03.09	–	–	24.03.12 ⁶	24.03.16
PSP ^{EPS}	328,228	–	–	–	328,228	nil	24.03.09	–	–	24.03.12 ⁶	24.03.16
PSP ^{TSR}	–	289,351	–	–	289,351	nil	23.03.10	–	–	23.03.13 ⁶	23.03.17
PSP ^{EPS}	–	289,352	–	–	289,352	nil	23.03.10	–	–	23.03.13 ⁶	23.03.17
	1,325,953	578,703	75,912	115,973	1,712,771						
ExSOP	318,314	–	–	–	318,314	1.72	30.09.03	–	–	30.09.06 ¹	30.09.13
ExSOP	272,388	–	–	–	272,388	2.01	30.03.04	–	–	30.03.07 ¹	30.03.14
ExSOP	221,903	–	–	–	221,903	2.64	24.03.05	–	–	24.03.08 ¹	24.03.15
ExSOP	145,443	–	–	–	145,443	4.28	12.04.06	–	–	12.04.09 ¹	12.04.16
ExSOP	173,960	–	–	–	173,960	4.57	30.03.07	–	–	30.03.10 ¹	30.03.17
	1,132,008	–	–	–	1,132,008						

LTIPs	1 January 2010	Granted during the year	Vested during the year	Lapsed during the year	31 December 2010	Market price at date of award £	Date of award	Date of vesting	Market price on vesting £
SMP	46,410	–	46,410	–	–	4.57	22.03.07	22.03.10 ¹	3.87
SMP	109,411	–	–	–	109,411	4.86	26.03.08	26.03.11 ¹	–
SMP	371,616	–	–	–	371,616	3.43	24.03.09	24.03.12 ⁵	–
SMP	–	431,701	–	–	431,701	3.80	23.03.10	23.03.13 ⁶	–
	527,437	431,701	46,410	–	912,728				

Ian King's SMP award that vested on 22 March 2010 attracted reinvested dividends which equated on vesting to an additional 4,912 shares. The market price on vesting was £3.87.

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 115 and 116.

- 1 Subject to a performance condition that has been met.
- 2 'Date exercisable' refers to the date on which the portion of the option exercised during the year became exercisable.
- 3 As (2) above. The option over shares remaining at the year end is exercisable on the fifth anniversary of grant.
- 4 The award lapsed during the financial year under review having not met the performance condition.
- 5 The outstanding award lapsed after the end of the financial year having not met the performance condition.
- 6 Subject to a performance condition that is yet to be tested.

PERFORMANCE SHARE PLAN (PSP)

A full description of the PSP is set out on pages 108 and 109. PSP awards granted since 2008 attract dividends prior to vesting.

PSP^{TSR} – nil vesting if the Company's TSR at the end of the three-year performance period is outside the top 50% of TSRs achieved by a sectoral comparator group; 25% vesting if TSR is at median (50%); and 100% vesting if TSR is in the top 20%, with vesting on a straight-line basis between these two points.

PSP^{EPS} – proportion of the award exercisable is determined by the rate of annual actual EPS growth over the three-year performance period, with nil vesting at annual actual EPS growth of 5% or less, 100% vesting at 11% growth, and vesting on a straight-line basis between these two points.

Awards that satisfy the performance conditions at the end of year three are exercisable in three tranches at the end of years three, four and five.

EXECUTIVE SHARE OPTION PLAN (EXSOP)

No options have been granted under this Plan since 2007 and it is intended only to be used in future in exceptional circumstances. Options granted under this Plan are normally exercisable between the third and tenth anniversary of grant. The maximum duration of an option is ten years.

- (i) **2005-2007 grants** – 33.33% of each option grant is exercisable if the Company achieves on average real EPS growth pa of 3% but less than 4% over the three-year performance period; 66.67% for real EPS growth pa of 4% but less than 5%; and 100% for real EPS growth of 5% or more.
- (ii) **2004 grant** – as in (i) but performance is retested at the end of year five against the full period from grant.
- (iii) **2003 grant** – as in (i) but performance is retested at the end of years four and five against the full period from grant.

TABLE B: SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – GEORGE ROSE

Share options	1 January 2010	Granted during the year	Exercised during the year	Lapsed during the year	31 December 2010	Exercise price £	Date of grant	Date of exercise or lapse	Market price on exercise £	Date from which exercisable	Expiry date
PSP ^{TSR}	63,133	–	63,133	–	–	nil	24.03.05	24.03.10	3.81	24.03.10 ^{1,2}	24.03.12
PSP ^{TSR}	67,942	–	33,970	–	33,972	nil	12.04.06	20.04.10	3.77	12.04.10 ^{1,3}	12.04.13
PSP ^{TSR}	122,538	–	–	122,538	–	nil	30.03.07	30.03.10	–	30.03.10 ⁴	30.03.14
PSP ^{TSR}	122,039	–	–	–	122,039	nil	26.03.08	–	–	26.03.11 ⁵	26.03.15
PSP ^{EPS}	122,039	–	–	–	122,039	nil	07.05.08	–	–	26.03.11 ¹	26.03.15
PSP ^{TSR}	227,024	–	–	–	227,024	nil	24.03.09	–	–	24.03.12 ⁶	24.03.16
PSP ^{EPS}	227,024	–	–	–	227,024	nil	24.03.09	–	–	24.03.12 ⁶	24.03.16
PSP ^{TSR}	–	200,135	–	–	200,135	nil	23.03.10	–	–	23.03.13 ⁶	23.03.17
PSP ^{EPS}	–	200,135	–	–	200,135	nil	23.03.10	–	–	23.03.13 ⁶	23.03.17
	951,739	400,270	97,103	122,538	1,132,368						
ExSOP	185,747	–	–	–	185,747	4.28	12.04.06	–	–	12.04.09 ¹	12.04.16
ExSOP	183,807	–	–	–	183,807	4.57	30.03.07	–	–	30.03.10 ¹	30.03.17
	369,554	–	–	–	369,554						

LTIPs	1 January 2010	Granted during the year	Vested during the year	Lapsed during the year	31 December 2010	Market price at date of award £	Date of award	Date of vesting	Market price on vesting £
SMP	52,286	–	–	–	52,286	4.86	26.03.08	26.03.11 ¹	–
SMP	175,413	–	–	–	175,413	3.43	24.03.09	24.03.12 ⁶	–
SMP	–	129,400	–	–	129,400	3.80	23.03.10	23.03.13 ⁶	–
	227,699	129,400	–	–	357,099				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 115 and 116.

- 1 Subject to a performance condition that has been met.
- 2 'Date exercisable' refers to the date on which the portion of the option exercised during the year became exercisable.
- 3 As (2) above. The option over shares remaining at the year end is exercisable on the fifth anniversary of grant.
- 4 The award lapsed during the financial year under review having not met the performance condition.
- 5 The outstanding award lapsed after the end of the financial year having not met the performance condition.
- 6 Subject to a performance condition that is yet to be tested.

SHARE MATCHING PLAN (SMP) – MATCHING SHARES

A full description of the SMP, under which awards are subject to a three-year performance period, is set out on page 109. SMP awards attract dividends prior to vesting.

2009 and 2010 awards – nil match for actual EPS growth of less than 5% pa increasing uniformly to a 2:1 match at 11% pa growth.

2008 award – nil match for actual EPS growth of 5% pa or less, increasing uniformly to a 1:1 match for 8% pa growth.

2007 award – nil vesting for real EPS growth pa of less than 3% over the three-year performance period, with one-third of the matched award vesting on average real EPS growth pa of 3% but less than 4%, two-thirds vesting with a growth rate of 4% but less than 5%, and full vesting at growth of 5% or over.

SHARE PRICE INFORMATION

The mid-market price for the Company's ordinary shares at 31 December 2010 was 330.0p (2009 359.5p). The range during the year was 294.7p to 388.8p.

AGGREGATE AMOUNT OF GAINS MADE BY DIRECTORS

The aggregate amount of gains made by directors from the exercise of share options in 2010, as calculated at the date of exercise, was £655,392 (2009 £1,268,104). The net aggregate value of assets received by directors in 2010 from Long-Term Incentive Plans, as calculated at the date of vesting, was £198,770 (2009 £247,044).

RATIONALE FOR KEY PERFORMANCE MEASURES FOR PSP, EXSOP AND SMP

EPS – importance to major investors as a key indicator of long-term financial performance and value creation.

TSR (and secondary financial measure) – importance to major investors as an indication of both earnings and capital growth relative to major companies in the same sector, and to ensure that awards only vest if there has been a clear improvement in the Company's performance over the relevant period.

TABLE B: SHARE OPTIONS AND LONG-TERM INCENTIVE PLAN (LTIP) AWARDS – LINDA HUDSON

Share options	1 January 2010	Granted during the year	Exercised or released during the year	Lapsed during the year	31 December 2010	Exercise price £	Date of grant	Date of exercise, release or lapse	Market price on release £	Date from which exercisable	Expiry date
PSP ^{TSR}	89,160	–	–	89,160	–	–	30.03.07	30.03.10	–	30.03.10 ¹	30.03.14
PSP ^{TSR}	45,881	–	–	–	45,881	–	26.03.08	–	–	26.03.11 ²	26.03.15
PSP ^{EPS}	45,882	–	–	–	45,882	–	26.03.08	–	–	26.03.11 ³	26.03.15
PSP ^{TSR}	104,813	–	–	–	104,813	–	24.03.09	–	–	24.03.12 ⁴	24.03.16
PSP ^{EPS}	104,813	–	–	–	104,813	–	24.03.09	–	–	24.03.12 ⁴	24.03.16
PSP ^{TSR}	–	191,983	–	–	191,983	–	23.03.10	–	–	23.03.13 ⁴	23.03.17
PSP ^{EPS}	–	191,983	–	–	191,983	–	23.03.10	–	–	23.03.13 ⁴	23.03.17
	390,549	383,966	–	89,160	685,355						
ExSOP	133,740	–	–	–	133,740	4.57	30.03.07	–	–	30.03.10 ³	30.03.17
	133,740	–	–	–	133,740						

LTIPs	1 January 2010	Granted during the year	Vested during the year	Lapsed during the year	31 December 2010	Market price at date of award £	Date of award	Date of vesting	Market price on vesting £
SMP	99,908	–	–	–	99,908	3.43	24.03.09	24.03.12 ⁴	–
SMP	–	96,383	–	–	96,383	3.80	23.03.10	23.03.13 ⁴	–
	99,908	96,383	–	–	196,291				

Note: Performance conditions for the options and awards set out above are detailed in the notes to Table B on pages 115 and 116.

- 1 The award lapsed during the financial year under review having not met the performance condition.
- 2 The outstanding award lapsed after the end of the financial year having not met the performance condition.
- 3 Subject to a performance condition that has been met.
- 4 Subject to a performance condition that is yet to be tested.

Note: Awards granted to Linda Hudson (a US national) under the PSP are technically characterised as long-term incentives rather than options as, subject to the attainment of the performance condition, they are delivered automatically on the third, fourth and fifth anniversary of grant without the need to exercise an option. They are shown in the top portion of the table for ease of comparison.

TABLE C: DIRECTORS' REMUNERATION

	2010						2009					
	Base salary £'000	Fees £'000	Bonus £'000	Benefits £'000	Other pay £'000	Total £'000	Base salary £'000	Fees £'000	Bonus £'000	Benefits £'000	Other pay £'000	Total £'000
Chairman												
R L Oliver	–	600	–	13	–	613	–	600	–	63	–	663
Executive directors												
W P Havenstein ¹	n/a	n/a	n/a	n/a	n/a	n/a	294	–	–	11	–	305
L P Hudson ²	583	–	1,168	22	–	1,773	105	–	189	9	–	303
I G King	900	–	1,437	26	–	2,363	900	–	1,680	70	–	2,650
G W Rose	623	–	645	28	–	1,296	623	–	755	74	–	1,452
M J Turner ³	n/a	n/a	n/a	n/a	n/a	n/a	–	–	–	–	591	591
Non-executive directors												
P M Anderson ²	–	76	–	–	20	96	–	15	–	–	4	19
P J Carroll ⁴	–	23	–	–	8	31	–	66	–	–	24	90
H Green ⁵	–	11	–	–	–	11	n/a	n/a	n/a	n/a	n/a	n/a
M J Hartnall	–	86	–	–	8	94	–	86	–	–	4	90
A G Inglis ⁴	–	45	–	–	–	45	–	86	–	–	4	90
Sir Peter Mason	–	86	–	–	8	94	–	86	–	–	4	90
R Quarta	–	66	–	–	4	70	–	66	–	–	4	70
N C Rose ⁵	–	59	–	–	4	63	n/a	n/a	n/a	n/a	n/a	n/a
Sir Nigel Rudd ¹	n/a	n/a	n/a	n/a	n/a	n/a	–	81	–	–	4	85
C G Symon	–	86	–	–	20	106	–	71	–	–	24	95
R K Uppal	–	66	–	–	20	86	–	66	–	–	24	90
	2,106	1,204	3,250	89	92	6,741	1,922	1,223	2,624	227	687	6,683

1 Resigned or retired in 2009.

2 Appointed in 2009.

3 Retired in 2008.

4 Retired in 2010.

5 Appointed in 2010.

All emoluments and compensation paid to the directors during the year are shown above. Where the individual was appointed during the year the amount is shown from appointment.

The benefits received by the UK-based executive directors include, where appropriate, the provision of a car allowance and the private use of a chauffeur-driven car. The benefits received by the Chairman, Dick Oliver, include the private use of a chauffeur-driven car.

The benefits received by the US-based executive director include a cash allowance for a car, medical examination, dental benefits, and insured life and disability benefits. In addition, the benefits received by Linda Hudson also include \$1,955 (£1,265) in respect of private use of a company aeroplane (2009 \$8,455).

The other pay received by the non-executive directors represents the travel allowance of £4,000 per meeting as set out on page 113.

Sir Richard Evans retired as a director and Chairman on 30 June 2004. He remained employed in a part-time customer relationship role and ceased to be an employee on 29 February 2008. He subsequently became a member of the Company's Home Market Advisory Board for Saudi Arabia of which he ceased to be a member on 28 February 2010 upon the expiry of his contract. His consultancy fees in 2010 for the period of time he spent in the role of a member of the Home Market Advisory Board were £47,000 (2009 £246,954).

A payment of £7,884 was made to Mike Turner in January 2010, due in relation to the tax payable in respect of his private use of a chauffeur-driven car in the 2008/09 tax year, the amount of which was agreed with HM Revenue and Customs. There were no other payments to former directors during the year other than the Company pension payments to Sir Richard Laphorne and Sir Peter Gershon referred to on page 119.

TABLE D: POST-RETIREMENT BENEFITS

	Age	NRA*	Accrued benefit at 1 January 2010 ¹ £ pa	Accrued benefit at 31 December 2010 ¹ £ pa	Change in accrued pension after allowing for inflation £ pa	Transfer value at 1 January 2010 ² £	Transfer value at 31 December 2010 £	Director's contributions £	Increase in value less director's contributions £
L P Hudson ³	60	65	347,088	514,438	167,350	242,180	389,262	2,379	144,703
I G King ⁴	54	62	509,944	585,228	75,284	6,780,197	8,174,403	79,200	1,315,006
G W Rose ⁵	58	60	366,564	388,568	22,004	6,840,222	7,374,857	57,663	476,972

* Normal Retirement Age

- 1 Accrued benefits may be reduced if they are taken before the normal retirement age of the scheme. In addition, a longevity adjustment factor applies to UK pension accrued after 5 April 2006.
- 2 Transfer values have been calculated in accordance with GN11 issued by the actuarial profession. For UK-based directors the assumptions are the same as those used in the calculation of cash equivalents from the schemes. For US-based directors the assumptions are the same as those used for accounting disclosures. The increase in transfer value arising from the change in assumptions is: Linda Hudson: £5,113; Ian King: £166,128; George Rose: £(104,428).
- 3 Linda Hudson is a member of a US retirement plan which provides a cash sum at retirement equal to a percentage of career average pay. The accrued benefit shown above is a cash lump sum amount payable at normal retirement age. This benefit comprises £61,457 from a contributory Qualified Plan and £452,981 from Non-Qualified Plans. In addition, Linda Hudson participates in a Section 401(k) defined contribution arrangement set up for US employees in which the Company will match employee contributions up to a limit. In 2010, the Company paid contributions of £8,087 into this 401(k) arrangement. Linda Hudson is paid in US dollars. Of the change in the accrued benefit and the transfer value £15,932 and £12,055, respectively, is due to currency movements.
- 4 Ian King has an unfunded unapproved retirement arrangement for benefits in excess of the Lifetime Allowance. The pension and transfer value figures shown are in respect of his total benefit.
- 5 George Rose has a funded unapproved retirement arrangement for pensionable service before 6 April 2006. No Company contributions have been made to this arrangement during the year. In addition, George Rose has an unfunded unapproved retirement arrangement for pensionable service before 6 April 2006 and for benefits in excess of the Lifetime Allowance. The pension and transfer value figures shown are in respect of his total benefit.

Sir Peter Gershon and Sir Richard Lapthorne, both former directors, have unfunded pension arrangements. In 2010, the Company paid Sir Peter Gershon a pension of £109,280 (2009 £109,230) and Sir Richard Lapthorne a pension of £102,382 (2009 £100,058) in respect of these arrangements.

Other statutory and regulatory information

Principal activities

BAE Systems is a global defence and security company. The BAE Systems Group delivers, through its subsidiaries and equity accounted investments, a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services.

Company registration

BAE Systems plc is registered in England and Wales with the registered number 1470151.

Directors

The current directors who served during the 2010 financial year are listed on pages 76 and 77. Of those directors, Nick Rose was appointed to the Board on 8 February 2010 and Harriet Green on 1 November 2010. In addition, Phil Carroll and Andy Inglis served as directors during the period up to their respective retirements from the Board on 5 May 2010 and 9 July 2010. It was announced on 10 December 2010 that George Rose would be retiring from the Board on 31 March 2011 and that Peter Lynas would be appointed in his stead with effect from 1 April 2011. Ravi Uppal will retire from the Board at the end of his three-year term of office on 1 April 2011.

Dividend

An interim dividend of 7.0p per share was paid on 30 November 2010. The directors propose a final dividend of 10.5p per ordinary share. Subject to shareholder approval, the final dividend will be paid on 1 June 2011 to shareholders on the share register on 26 April 2011.

Annual General Meeting (AGM)

The Company's AGM will be held on 4 May 2011. The Notice of Annual General Meeting is enclosed with this Annual Report and details the resolutions to be proposed at the meeting.

Office of Fair Trading undertakings

As a consequence of the merger between British Aerospace and the former Marconi Electronics Systems businesses in 1999, the Company gave certain undertakings to the Secretary of State for Trade and Industry (now the Secretary of State for Business, Innovation and Skills). In February 2007, the Company was released from the majority of these undertakings and the remainder have been superseded and varied by a new set of undertakings. Compliance with the undertakings is monitored by a compliance officer. Further information regarding the undertakings and the contact details of the compliance officer may be obtained through the Company Secretary at the Company's registered office or through the Company's website.

Supplier payment policy

It is Group policy that suppliers should be paid in accordance with the payment terms and conditions stated in the applicable purchase order. In the UK, the Group is a signatory to the government's Prompt Payment Code (see www.promptpaymentcode.org.uk), under which it has undertaken to pay suppliers on time, give clear guidance on payment procedures and encourage the adoption of the code throughout its supply chain.

The average number of days' credit provided in 2010 by suppliers was 34 days (2009 31 days).

Charitable donations

During 2010, the amount donated for charitable purposes in the UK was £1.5m (2009 £1.6m). In line with the Company Giving strategy, this included:

- £852,000 given to armed forces charities, including ABF The Soldiers' Charity, Combat Stress, RAF Benevolent Fund, Royal Navy and Royal Marines Charity, Soldiers, Sailors,

Airmen and Families Association (SSAFA) Forces Help, St Dunstan's and uk4u Thanks!;

- £652,000 donated to education charities, including Arkwright Scholarships Trust, Smallpeice Trust, Enthuse Charitable Trust and The Prince's Trust; with
- the remaining £28,000 donated for other charitable purposes, including the advance of health and culture/heritage.

Further details of the Company's charitable activities are set out on page 53.

Political donations

No political donations were made in 2010.

Issued share capital

As at 31 December 2010, BAE Systems' issued share capital of £89,684,547 comprised 3,587,381,835 ordinary shares of 2.5p each and one Special Share of £1.

Treasury shares

During the year 143,951,447 ordinary shares of 2.5p each were repurchased under the buyback programme announced on 18 February 2010. The total consideration for the purchase of the shares, including commission and stamp duty, was £503,128,212.

As at 1 January 2010, the number of shares held in treasury totalled 43,952,360 (having a total nominal value of £1,098,809 and representing 1.23% of the Company's called up share capital at 1 January 2010). During 2010, the Company used 9,526,179 treasury shares (having a total nominal value of £238,154 and representing 0.27% of the Company's called up share capital at 31 December 2010) to satisfy awards under the Free and Matching elements of the Share Incentive Plan and awards vested under the Share Matching Plan. Of the 9,186,543 treasury shares utilised in respect of the Share Incentive Plan, the 6,026,625 treasury shares used in respect of the Free Shares element and the 3,159,918 treasury shares used in respect of the Matching Shares element were disposed of by the Company for nil consideration as were the 339,636 treasury shares utilised under the Share Matching Plan. As at 31 December 2010, the number of shares held in treasury totalled 178,377,628 (having a total nominal value of £4,459,441 and representing 4.97% of the Company's called up share capital at 31 December 2010).

The rights to such shares are restricted in accordance with the Companies Act and, in particular, the voting rights attaching to these shares are automatically suspended.

Rights and obligations of ordinary shares

On a show of hands at a general meeting every holder of ordinary shares present in person and entitled to vote shall have one vote, and every proxy entitled to vote shall have one vote (unless the proxy is appointed by more than one member in which case the proxy has one vote for and one vote against if the proxy has been instructed by one or more members to vote for the resolution and by one or more members to vote against the resolution; or if the proxy has been instructed by one or more shareholders to vote either for or against a resolution and by one or more of those shareholders to use his discretion how to vote). On a poll, every member present in person or by proxy and entitled to vote shall have one vote for every ordinary share held. Subject to the relevant statutory provisions and the Company's Articles of Association, holders of ordinary shares are entitled to a dividend where declared or paid out of profits available for such purposes. Subject to the relevant statutory provisions and the Company's Articles of Association, on a return of capital on a winding-up, holders of ordinary shares are entitled, after repayment of the £1 Special Share, to participate in such a return. There are no redemption rights in relation to the ordinary shares.

Rights and obligations of the Special Share

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

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

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

Restrictions on transfer of securities

The restrictions on the transfer of shares in the Company are as follows:

- the Special Share may only be issued to, held by and transferred to the Special Shareholder or his successor or nominee;
- the directors shall not register any allotment or transfer of any shares to a foreign person, or foreign persons acting in concert, who at the time have more than a 15% voting interest in the Company, or who would, following such allotment or transfer, have such an interest;
- the directors shall not register any person as a holder of any shares unless they have received: (i) a declaration stating that upon registration, the share(s) will not be held by foreign persons or that upon registration the share(s) will be held by a foreign person or persons; (ii) such evidence (if any) as the directors may require of the authority of the signatory of the declaration; and (iii) such evidence or information (if any) as to the matters referred to in the declaration as the directors consider appropriate;
- the directors may, in their absolute discretion, refuse to register any transfer of shares which are not fully paid up (but not so as to prevent dealings in listed shares from taking place);
- the directors may also refuse to register any instrument of transfer of shares unless the instrument of transfer is in respect of only one class of share and it is lodged at the place where the register of members is kept, accompanied by a relevant certificate or such other evidence as the directors may reasonably require to show the right of the transferor to make the transfer;
- the directors may refuse to register an allotment or transfer of shares in favour of more than four persons jointly;
- where a shareholder has failed to provide the Company with certain information relating to their interest in shares, the directors can, in certain circumstances, refuse to register a transfer of such shares;
- certain restrictions may from time to time be imposed by laws and regulations (for example, insider trading laws);
- restrictions may be imposed pursuant to the Listing Rules of the Financial Services Authority whereby certain of the Group's

employees require the Company's approval to deal in shares; and

- awards of shares made under the Company's share incentive plan are subject to restrictions on the transfer of shares prior to vesting.

The Company is not aware of any arrangements between its shareholders that may result in restrictions on the transfer of shares and/or voting rights.

Significant direct and indirect holders of securities

As at 16 February 2011, the Company had been advised of the following significant direct and indirect interests in the issued ordinary share capital of the Company:

Name of shareholder	Percentage notified
AXA S.A. and its group of companies	5.00%
Barclays PLC	3.98%
BlackRock, Inc	5.16%
Invesco Ltd	5.08%
Franklin Resources Inc, and affiliates	4.92%
Legal & General Group Plc	3.99%

Exercise of rights of shares in employee share schemes

The Trustees of the employee trusts do not seek to exercise voting rights on shares held in the employee trusts other than on the direction of the underlying beneficiaries. No voting rights are exercised in relation to shares unallocated to individual beneficiaries.

Restrictions on voting deadlines

The notice of any general meeting shall specify the deadline for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be proposed at the general meeting. The number of proxy votes for, against or withheld in respect of each resolution are publicised on the Company's website after the meeting.

Appointment and replacement of directors

Subject to certain nationality requirements mentioned below, the Company may by ordinary resolution appoint any person to be a director.

The majority of directors holding office must be British. Otherwise the directors who are not British shall vacate office in such order that those who have been in office for the shortest period since their appointment shall vacate their office first, unless all of the directors otherwise agree among themselves. Any director who holds the office of either Chairman (in an executive capacity) or Chief Executive shall also be British.

The Company must have six directors holding office at all times. If the number is reduced to below six, then such number of persons shall be appointed as directors as soon as is reasonably practicable to reinstate the number of directors to six. The Company may by ordinary resolution from time to time vary the minimum number of directors.

At each AGM of the Company, any director who was elected or last re-elected at or before the AGM held in the third calendar year before the then current calendar year must retire by rotation and such further directors must retire by rotation so that in total one-third of the directors retire by rotation each year. A retiring director is eligible for re-election. It is the Board's intention that all directors will stand for election or re-election in 2011 in compliance with the UK Corporate Governance Code.

Amendment of the Company's Articles of Association

The Company's Articles of Association may only be amended by a special resolution at a general meeting of shareholders. Where class rights are varied, such amendments must be approved by the members of each class of shares separately.

In addition, certain provisions of the Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British.

Powers of the directors

The directors are responsible for the management of the business of the Company and may exercise all powers of the Company subject to applicable legislation and regulation, and the Articles of Association.

At the 2010 AGM, the directors were given the power to buy back a maximum number of 351,599,099 ordinary shares at a minimum price of 2.5p each. The maximum price was the higher of (i) an amount equal to 105% of the average of the middle market quotations of the Company's ordinary shares as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the day on which such ordinary shares are contracted to be purchased, and (ii) the higher of the price of the last independent trade and the highest current independent bid on the London Stock Exchange as stipulated in Article 5(1) of the Buy-back and Stabilisation Regulation. This power will expire at the earlier of the conclusion of the 2011 AGM or 30 June 2011. A special resolution will be proposed at the 2011 AGM to renew the Company's authority to acquire its own shares.

At the 2010 AGM, the directors were given the power to issue new shares up to a nominal amount of £29,296,994. This power will expire on the earlier of the conclusion of the 2011 AGM or 30 June 2011. Accordingly, a resolution will be proposed at the 2011 AGM to renew the Company's authority to issue further new shares. At the 2010 AGM, the directors were also given the power to issue new issue shares up to a further nominal amount of £29,296,994 in connection with an offer by way of a rights issue. This authority too will expire on the earlier of the conclusion of the 2011 AGM or 30 June 2011, and a resolution will be proposed at the 2011 AGM to renew this additional authority.

Conflicts of interest

As permitted under the Companies Act 2006, the Company's Articles of Association contain provisions which enable the Board to authorise conflicts or potential conflicts that individual directors may have.

To avoid potential conflicts of interest the Board requires the Nominations Committee to check that any individuals it nominates for appointment to the Board are free of potential conflicts. In addition, the Board's procedures and the induction programme for new directors emphasise a director's personal responsibility for complying with the duties relating to conflicts of interest. The procedure adopted by the Board for the authorisation of conflicts reminds directors of the need to consider their duties as directors and not grant an authorisation unless they believe, in good faith, that this would be likely to promote the success of the Company. As required by law, the potentially conflicted director cannot vote on an authorisation resolution or be counted in the quorum. Any authorisation granted may be terminated at any time and the director is informed of the obligation to inform the Company without delay should there be any material change in the nature of the conflict or potential conflict so authorised. The Nominations Committee has been asked to review on an annual basis any authorisations granted and to make recommendations to the Board as appropriate.

Directors' indemnities

The Company has entered into deeds of indemnity with all its current directors and those persons who were directors for any part of 2010 which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

The directors of BAE Systems Pension Funds Trustees Limited, BAE Systems 2000 Pension Plan Trustees Limited, BAE Systems Executive Pension Scheme Trustees Limited and Alvis Pension Scheme Trustees Limited benefit from indemnities in the governing documentation of the BAE Systems Pension Scheme, the BAE Systems 2000 Pension Plan, the BAE Systems Executive Pension Scheme and the Alvis Pension Scheme, respectively, which are qualifying indemnity provisions for the purpose of the Companies Act 2006.

All such indemnity provisions are in force as at the date of this Directors' report.

Change of control – significant agreements

The following significant agreements contain provisions entitling the counterparties to exercise termination, alteration or other similar rights in the event of a change of control of the Company:

- The Group has entered into a £2bn Revolving Credit Facility dated 8 December 2010 and a £500m Letter of Credit Facility dated 27 March 2006 (as amended), which provide that, in the event of a change of control of the Company, the lenders are entitled to renegotiate terms, or if no agreement is reached on negotiated terms within a certain period, to call for the repayment or cancellation of the facilities. The Revolving Credit Facility was undrawn as at 31 December 2010.
- The Company has entered into a Restated and Amended Shareholders Agreement with European Aeronautic Defence and Space Company EADS N.V. (EADS) and Finmeccanica S.p.A (Finmeccanica) relating to MBDA S.A.S. dated 18 December 2001 (as amended). In the event that control of the Company passes to certain specified third party acquirors, the agreement allows EADS and Finmeccanica to exercise an option to terminate certain executive management level nomination and voting rights, and certain shareholder information rights of the Company in relation to the MBDA joint venture. Following the exercise of this option, the Company would have the right to require the other shareholders to purchase its interest in MBDA at fair market value.
- The Company and EADS have agreed that if Finmeccanica acquires a controlling interest in the Company, EADS will increase its shareholding in MBDA to 50% by purchasing the appropriate number of shares in MBDA at fair market value.
- The Company, BAE Systems, Inc., BAE Systems (Holdings) Limited and BAE Systems Holdings Inc. entered into a Special Security Agreement dated 8 November 2010 with the US Department of Defense regarding the management of BAE Systems, Inc. in order to comply with the US government's national security requirements. In the event of a change of control of the Company, the Agreement may be terminated or altered by the US Department of Defense.

In addition, the Company's share plans contain provisions as a result of which options and awards may vest and become exercisable on a change of control of the Company in accordance with the rules of the plans.

Auditors

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 AGM.

Statement of directors' responsibilities in respect of the Annual Report and financial statements

The directors are responsible for preparing the Annual Report, and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and applicable law, and have elected to prepare the parent company financial statements in accordance with UK accounting standards and applicable law (UK Generally Accepted Accounting Practice).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company, and of their profit or loss for that period. In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK accounting standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

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

Under applicable law and regulations, the directors are also responsible for preparing a directors' report, directors' remuneration report and corporate governance statement that comply with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Statement of disclosure of information to auditors

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

On behalf of the Board

David Parkes Company Secretary

16 February 2011

Responsibility statement of the directors in respect of the Annual Report and financial statements

Each of the directors listed below confirms that to the best of their knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company, and the undertakings included in the consolidation taken as a whole; and
- the Directors' report includes a fair review of the development and performance of the business, and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

Dick Oliver	Chairman
Ian King	Chief Executive
Linda Hudson	President and Chief Executive Officer of BAE Systems, Inc.
George Rose	Group Finance Director
Paul Anderson	Non-executive director
Harriet Green	Non-executive director
Michael Hartnall	Non-executive director
Sir Peter Mason	Non-executive director
Roberto Quarta	Non-executive director
Nick Rose	Non-executive director
Carl Symon	Non-executive director
Ravi Uppal	Non-executive director

On behalf of the Board

Dick Oliver Chairman

16 February 2011

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

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

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 123, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's website at www.frc.org.uk/apb/scope/private.cfm

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2010 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

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

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, set out on page 88, in relation to going concern;
- the part of the Corporate Governance Statement on pages 86 to 88 in the Directors' Report relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review; and
- certain elements of the report to shareholders by the Board on directors' remuneration.

A G Cates (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor

Chartered Accountants
15 Canada Square
London
E14 5GL

16 February 2011

Consolidated income statement

for the year ended 31 December

		2010		Restated ¹ 2009	
	Notes	£m	Total £m	£m	Total £m
Continuing operations					
Combined sales of Group and equity accounted investments	3		22,392		21,990
Less: share of sales of equity accounted investments	3		(1,295)		(1,616)
Revenue	3		21,097		20,374
Operating costs	4		(19,761)		(20,060)
Other income	5		169		465
<i>Group operating profit excluding amortisation and impairment of intangible assets</i>			2,022	2,038	
<i>Amortisation</i>	11	(392)		(286)	
<i>Impairment</i>	11	(125)		(973)	
Group operating profit			1,505		779
<i>Share of results of equity accounted investments excluding finance costs and taxation expense</i>			177	210	
<i>Financial (expense)/income of equity accounted investments</i>	6	(2)		2	
<i>Taxation expense of equity accounted investments</i>		(44)		(25)	
Share of results of equity accounted investments	14		131		187
<i>EBITA² excluding non-recurring items</i>			2,214	2,197	
<i>Profit on disposal of businesses³</i>	9	1		68	
<i>Pension curtailment gains³</i>		2		261	
<i>Regulatory penalties⁴</i>		(18)		(278)	
<i>EBITA²</i>			2,199	2,248	
<i>Amortisation</i>	11	(392)		(286)	
<i>Impairment</i>	11	(125)		(973)	
<i>Financial (expense)/income of equity accounted investments</i>	6	(2)		2	
<i>Taxation expense of equity accounted investments</i>		(44)		(25)	
Operating profit	3		1,636		966
Finance costs	6				
Financial income		1,358		1,573	
Financial expense		(1,550)		(2,273)	
			(192)		(700)
Profit before taxation			1,444		266
Taxation expense	8				
UK taxation		(152)		(105)	
Overseas taxation		(265)		(222)	
			(417)		(327)
Profit/(loss) for the year – continuing operations			1,027		(61)
Profit for the year – discontinued operations	9		54		16
Profit/(loss) for the year			1,081		(45)
Attributable to:					
BAE Systems shareholders			1,052		(67)
Non-controlling interests			29		22
			1,081		(45)
Earnings/(loss) per share	10				
Basic earnings/(loss) per share			30.5p		(1.9)p
Diluted earnings/(loss) per share			30.3p		(1.9)p
Earnings/(loss) per share – continuing operations					
Basic earnings/(loss) per share			28.9p		(2.3)p
Diluted earnings/(loss) per share			28.7p		(2.3)p

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

2 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

3 Included in other income.

4 Included in operating costs.

Consolidated statement of comprehensive income

for the year ended 31 December

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

Consolidated statement of changes in equity

for the year ended 31 December

	Attributable to equity holders of the parent					Non-controlling interests	Total equity
	Issued share capital £m	Share premium £m	Other reserves ² £m	Retained earnings £m	Total £m	£m	£m
At 1 January 2010	90	1,243	5,399	(2,141)	4,591	72	4,663
Profit for the year	–	–	–	1,052	1,052	29	1,081
Total other comprehensive income for the year	–	–	71	654	725	–	725
Share-based payments	–	–	–	58	58	–	58
Share options:							
Proceeds from shares issued	–	6	–	–	6	–	6
Purchase of own shares	–	–	–	(23)	(23)	–	(23)
Purchase of treasury shares ⁵	–	–	–	(503)	(503)	–	(503)
Other	–	–	–	–	–	2	2
Ordinary share dividends	–	–	–	(574)	(574)	(32)	(606)
At 31 December 2010	90	1,249	5,470	(1,477)	5,332	71	5,403
At 1 January 2009	90	1,238	5,974	(68)	7,234	55	7,289
(Loss)/profit for the year	–	–	–	(67)	(67)	22	(45)
Total other comprehensive income for the year	–	–	(575)	(1,499)	(2,074)	–	(2,074)
Share-based payments	–	–	–	52	52	–	52
Share options:							
Proceeds from shares issued	–	5	–	–	5	–	5
Purchase of own shares	–	–	–	(25)	(25)	–	(25)
Ordinary share dividends	–	–	–	(534)	(534)	(5)	(539)
At 31 December 2009 (restated¹)	90	1,243	5,399	(2,141)	4,591	72	4,663

1 Other reserves reduced by £64m following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).

2 An analysis of other reserves is provided in note 24.

3 Includes a £348m benefit arising from the change from the Retail Prices Index to the Consumer Prices Index as the measure for determining minimum statutory pension increases (see note 21).

4 The UK current tax rate will be reduced from 28% to 27% with effect from 1 April 2011, which creates a tax rate adjustment (see note 8).

5 Includes transaction costs of £3m.

Consolidated balance sheet

as at 31 December

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

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

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

I G King
Chief Executive

G W Rose
Group Finance Director

Consolidated cash flow statement

for the year ended 31 December

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

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

Notes to the Group accounts

1. Accounting policies

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

Basis of preparation

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

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

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

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

- the determination of the revenue recognition approach to apply to individual contracts;
- the classification of financial assets or liabilities;
- the classification of retirement benefit plans between defined benefit and defined contribution arrangements; and
- the classification of investments as subsidiaries, equity accounted investments or otherwise.

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

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

Basis of consolidation

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

Subsidiaries

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

Business combinations on or after 1 January 2010 (IFRS 3, *Business Combinations*)

Business combinations are accounted for using the acquisition method as at the acquisition date, which is the date on which control is transferred to the Group. The Group measures goodwill as the acquisition-date fair value of the consideration

transferred, including the amount of any non-controlling interest in the acquiree, less the net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed, including contingent liabilities as required by IFRS 3.

Consideration transferred includes the fair values of assets transferred, liabilities incurred by the Group to the previous owners of the acquiree, equity interests issued by the Group, contingent consideration, and share-based payment awards of the acquiree that are replaced in the business combination. Any contingent consideration payable is recognised at fair value at the acquisition date. Subsequent changes to the fair value of contingent consideration that is not classified as equity are recognised in the consolidated income statement. If a business combination results in the termination of pre-existing relationships between the Group and the acquiree, then the lower of the termination amount, as contained in the agreement, and the value of the off-market element, is deducted from the consideration transferred and recognised in other expenses.

Transaction costs that the Group incurs in connection with a business combination, such as finder's fees, legal fees, due diligence fees, and other professional and consulting fees, are expensed as incurred.

Non-controlling interests are measured at either the non-controlling interest's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised or at fair value. The method used is determined on an acquisition-by-acquisition basis.

Business combinations between 1 January 2004 and 1 January 2010 (IFRS 3, *Business Combinations* (2004))

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired, and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. Previously held identifiable assets, liabilities and contingent liabilities of the acquired entity are revalued to their fair value at the date of acquisition, being the date at which the Group achieves control of the acquiree. The movement in fair value is taken to the asset revaluation reserve.

Upon initial acquisition of a non-controlling interest, the interest of minority shareholders is measured at the minority's proportion of the net fair value of the identifiable assets, liabilities and contingent liabilities recognised.

Business combinations prior to 1 January 2004 (date of transition to IFRS)

On transition to IFRS, IFRS 3 (2004) was not retrospectively applied and, therefore, the goodwill arising on acquisition under UK Generally Accepted Accounting Practice (GAAP) is the difference between the consideration paid for an acquisition and the fair value of the net tangible assets acquired. Goodwill arising on acquisitions before the date of transition to IFRS has been retained at the previous UK GAAP amounts, as any amounts related to intangible assets that would have been recorded in the acquired entities if the Group had applied IAS 38, *Intangible Assets*, at the dates they were acquired were considered immaterial, after being tested for impairment at those dates. Goodwill written off to reserves under UK GAAP

1. Accounting policies *continued*

prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

Accounting for acquisition of non-controlling interests that do not result in a change in control

Acquisitions of non-controlling interests are accounted for as transactions with equity holders in their capacity as equity holders and, therefore, no goodwill or profit or loss in the consolidated income statement is recognised as a result of such transactions.

Prior to 1 January 2010, goodwill was recognised on the acquisition of non-controlling interests in a subsidiary, which represented the excess of the cost of the additional investment over the carrying amount of the interest in the net assets acquired at the date of the transaction.

Equity accounted investments

An entity is regarded as a joint venture if the Group has joint control over its operating and financial policies. Joint ventures are accounted for under the equity method where the Group's income statement includes its share of their profits and losses, and the Group's balance sheet includes its share of their net assets.

Intangible assets

Goodwill

Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of joint ventures and associates is included in the carrying value of equity accounted investments. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Research and development

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

Group-funded expenditure on research activities is written off as incurred and charged to the income statement.

Group-funded expenditure on development activities applied to a plan or design for the production of new or substantially improved products and processes is capitalised as an internally generated intangible asset if certain conditions are met. The expenditure capitalised includes the cost of materials, direct labour and related overheads. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses.

Capitalised development expenditure is amortised over the expected life of the product.

Where the research and development activity is performed for customers, the revenue arising is recognised in accordance with the Group's revenue recognition policy.

Other intangible assets

Acquired computer software licences for use within the Group are capitalised as an intangible asset on the basis of the costs incurred to acquire and bring to use the specific software.

Costs that are directly associated with the production of identifiable and unique software products controlled by the Group, and that will probably generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Capitalised software development expenditure is stated at cost less accumulated amortisation and impairment losses. Group-funded expenditure associated with enhancing

or maintaining computer software programmes for sale is recognised as an expense as incurred.

Trademarks and licences have definite useful lives and are carried at cost less accumulated amortisation and impairment losses.

Intangible assets arising from a business combination are recognised at fair value, amortised over their estimated useful lives and subject to impairment testing. The most significant intangible assets recognised by the Group on businesses acquired to date are in relation to programmes. For programme-related intangibles, amortisation is set on a programme-by-programme basis over the life of the individual programme. Amortisation for customer-related intangibles is also set on an individual basis.

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

The estimated useful lives are as follows:

Programme and customer related	
Programme and customer related	up to 15 years
Other	
Acquired computer software licences	2 to 5 years
Capitalised software development	2 to 5 years
Capitalised research and development expenditure	up to 10 years
Trademarks and licences	up to 20 years
Other intangibles	up to 10 years

Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads.

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

Buildings	
Buildings	up to 50 years, or the lease term if shorter
Plant and machinery	
Computing equipment, motor vehicles and short-life works equipment	3 to 5 years
Research equipment	8 years
Other equipment	10 to 15 years, or the project life if shorter
Aircraft	
Aircraft	up to 15 years, or the lease term if shorter

For certain items of plant and equipment in the Group's US businesses, depreciation is normally provided on a basis consistent with cost reimbursement profiles under US government contracts. Typically this provides for a faster rate of depreciation than would otherwise arise on a straight-line basis.

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

The assets' residual values, useful lives and depreciation methods are reviewed, and adjusted if appropriate, at each balance sheet date. Where applicable, useful lives reflect the component accounting principle.

1. Accounting policies *continued*

Assets obtained under finance leases are included in property, plant and equipment and stated at an amount equal to the lower of the fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

Impairment

The carrying amounts of the Group's intangible assets, property, plant and equipment, and equity accounted investments are reviewed at each balance sheet date to determine whether there is any indication of impairment as required by IAS 36, *Impairment of Assets*. If any such indication exists, the asset's recoverable amount is estimated. For goodwill and intangible assets that are not yet available for use, impairment testing is performed annually. All other assets are considered for impairment under the relevant standard.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

The carrying value of an equity accounted investment comprises the Group's share of net assets and purchased goodwill, and is assessed for impairment as a single asset.

The recoverable amount of assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at appropriate pre-tax discount rates.

The recoverable amount of other assets is the greater of their fair value less cost to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using an appropriate pre-tax discount rate.

For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss in respect of assets, other than goodwill, carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

An impairment loss in respect of goodwill is not reversed.

An impairment loss in respect of other assets is reversed if there has been a change in the estimate used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

Investment property

Land and buildings that are leased to non-Group entities are classified as investment property. The Group measures investment property at its cost less accumulated depreciation and accumulated impairment losses.

Depreciation is provided, on a straight-line basis, to write off the cost of investment property over its estimated useful life of up to 50 years.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Other investments

The Group determines the classification of its other investments at initial recognition taking account of, where relevant, the purpose for which the investments were acquired. The Group classifies its other investments as follows:

- (a) loans and receivables: term deposits, principally comprising funds held with banks and other financial institutions, are carried at amortised cost using the effective interest method;
- (b) at fair value through profit or loss: financial instruments held for trading or designated by management on initial recognition. They are held at fair value and included in non-current assets unless management intends to dispose of the investment within 12 months of the balance sheet date;
- (c) held to maturity: non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity;
- (d) available-for-sale: investments other than interests in joint ventures and associates and term deposits and not classified as (b) or (c) above. They are held at fair value.

Purchases and sales of investments are recognised at the date on which the Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss.

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all risks and rewards of ownership.

Realised and unrealised gains and losses arising from changes in the fair value of the investments classified as fair value through profit or loss are included in finance costs in the income statement in the period in which they arise. Unrealised gains or losses arising from changes in the fair value of investments classified as available-for-sale are recognised in equity. When investments classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains and losses from investment securities within finance costs.

The fair values of quoted investments are based on bid prices at the balance sheet date.

Inventories

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

Trade and other receivables

Trade and other receivables are stated at their amortised cost less impairment losses. A provision for impairment is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivable is impaired. Receivables with a short-term duration are not discounted.

1. Accounting policies *continued*

An impairment loss is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Amounts due from customers for contract work include long-term contract balances less attributable progress payments.

Long-term contract balances are stated at cost, plus attributable profit, less provision for any anticipated losses. Appropriate provisions for any losses are made in the year in which they are first foreseen.

Progress payments are amounts received from customers in accordance with the terms of contracts which specify payments in advance of delivery and are credited, as progress payments, against any expenditure incurred for the particular contract. Any unexpended balance in respect of progress payments is held in trade and other payables as customer stage payments or, if the amounts are subject to advance payment guarantees unrelated to company performance, as cash received on customers' account.

Cash received on customers' account is excluded from net cash/(debt) (as defined by the Group).

Derivative financial instruments and hedging activities

The global nature of the Group's business means it is exposed to volatility in currency exchange rates. In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures as well as to manage anticipated economic cash flow exposures over the medium term. The Group also uses interest rate derivative instruments to manage the Group's exposure to interest rate fluctuations on its borrowings and deposits by varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon. The Group aims to achieve hedge accounting treatment for all derivatives that hedge material foreign currency exposures and those interest rate exposures where hedge accounting can be achieved.

In accordance with its treasury policy, the Group does not hold derivative financial instruments for trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

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

Cash flow hedges

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

Fair value hedges

Where a derivative financial instrument is designated as a fair value hedge, changes in the fair value of the underlying asset or liability attributable to the hedged risk, and gains and losses on the derivative instrument, are recognised in the income statement for the period.

Cash and cash equivalents

Cash and cash equivalents includes cash in hand, call deposits and other short-term liquid investments with original maturities of three months or less and which are subject to an insignificant risk of change in value. For the purpose of the cash flow statement, cash and cash equivalents also includes bank overdrafts that are repayable on demand.

Loans and overdrafts

Loans and overdrafts are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, loans and overdrafts are stated at amortised cost or fair value in respect of the hedged risk where hedge accounting has been adopted, with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Trade and other payables

Trade and other payables are stated at their cost.

Provisions

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and the amount has been reliably estimated. If the effect is material, provisions are determined by discounting the expected future cash flows at an appropriate pre-tax discount rate.

A provision for warranties is recognised when the underlying products and services are sold. The provision is based on historical warranty data and a weighting of all possible outcomes against their associated probabilities.

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been publicly announced. Future operating costs are not provided for.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract.

Provisions for losses on contracts are recorded when it becomes probable that total estimated contract costs will exceed total contract revenues. Such provisions are recorded as write downs of work-in-progress for that portion of the work which has already been completed, and as liability provisions for the remainder. Losses are determined on the basis of estimated results on completion of contracts and are updated regularly.

Pension obligations

Group companies operate various pension plans. The Group has both defined benefit and defined contribution plans.

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

For defined benefit retirement plans, the cost of providing benefits is determined periodically by independent actuaries and charged to the income statement in the period in which those benefits are earned by the employees. Actuarial gains and losses are recognised in full in the period in which they occur, and are recognised in the statement of comprehensive income. Past service cost is recognised immediately to the extent the benefits are already vested, or otherwise is recognised on a straight-line basis over the average period

1. Accounting policies *continued*

until the benefits become vested. Curtailments due to the material reduction of the expected years of future services of current employees or the elimination of the accrual of defined benefits for some or all of the future services for a significant number of employees are recognised immediately as a gain or loss in the income statement.

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

Tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided in full, using the balance sheet liability method, on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes; the initial recognition of assets or liabilities that affect neither accounting nor taxable profit; and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

Share-based payment compensation

The Group issues equity-settled and cash-settled share options to employees. In accordance with the requirements of IFRS 2, *Share-based Payment*, the Group has applied IFRS 2 to all equity-settled share options granted after 7 November 2002 that were unvested as of 1 January 2005 and all cash-settled options outstanding at the balance sheet date.

As explained in note 25, equity-settled share options are measured at fair value at the date of grant using an option pricing model.

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

Cash-settled share options are measured at fair value at the balance sheet date using an option pricing model. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of the options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the consolidated income statement unless they qualify for net investment hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

For consolidation purposes, the assets and liabilities of overseas subsidiary entities, joint ventures and associates are translated at the exchange rate ruling at the balance sheet date. Income statements of such entities are translated at average rates of exchange during the year. All resulting exchange differences, including exchange differences arising from the translation of borrowings and other financial instruments designated as hedges of such investments, are recognised directly in a separate component of equity.

Translation differences that arose before the transition date to IFRS (1 January 2004) are presented in equity but not as a separate component. When a foreign operation is sold, the cumulative exchange differences recognised since 1 January 2004 are recognised in the income statement as part of the profit or loss on sale.

Revenue and profit recognition

Sales include the Group's net share of sales of equity accounted investments. Revenue represents sales made by the Company and its subsidiary undertakings, excluding the Group's share of sales of equity accounted investments.

Long-term contracts

The majority of the Group's long-term contract arrangements are accounted for under IAS 11, *Construction Contracts*. Sales are recognised when the Group has obtained the right to consideration in exchange for its performance. This is usually when title passes or a separately identifiable phase (milestone) of a contract or development has been completed and accepted by the customer.

No profit is recognised on contracts until the outcome of the contract can be reliably estimated. Profit is calculated by reference to reliable estimates of contract revenue and forecast costs after making suitable allowances for technical and other risks related to performance milestones yet to be achieved. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Goods sold and services rendered

Revenue is measured at the fair value of the consideration received or receivable, net of returns, rebates and other similar allowances.

1. Accounting policies *continued*

Revenue from the sale of goods not under a long-term contract is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, there is no continuing management involvement with the goods, and the amount of revenue and costs can be measured reliably. Profit is recognised at the time of sale.

Revenue from the provision of services not under a long-term contract is recognised in the income statement in proportion to the stage of completion of the contract at the reporting date. The stage of completion is measured on the basis of direct expenses incurred as a percentage of total expenses to be incurred for material contracts and labour hours delivered as a percentage of total labour hours to be delivered for time contracts.

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

Lease income

Rental income from aircraft operating leases is recognised in revenue on a straight-line basis over the term of the relevant lease. Lease incentives granted are charged to the income statement over the term of the lease.

Leases

Assets obtained under finance leases are included in property, plant and equipment at cost and are depreciated over their useful lives, or the lease term, whichever is the shorter. Future instalments under such leases, net of financing costs, are included within loans. Rental payments are apportioned between the finance element, which is included in finance costs, and the capital element, which reduces the outstanding obligation for future instalments, so as to give a constant charge on the outstanding obligation.

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

Assets held for leasing out under operating leases are included in property, plant and equipment at cost less accumulated depreciation and accumulated impairment losses. Rental income is recognised in revenue on a straight-line basis.

Assets leased out under finance leases cease to be recognised in the balance sheet after the inception of the lease. Instead, a finance lease receivable, representing the discounted future lease payments to be received from the lessee plus any discounted unguaranteed residual value, is recorded as a long-term financial asset. Interest income is recognised in the income statement as it accrues, taking into account the effective yield on the asset.

Underlying EBITA

Management uses an underlying profit measure to monitor the year-on-year profitability of the Group, which is defined as earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. This definition is referred to as Underlying EBITA. Underlying EBITA is the measure of profit on which segmental performance is monitored by management. As such, it is disclosed in note 3 on a segmental basis. Non-recurring items are defined as items that are relevant to an understanding of the Group's performance with reference to their materiality and nature. The non-recurring items for the current and prior years are presented on the face of the Group's consolidated income statement.

Finance costs

Financial income comprises interest income on funds invested, gains on the disposal of available-for-sale financial assets, changes in the fair value of financial assets at fair value through profit or loss, and gains on hedging instruments that are recognised in profit or loss.

Financial expense comprises interest expense on borrowings, unwinding of the discounts on provisions, changes in the fair value of financial assets at fair value through profit or loss, and losses on hedging instruments that are recognised in profit or loss.

Borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset (one that takes a substantial period of time to get ready for use or sale) are capitalised as part of the cost of that asset, until such time as the assets are ready for their intended use or sale.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

Dividends

Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

Discontinued operations

A discontinued operation is a component of the Group's business that represents a separate major line of business or geographical area of operations that has been disposed of or meets the criteria as held for sale. When an operation is classified as a discontinued operation, the comparative consolidated income statement is re-presented as if the operation had been discontinued from the start of the comparative period.

2. Changes in accounting policies

Standards, amendments and interpretations effective in 2010

With effect from 1 January 2010, the Group early adopted *Improvements to IFRSs 2010* which makes minor amendments to seven existing standards. These amendments impact disclosures and, therefore, have had no impact on the reported results or financial position of the Group. The amendment to IAS 1, *Presentation of Financial Statements*, allows the presentation either in the statement of changes in equity, or within the notes, of an analysis of the components of other comprehensive income by item.

With effect from 1 January 2010, the Group adopted the following amendments to existing standards:

- IFRS 3, *Business Combinations*, introduces changes in the accounting treatment of acquisitions, such as the accounting for acquisition-related costs, the initial recognition and subsequent measurement of contingent consideration, and business combinations achieved in stages. The change in accounting policy has been applied prospectively and has not had a material impact on reported results. The impact on future years will depend on the specific acquisitions undertaken; and
- Amendment to IAS 27, *Consolidated and Separate Financial Statements*, requires that acquisitions of non-controlling interests that do not result in a change of control are accounted for as transactions with equity holders and, therefore, no goodwill is recognised as a result. The change in accounting policy has been applied prospectively and has not had a material impact on reported results.

In addition, the Group has reviewed the effect of the following amendments and interpretations effective from 1 January 2010, and has concluded that they have no impact on the Group's accounts:

- Amendment to IAS 39, *Financial Instruments: Recognition and Measurement: Eligible Hedged Items*;
- Amendment to IFRS 2, *Share-based Payment: Group Cash-settled Share-based Payment Transactions*;
- *Improvements to IFRSs 2009*;
- International Financial Reporting Interpretations Committee (IFRIC) 17, *Distributions of Non-cash Assets to Owners*; and
- IFRIC 18, *Transfers of Assets from Customers*.

Amendments to existing standards and interpretations that are not yet effective and have not been early adopted by the Group

The Group has reviewed the effect of the following EU-endorsed amendments and interpretations, and does not expect that they will have an impact on the Group's accounts:

- Amendment to IAS 32, *Financial instruments: Presentation: Classification of Rights Issues*, effective on or after 1 February 2010;
- IFRIC 19, *Extinguishing Financial Liabilities with Equity Instruments*, effective on or after 1 July 2010;
- IAS 24, *Related Party Disclosures*, effective on or after 1 January 2011; and
- Amendment to IFRIC 14, *IAS 19, The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*, effective on or after 1 January 2011.

3. Segmental analysis

The Group reports on five operating groups which are organised around a combination of the different products and services they provide, and the geographical areas in which they operate:

– **BAE Systems, Inc.:**

- **Electronics, Intelligence & Support**, based primarily in the US, provides a wide range of electronic systems and subsystems for military and commercial applications, technical and professional services for US national security and federal markets, and ship repair and modernisation services. It comprises four businesses: Electronic Solutions, Intelligence & Security, Platform Solutions and Support Solutions;
- **Land & Armaments**, based primarily in the US, designs, develops, produces, supports and upgrades armoured combat vehicles, tactical wheeled vehicles, naval guns, missile launchers, artillery systems, munitions and law enforcement products;
- **Programmes & Support** primarily comprises the Group's UK-based air, maritime and Cyber & Intelligence activities;
- **International** comprises the Group's businesses in Australia, India and Saudi Arabia, together with interests in the pan-European MBDA joint venture and Air Astana; and
- **HQ & Other Businesses** comprises the regional aircraft asset management and support activities, head office and UK shared services activity, including research centres and property management.

The Group has not aggregated any segments in arriving at the analysis.

Management monitors the results of these operating groups to assess performance and make decisions about the allocation of resources. Segment performance is evaluated based on underlying EBITA¹. This is reconciled below to the operating group result and the operating profit in the consolidated financial statements. Finance costs and taxation expense are managed on a Group basis.

Analysis by operating group – continuing operations

	Combined sales of Group and equity accounted investments		Less: sales by equity accounted investments		Add: sales to equity accounted investments		Revenue	
	2010 £m	Restated ² 2009 £m	2010 £m	Restated ² 2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Electronics, Intelligence & Support	5,653	5,637	(49)	–	49	–	5,653	5,637
Land & Armaments	5,930	6,738	(42)	(6)	–	–	5,888	6,732
Programmes & Support	6,680	6,298	(1,445)	(1,779)	1,339	1,166	6,574	5,685
International	4,534	3,828	(1,221)	(1,088)	–	–	3,313	2,740
HQ & Other Businesses	278	254	–	–	–	–	278	254
	23,075	22,755	(2,757)	(2,873)	1,388	1,166	21,706	21,048
Intra-operating group sales/revenue	(683)	(765)	21	16	53	75	(609)	(674)
	22,392	21,990	(2,736)	(2,857)	1,441	1,241	21,097	20,374

	Intra-operating group revenue		Revenue from external customers	
	2010 £m	2009 £m	2010 £m	2009 £m
Electronics, Intelligence & Support	130	138	5,523	5,499
Land & Armaments	106	45	5,782	6,687
Programmes & Support	274	431	6,300	5,254
International	7	12	3,306	2,728
HQ & Other Businesses	92	48	186	206
	609	674	21,097	20,374

	Capital expenditure ³		Depreciation and amortisation ³	
	2010 £m	2009 £m	2010 £m	2009 £m
Electronics, Intelligence & Support	116	123	134	125
Land & Armaments	99	84	348	244
Programmes & Support	119	109	140	116
International	61	142	61	55
HQ & Other Businesses	42	64	48	64
	437	522	731	604

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

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

3 Includes intangible assets, property, plant and equipment, and investment property.

3. Segmental analysis *continued*

	Underlying EBITA ¹		Non-recurring items ³		Amortisation of intangible assets		Impairment of intangible assets ⁴		Operating group result ⁵	
	2010 £m	Restated ² 2009 £m	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	Restated ² 2009 £m
Electronics, Intelligence & Support	668	575	2	202	(27)	(27)	(8)	(8)	635	742
Land & Armaments	604	604	–	59	(281)	(177)	(25)	(927)	298	(441)
Programmes & Support	529	670	1	68	(58)	(49)	(85)	(34)	387	655
International	478	419	–	–	(25)	(32)	(7)	(4)	446	383
HQ & Other Businesses	(65)	(71)	(18)	(278)	(1)	(1)	–	–	(84)	(350)
	2,214	2,197	(15)	51	(392)	(286)	(125)	(973)	1,682	989
Financial (expense)/income of equity accounted investments									(2)	2
Taxation expense of equity accounted investments									(44)	(25)
Operating profit									1,636	966
Finance costs									(192)	(700)
Profit before taxation									1,444	266
Taxation expense									(417)	(327)
Profit/(loss) for the year – continuing operations									1,027	(61)

Analysis of non-current assets by geographical location

Asset location	Carrying value of non-current assets	
	2010 £m	Restated ⁶ 2009 £m
United Kingdom	2,582	2,587
Rest of Europe	1,105	1,190
Saudi Arabia	734	729
United States	10,022	9,838
Asia and Pacific	621	589
Africa, Central and South America	31	47
Non-current operating group assets	15,095	14,980
Financial instruments	354	310
Inventories	644	887
Trade and other receivables	3,559	3,764
Total operating group assets	19,652	19,941
Tax	1,211	1,563
Retirement benefit obligations (note 21)	49	42
Cash (as defined by the Group) (note 27)	3,118	3,943
Consolidated total assets	24,030	25,489

1 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items (see page 37).

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

3 Non-recurring items comprise profit on disposal of businesses of £1m (2009 £68m), pension curtailment gains of £2m (2009 £261m) and regulatory penalties of £18m (2009 £278m).

4 See note 11.

5 The analysis by operating group of the share of results of equity accounted investments is provided in note 14.

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

3. Segmental analysis *continued*

Analysis of sales and revenue by geographical location – continuing operations

Customer location	Sales		Revenue	
	2010 £m	Restated ¹ 2009 £m	2010 £m	2009 £m
United Kingdom	4,306	4,148	4,161	3,562
Rest of Europe	2,793	2,559	2,036	1,811
Saudi Arabia	3,186	2,779	2,994	2,607
Rest of Middle East	217	105	162	64
United States	10,129	10,921	10,126	10,902
Canada	77	119	77	119
Australia	1,028	675	1,027	672
Rest of Asia and Pacific	339	261	257	226
Africa, Central and South America	317	423	257	411
	22,392	21,990	21,097	20,374

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

Analysis of revenue by category – continuing operations

	2010 £m	2009 £m
Sale of goods	5,793	6,777
Construction contracts	11,757	10,274
Provision of services	3,480	3,239
Lease income	60	73
Royalty income	7	11
	21,097	20,374

Analysis of revenue by major customer – continuing operations

Revenue from the Group's three principal customers, which individually represent over 10% of total revenue, is as follows:

	2010 £m	2009 £m
UK Ministry of Defence ¹	5,060	4,101
US Department of Defense	7,696	8,381
Kingdom of Saudi Arabia Ministry of Defence and Aviation	2,870	2,602

1 Revenue from the UK Ministry of Defence includes £1.3bn (2009 £1.1bn) generated under the Typhoon workshare agreement with Eurofighter GmbH. This revenue is included within Rest of Europe in the analysis by geographical location above.

Revenue from the UK Ministry of Defence and the US Department of Defense was generated by all four principal operating groups. Revenue from the Kingdom of Saudi Arabia Ministry of Defence and Aviation was generated by the International operating group.

4. Operating costs

	2010 £m	2009 £m
Raw materials and other bought-in items	8,471	9,330
Change in inventories of finished goods and work-in-progress	985	(538)
Cost of inventories expensed	9,456	8,792
Staff costs (note 7)	5,633	5,605
Depreciation, amortisation and impairment	899	1,600
Loss on disposal of property, plant and equipment	10	–
Regulatory penalties ¹	18	278
Trinidad and Tobago charge	100	–
Other operating charges	3,645	3,785
	19,761	20,060

Included within the analysis of operating costs are the following expenses:

Lease and sublease payments:		
Minimum lease payments	177	167
Research and development expense including amounts funded under contract	1,298	1,211 ²

1 The regulatory penalties of £278m in 2009 reflected the global settlement of the regulatory investigations by the US Department of Justice (DoJ) and the UK's Serious Fraud Office. The £18m charge in the current year reflects the US dollar exchange rate movement on payment of the penalty in respect of the DoJ.

2 Restated.

Costs of rationalisation programmes included in operating costs

	2010 £m	2009 £m
Electronics, Intelligence & Support	14	24
Land & Armaments	26	32
Programmes & Support	90	80
International	13	9
HQ & Other Businesses	12	6
	155	151

4. Operating costs *continued*

Fees payable to the Company's auditor and its associates included in operating costs

	2010			2009		
	UK £'000	Overseas £'000	Total £'000	UK £'000	Overseas £'000	Total £'000
Fees payable to the Company's auditor for the audit of the Company's annual accounts*	1,484	–	1,484	1,486	–	1,486
Fees payable to the Company's auditor and its associates for other services						
The audit of the Company's subsidiaries pursuant to legislation*	2,499	4,536	7,035	2,497	4,217	6,714
Other services pursuant to legislation:						
Interim review	579	–	579	581	–	581
Other	92	139	231	57	–	57
Further assurance services						
Advice on accounting matters	51	17	68	–	22	22
Internal controls	–	–	–	–	2	2
Due diligence	365	337	702	437	45	482
Tax services						
Compliance	637	2,026	2,663	481	768	1,249
Advisory	290	379	669	272	542	814
Other services						
M&A	58	638	696	99	–	99
Other	148	240	388	76	2	78
Total fees payable to the Company's auditor and its associates	6,203	8,312	14,515	5,986	5,598	11,584

* Total fees payable to the Company's auditor and its associates for audit services

8,519

8,200

In addition to the amounts above, the auditors' fees for audit services in respect of the Group's pension schemes were £144,000 (2009 £143,000).

The increase in overseas fees for the audit of subsidiaries includes £317,000 relating to foreign exchange translation.

Tax services include tax compliance support and services in relation to the Group's expatriate employees based around the world.

5. Other income

	2010 £m	2009 £m
Rental income from operating leases (including from investment property)	48	50
Profit on disposal of property, plant and equipment	23	17
Profit on disposal of businesses (note 9)	1	68
Management recharges to equity accounted investments (note 31)	14	24
Pension curtailment gains (note 21)	2	261
US healthcare curtailment gains (note 21)	5	–
Other	76	45
	169	465

6. Finance costs

	2010 £m	2009 £m
Interest income	40	66
Net present value adjustments	–	5
Expected return on pension scheme assets (note 21)	916	777
Gain on remeasurement of financial instruments at fair value through profit or loss ¹	176	408
Foreign exchange gains	226	317
Financial income	1,358	1,573
Interest expense:		
On bank loans and overdrafts	–	(1)
On finance leases	(1)	(2)
On bonds and other financial instruments	(203)	(225)
	(204)	(228)
Facility fees	(4)	(4)
Net present value adjustments	(28)	(40)
Interest charge on pension scheme liabilities (note 21)	(996)	(900)
Loss on remeasurement of financial instruments at fair value through profit or loss	(225)	(467)
Foreign exchange losses	(93)	(634)
Financial expense	(1,550)	(2,273)
Net finance costs	(192)	(700)

1 Includes a £26m (translated at average exchange rates) fair value movement in 2010 in respect of the remaining 10.25% shareholding in Saab AB.

Additional analysis of finance costs

	2010 £m	Restated ² 2009 £m
Net finance costs:		
Group	(192)	(700)
Share of equity accounted investments – continuing operations	(2)	2
	(194)	(698)
Analysed as:		
Net interest:		
Interest income	40	66
Interest expense	(204)	(228)
Facility fees	(4)	(4)
Net present value adjustments	(28)	(35)
Share of equity accounted investments – continuing operations	5	8
	(191)	(193)
Other finance costs:		
Group:		
Net financing charge on pensions	(80)	(123)
Market value and foreign exchange movements on financial instruments and investments ³	84	(376)
Share of equity accounted investments – continuing operations	(7)	(6)
	(194)	(698)

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

3 The loss in 2009 primarily reflected net foreign exchange movements on the unhedged portion of an intercompany loan from the UK to the US businesses.

Borrowing costs capitalised during the year were £nil (2009 £nil).

7. Employees and directors

The weekly average and year-end numbers of employees, excluding those in equity accounted investments, were as follows:

	Weekly average		At year end	
	2010 Number '000	2009 Number '000	2010 Number '000	2009 Number '000
Electronics, Intelligence & Support	31	33	31	32
Land & Armaments	18	21	16	20
Programmes & Support	33	27	32	33
International	11	11	11	11
HQ & Other Businesses	2	2	2	2
	95	94	92	98

The aggregate staff costs of Group employees, excluding employees of equity accounted investments, were:

	2010 £m	2009 £m
Wages and salaries	4,884	4,897
Social security costs	409	400
Share options granted to directors and employees – equity-settled	18	13
Share options granted to directors and employees – cash-settled	(2)	(2)
Pension costs – defined contribution plans (note 21)	110	127
Pension costs – defined benefit plans (note 21)	212	167
US healthcare plans (note 21)	2	3
	5,633	5,605

The Group considers key management personnel as defined under IAS 24, *Related Party Disclosures*, to be the members of the Group's Executive Committee and the Company's non-executive directors. Fuller disclosures on directors' remuneration are set out in the Remuneration report on pages 96 to 119. Total emoluments for directors and other key management personnel were:

	2010 £'000	2009 £'000
Short-term employee benefits	15,131	14,761
Post-employment benefits ¹	1,300	1,754
Share-based payments	4,033	4,773
	20,464	21,288

1 2009 includes special incentive awards.

8. Tax

Taxation expense

	2010 £m	Restated ¹ 2009 £m
Current taxation expense		
UK corporation tax		
Current tax	(121)	(83)
Double tax relief	3	8
Adjustment in respect of prior years	(29)	(44)
	(147)	(119)
Overseas tax charges		
Current year	(263)	(300)
Adjustment in respect of prior years	26	46
	(237)	(254)
	(384)	(373)
Deferred taxation expense		
UK		
Origination and reversal of temporary differences	(22)	(2)
Adjustment in respect of prior years	23	16
Tax rate adjustment ²	(6)	–
Overseas		
Origination and reversal of temporary differences	(9)	55
Adjustment in respect of prior years	(19)	(23)
	(33)	46
Taxation expense	(417)	(327)

Reconciliation of taxation expense – continuing operations

The following table reconciles the theoretical income tax expense, using the UK corporation tax rate, to the reported tax expense. The reconciling items represent, besides the impact of tax rate differentials and changes, non-taxable benefits or non-deductible expenses arising from differences between the local tax base and the reported financial statements.

	2010 £m	Restated ³ 2009 £m
Profit before taxation	1,444	266
UK corporation tax rate	28.0%	28.0%
Expected income tax expense	(404)	(74)
Effect of tax rates in foreign jurisdictions	(43)	(37)
Expenses not tax effected	(24)	(43)
Income not subject to tax	42	32
Research and development tax credits	32	36
Goodwill impairment	(24)	(203)
Chargeable gains	(2)	(1)
Utilisation of previously unrecognised tax losses	7	6
Current year losses not tax effected	–	(7)
Adjustments in respect of prior years	1	(5)
Adjustments in respect of equity accounted investments	37	52
Regulatory penalties	(5)	(78)
Tax rate adjustment ²	(6)	–
Other	(28)	(5)
Taxation expense	(417)	(327)

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

2 The UK current tax rate will be reduced from 28% to 27% with effect from 1 April 2011. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 28% to 27%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

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

8. Tax continued

Tax recognised in other comprehensive income

	2010			Restated ¹ 2009		
	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m	Before tax £m	Tax benefit/ (expense) £m	Net of tax £m
Currency translation on foreign currency net investments:						
Subsidiaries	160	–	160	(246)	–	(246)
Equity accounted investments	(6)	–	(6)	(56)	–	(56)
Amounts (charged)/credited to hedging reserve	(84)	22	(62)	(393)	110	(283)
Gain on revaluation of step acquisition	–	–	–	14	(4)	10
Net actuarial gains/(losses) on defined benefit pension schemes:						
Subsidiaries	874	(234)	640	(2,008)	541	(1,467)
Equity accounted investments	40	(12)	28	(54)	16	(38)
Fair value movements on available-for-sale investments	14	–	14	2	–	2
Recycling of cumulative currency translation reserve on disposal	(17)	–	(17)	–	–	–
Recycling of cumulative net hedging reserve on disposal	(4)	–	(4)	–	–	–
Share-based payments	–	1	1	–	(2)	(2)
Tax rate adjustment ²	–	(23)	(23)	–	–	–
Other	–	(6)	(6)	–	6	6
	977	(252)	725	(2,741)	667	(2,074)

Current tax taken in equity

	2010 £m	Restated ¹ 2009 £m
Relating to financial instruments	(2)	(3)
Relating to share-based payments	2	2
Relating to pensions	69	53
Relating to gain on revaluation of step acquisition	–	12
Other	(1)	14
	68	78

Deferred tax assets/(liabilities)

	Deferred tax assets		Deferred tax liabilities		Net balance at 31 December	
	2010 £m	Restated ¹ 2009 £m	2010 £m	Restated ¹ 2009 £m	2010 £m	Restated ¹ 2009 £m
Property, plant and equipment	14	1	(118)	(47)	(104)	(46)
Intangible assets	–	–	(207)	(325)	(207)	(325)
Provisions and accruals	394	432	–	–	394	432
Goodwill	–	–	(110)	(69)	(110)	(69)
Pension/retirement plans:						
Deficits	1,060	1,430	–	–	1,060	1,430
Additional contributions	18	15	–	–	18	15
Share-based payments	11	22	–	–	11	22
Financial instruments	20	–	(12)	(4)	8	(4)
Other items	58	58	(2)	(6)	56	52
Rolled over capital gains	–	–	(17)	(18)	(17)	(18)
Capital losses carried forward	17	18	–	–	17	18
Trading losses carried forward	28	19	–	–	28	19
Unremitted overseas dividends	–	–	–	(3)	–	(3)
Deferred tax assets/(liabilities)	1,620	1,995	(466)	(472)	1,154	1,523
Set off of tax	(460)	(464)	460	464	–	–
Net deferred tax assets/(liabilities)	1,160	1,531	(6)	(8)	1,154	1,523

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

2 The UK current tax rate will be reduced from 28% to 27% with effect from 1 April 2011. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 28% to 27%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income.

8. Tax *continued***Movement in temporary differences during the year**

	At 1 January 2010 ¹ £m	Exchange movements £m	Acquisitions and disposals ² £m	Recognised in income £m	Recognised in equity £m	At 31 December 2010 £m
Property, plant and equipment	(46)	–	(46)	(12)	–	(104)
Intangible assets	(325)	(10)	(14)	138	4	(207)
Provisions and accruals	432	18	8	(64)	–	394
Goodwill	(69)	(2)	–	(39)	–	(110)
Pension/retirement plans:						
Deficits ³	1,430	11	–	(47)	(334)	1,060
Additional contributions	15	–	–	–	3	18
Share-based payments	22	–	–	(11)	–	11
Financial instruments	(4)	–	–	(11)	23	8
Other items	52	2	1	5	(4)	56
Rolled over capital gains	(18)	–	–	1	–	(17)
Capital losses carried forward	18	–	–	(1)	–	17
Trading losses carried forward	19	3	1	5	–	28
Unremitted overseas dividends	(3)	–	–	3	–	–
	1,523	22	(50)	(33)	(308)	1,154

	At 1 January 2009 £m	Exchange movements £m	Acquisitions and disposals ⁴ £m	Recognised in income £m	Recognised in equity £m	At 31 December 2009 £m
Property, plant and equipment ¹	(69)	6	(2)	16	3	(46)
Intangible assets	(509)	33	(34)	214	(29)	(325)
Provisions and accruals ¹	457	(23)	20	(25)	3	432
Goodwill	(34)	5	–	(40)	–	(69)
Pension/retirement plans:						
Deficits ³	1,115	(45)	–	(164)	524	1,430
Additional contributions	66	–	(3)	(12)	(36)	15
Share-based payments ¹	30	(1)	(1)	(1)	(5)	22
Financial instruments	(136)	–	–	19	113	(4)
Other items ¹	25	–	(3)	33	(3)	52
Rolled over capital gains	(18)	–	–	–	–	(18)
Capital losses carried forward	18	–	–	–	–	18
Trading losses carried forward ¹	1	1	5	9	3	19
Unremitted overseas dividends	–	–	–	(3)	–	(3)
	946	(24)	(18)	46	573	1,523

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

2 Acquisitions and disposals includes net deferred tax liabilities on the acquisitions of Atlantic Marine (£40m) and Tenix Defence (£10m).

3 Includes deferred tax assets on workers' deferred compensation plans in the US.

4 Acquisitions and disposals includes deferred tax assets on the acquisition of Tenix Defence (£7m) and Detica (£4m), less deferred tax liabilities arising on the acquisition of the remaining shareholding in BVT (£27m).

Unrecognised deferred tax assets

Deferred tax assets have not been recognised in respect of the following items:

	2010 £m	2009 £m
Deductible temporary differences	3	10
Capital losses carried forward	56	58
Trading and other losses carried forward	194	158
	253	226

These assets have not been recognised as the incidence of future profits in the relevant countries and legal entities cannot be sufficiently accurately predicted at this time.

Due to changes in UK tax legislation during 2009, there are no unrecognised deferred tax liabilities arising on the aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures (2009 £nil). Any withholding tax due on the remittance of future earnings is expected to be insignificant.

8. Tax continued

Future changes in tax rates

The Emergency Budget on 22 June 2010 announced that the UK current tax rate will reduce from 28% to 24% over a period of four years from 2011. This will reduce future current tax charges accordingly. The first reduction from 28% to 27% was substantively enacted before 31 December 2010 and will be effective from 1 April 2011. In line with this change, the rate applying to UK deferred tax assets and liabilities has also been reduced from 28% to 27%, creating a rate adjustment, which is partly reflected in the consolidated income statement and partly in the consolidated statement of comprehensive income. Accordingly, both recognised and unrecognised UK deferred tax balances as at 31 December 2010 have been calculated at 27%.

The reduction in the rate from 27% to 24% has not yet been substantively enacted. If these reductions had been substantively enacted by 31 December 2010, the effect would have been to reduce the net deferred tax asset as at 31 December 2010 from £1,154m to £1,065m. Of this reduction, it is estimated that £19m would have been charged to the consolidated income statement and £70m charged to the consolidated statement of comprehensive income. In addition, unrecognised deferred tax assets as at 31 December 2010 would have reduced from £253m to £235m.

9. Disposals

Discontinued operations for the year ended 31 December 2010

On 3 June 2010, the Group sold half of its 20.5% shareholding in Saab AB to Investor AB for a cash consideration of SEK1,041m (£92m). Following the loss of significant influence over the company, the Group has discontinued the use of the equity method and the remaining shareholding in Saab is shown within other financial assets as a financial asset at fair value through profit or loss at 31 December 2010 (see note 17). The Group's share of the results of Saab to the date of disposal is shown within discontinued operations for the current and prior periods.

The results from discontinued operations which have been included in the consolidated income statement are as follows:

	2010 £m	2009 £m
Share of results of equity accounted investments	2	16
Profit on disposal of discontinued operations	52	–
Profit for the year – discontinued operations	54	16

The profit on disposal of discontinued operations is calculated as follows:

	£m
Cash consideration	92
Fair value of retained 10.25% investment	97
Transaction costs	(3)
Carrying value of 20.5% shareholding (note 14)	(155)
Cumulative net hedging gain	4
Cumulative currency translation gain	17
Profit on disposal of discontinued operations	52

Following the classification of Saab as a discontinued operation, combined sales of Group and equity accounted investments in the comparatives for the year ended 31 December 2009 have been reduced by £425m.

Continuing operations for the year ended 31 December 2010

During 2010, the Group completed the disposal of its Sistemas y Desarrollos Funcionales Limitada (SISDEF) joint venture for total cash consideration of £1m. Profit on disposal is £1m.

Continuing operations for the year ended 31 December 2009

Profit on disposal of businesses of £68m comprised the finalisation of the accounting gain recognised in 2008 on the disposal of the Group's interests in the businesses contributed to the BVT joint venture following acquisition of VT Group's 45% interest in 2009 (£58m) and additional proceeds received in respect of the disposal in 2008 of the Group's interest in Flagship Training (£10m).

The Group received deferred consideration of £72m in the year ended 31 December 2009 in respect of the disposals of Flagship Training Limited in 2008 (£70m) and the Inertial Products business in 2007 (£2m).

10. Earnings per share

	2010			Restated ¹ 2009		
	£m	Basic pence per share	Diluted pence per share	£m	Basic pence per share	Diluted pence per share
Profit/(loss) for the year attributable to equity shareholders	1,052	30.5	30.3	(67)	(1.9)	(1.9)
Represented by:						
<i>Continuing operations</i>	998	28.9	28.7	(83)	(2.3)	(2.3)
<i>Discontinued operations</i>	54	1.6	1.6	16	0.4	0.4
Add back/(deduct):						
Profit on disposal of businesses, post tax	(1)			(65)		
Pension curtailment gains, post tax	(1)			(188)		
Regulatory penalties	18			278		
Net financing charge on pensions, post tax	59			91		
Market value movements on derivatives, post tax	(57)			278		
Amortisation and impairment of intangible assets, post tax	307			384		
Impairment of goodwill	84			725		
Underlying earnings, post tax	1,461	42.4	42.1	1,436	40.7	40.6
Represented by:						
Continuing operations	1,407	40.8	40.5	1,415	40.1	40.0
Discontinued operations	54	1.6	1.6	21	0.6	0.6
	1,461	42.4	42.1	1,436	40.7	40.6
		Millions	Millions		Millions	Millions
Weighted average number of shares used in calculating basic earnings per share		3,451	3,451		3,532	3,532
Incremental shares in respect of employee share schemes			20			4
Weighted average number of shares used in calculating diluted earnings per share			3,471			3,536

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

Underlying earnings per share is presented in addition to that required by IAS 33, *Earnings per Share*, to align the adjusted earnings measure with the performance measure reviewed by the directors. The directors consider that this gives a more appropriate indication of underlying performance.

In the 12 months to 31 December 2009, outstanding share options were anti-dilutive and so were excluded from the diluted loss per share in accordance with IAS 33.

11. Intangible assets

	Goodwill £m	Programme and customer related ¹ £m	Other ² £m	Total £m
Cost or valuation				
At 1 January 2009	13,201	1,728	417	15,346
Additions:				
Acquired separately	–	–	28	28
Internally developed	–	–	14	14
Reclassification from equity accounted investments (note 14) ³	253	–	–	253
Acquisition of subsidiaries (note 29) (restated ⁴)	420	225	–	645
Adjustment on finalisation of provisional goodwill ⁵	5	11	–	16
Disposals	–	–	(7)	(7)
Transfer from property, plant and equipment	–	–	4	4
Exchange adjustments	(655)	(144)	(8)	(807)
At 31 December 2009 (restated ⁴)	13,224	1,820	448	15,492
Additions:				
Acquired separately	–	–	17	17
Internally developed	–	–	2	2
Acquisition of subsidiaries (note 29)	161	37	4	202
Adjustment to fair value of consideration ⁶	(64)	–	–	(64)
Disposals	(12)	–	(6)	(18)
Asset reclassifications	–	27	(27)	–
Transfer from property, plant and equipment	–	–	3	3
Transfer from inventories	–	–	3	3
Exchange adjustments	279	60	21	360
At 31 December 2010	13,588	1,944	465	15,997
Amortisation and impairment				
At 1 January 2009	2,333	556	151	3,040
Disposals	–	–	(7)	(7)
Amortisation charge ⁷	–	219	67	286
Impairment charge	725	240	8	973
Exchange adjustments	(55)	(48)	(3)	(106)
At 31 December 2009	3,003	967	216	4,186
Disposals	–	–	(6)	(6)
Amortisation charge ⁷	–	327	65	392
Impairment charge	84	30	11	125
Asset reclassifications	–	15	(15)	–
Transfer from property, plant and equipment	–	–	1	1
Exchange adjustments	36	34	13	83
At 31 December 2010	3,123	1,373	285	4,781
Net book value				
At 31 December 2010	10,465	571	180	11,216
At 31 December 2009 (restated ⁴)	10,221	853	232	11,306
At 1 January 2009	10,868	1,172	266	12,306

1 Relates to intangible assets recognised on acquisition of subsidiary companies, mainly in respect of ongoing programme relationships and the acquired order book.

2 Other intangibles includes patents, trademarks, software and internally funded development costs.

3 Goodwill arising on the formation of the BVT joint venture in the year ended 31 December 2008 and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited was reclassified from equity accounted investments to intangible assets in accordance with IFRS 3 (2004) in 2009 upon acquisition of VT Group's 45% shareholding in the BVT joint venture (see note 14).

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

5 Adjustment on finalisation of provisional goodwill relating to the acquisition of MTC Technologies, Inc., Tenix Defence Holdings Pty Limited, Tenix Toll Defence Logistics Pty Limited, Detica Group Plc and IST Dynamics in 2008. The amounts were not considered material for the restatement of comparative information in 2009.

6 See note 29.

7 Amortisation is included in operating costs in the income statement. The 2010 charge for programme and customer related intangibles includes an acceleration of amortisation (£137m) reflecting the profile of vehicle deliveries under the Family of Medium Tactical Vehicles contract.

The Group has no indefinite life intangible assets other than goodwill. The Group's approach to goodwill impairment testing is set out in the accounting policies on page 132.

Impairment testing

In order to calculate the recoverable amount of the Group's goodwill, all goodwill balances have been considered with regard to value in use calculations. These calculations use risk-adjusted future cash flow projections based on the Group's five-year

11. Intangible assets *continued*

Integrated Business Plan (IBP) and include a terminal value based on the projections for the final year of that plan, with an inflationary growth rate assumption applied. The IBP process uses historic experience, available government spending data and the Group's order book. Pre-tax discount rates, derived from the Group's post-tax weighted average cost of capital of 7.28% (2009 7.72%) (adjusted for risks specific to the market in which the cash-generating unit (CGU) operates), have been used in discounting these projected risk-adjusted cash flows.

Significant CGUs

2010

The Group has two CGUs with allocated goodwill which is significant in comparison with the total carrying amount of goodwill, the Electronic Solutions business (£2.0bn) within Electronics, Intelligence & Support (EI&S), and the Land & Armaments business (£3.6bn).

The key assumptions underpinning the cash flow projections are, for Electronic Solutions, continuing demand from the US government for electronic warfare systems (where the business has a leadership position) and other technology-based solutions, and for Land & Armaments, the continued demand in the Group's home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support.

The pre-tax discount rates used to discount the risk-adjusted five-year cash flow projections were 9.1% and 9.0%, respectively.

The growth rate assumption applied to the final year of these projections was 3%.

2009

The Group had three CGUs with allocated goodwill which was significant in comparison with the total carrying amount of goodwill. These were the US-based electronic warfare, network and mission solutions business in the EI&S operating group (£2.6bn), and the US-based ex-United Defense Industries, Inc. (UDI) (£2.0bn) and ex-Armor Holdings, Inc. (Armor) (£1.7bn pre-impairment below) businesses in the Land & Armaments operating group.

The key assumptions underpinning the cash flow projections were, for the EI&S CGU, the continuing demand from the US government for electronic warfare systems, mission solutions and other technology-based solutions, and from non-military agencies for network solutions, and for the Land & Armaments CGUs, the continued demand in the Group's home markets and from exports for existing and successor military land and tracked vehicles, upgrade programmes and support.

The pre-tax discount rates used to discount the risk-adjusted five-year cash flow projections were 9.9%, 9.8% and 10.3%, respectively.

The growth rate assumption applied to the final year of these projections was 3% (2% for Armor).

Whilst there are no other CGUs with allocated goodwill balances exceeding 15% of the Group's total goodwill balance, the majority of the projected cash flows within the remaining CGUs are underpinned by expected levels of government spending on defence and security, and the Group's ability to capture a broadly consistent market share.

The directors have not identified any reasonably possible material changes relating either specifically to the global military vehicle market, or to the levels of defence and security spending in the Group's home markets, particularly in the US, that would cause the carrying value of goodwill to exceed its recoverable amount. The Group continues to monitor changes in US defence budgets on an annual basis.

Impairment – goodwill

2010

The total goodwill impairment charge of £84m mainly arose in Surface Ships (£70m) reflecting the underperformance of the ex-VT Group export ship contracts. The pre-tax discount rate was 10.4%.

2009

The total goodwill impairment charge of £725m mainly arose in three CGUs, Armor (£526m), Products Group (£156m) and Detica (£34m).

The Armor impairment charge reflected both the non-award of a follow-on contract for production of vehicles under the Family of Medium Tactical Vehicles (FMTV) programme and the subsequent impact on the growth prospects of the business.

The Products Group impairment charge reflected a weaker outlook for the business as spending from customer discretionary budgets had reduced in both domestic and export markets. The pre-tax discount rate used was 9.5%.

The Detica impairment charge related to the discontinued financial services element of the business. The pre-tax discount rate used was 10.0%.

Impairment – intangible assets

2010

The total intangible assets impairment charge of £41m comprises £30m relating to programme and customer related intangibles, and £11m relating to other intangibles. The charge impacted the EI&S (£8m), Land & Armaments (£25m) and Programmes & Support (£8m) operating groups.

2009

The total intangible assets impairment charge of £248m comprised £240m relating to programme and customer related intangibles, and £8m relating to other intangibles. The charge impacted the EI&S (£8m), Land & Armaments (£236m) and International (£4m) operating groups.

11. Intangible assets *continued*

The charge relating to Land & Armaments included £108m in respect of the Products Group business, £66m relating to the FMTV non-award and a number of individually small items each calculated on a programme-by-programme basis.

12. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Cost				
At 1 January 2009	1,972	2,529	826	5,327
Additions	245	187	48	480
Acquisition of subsidiaries (note 29)	85	53	–	138
Transfers from inventories	–	2	–	2
Transfer to investment properties	(2)	–	–	(2)
Transfer to other intangible assets	–	(4)	–	(4)
Reclassification between categories	28	(28)	–	–
Disposals	(23)	(78)	(43)	(144)
Exchange adjustments	(110)	(110)	(72)	(292)
At 31 December 2009	2,195	2,551	759	5,505
Additions	159	225	20	404
Acquisition of subsidiaries (note 29)	98	15	–	113
Transfers from inventories	–	1	–	1
Transfers to inventories	–	(5)	(5)	(10)
Transfer to investment properties	(15)	–	–	(15)
Transfer to other intangible assets	–	(3)	–	(3)
Reclassification between categories	17	(18)	1	–
Disposals	(41)	(136)	(95)	(272)
Exchange adjustments	64	51	21	136
At 31 December 2010	2,477	2,681	701	5,859
Depreciation and impairment				
At 1 January 2009	605	1,690	586	2,881
Depreciation charge for the year	80	184	51	315
Impairment charge for the year	11	2	10	23
Reclassification between categories	(5)	5	–	–
Disposals	(20)	(73)	(32)	(125)
Exchange adjustments	(27)	(63)	(51)	(141)
At 31 December 2009	644	1,745	564	2,953
Depreciation charge for the year	101	201	34	336
Impairment charge for the year	29	–	14	43
Transfers to inventories	–	(5)	(3)	(8)
Transfer to investment properties	(1)	–	–	(1)
Transfer to other intangible assets	–	(1)	–	(1)
Reclassification between categories	(12)	13	(1)	–
Disposals	(32)	(123)	(80)	(235)
Exchange adjustments	12	29	17	58
At 31 December 2010	741	1,859	545	3,145
Net book value:				
Freehold property	1,511	–	–	1,511
Long leasehold property	173	–	–	173
Short leasehold property	52	–	–	52
Plant and machinery	–	734	–	734
Fixtures, fittings and equipment	–	88	–	88
Aircraft	–	–	156	156
At 31 December 2010	1,736	822	156	2,714
At 31 December 2009	1,551	806	195	2,552
At 1 January 2009	1,367	839	240	2,446

12. Property, plant and equipment *continued***Impairment****2010**

The impairment charge of £43m in 2010 mainly comprises charges in respect of the carrying values of land and buildings in Saudi Arabia (£16m) and the US (£10m), and aircraft within the Regional Aircraft business (£14m). The impairment impacts the following segments: Electronics, Intelligence & Support (£10m); Land & Armaments (£3m); International (£16m); and HQ & Other Businesses (£14m).

2009

The impairment charge of £23m mainly comprised charges in respect of aircraft carrying values within the Regional Aircraft business (£8m) and a £13m charge following the reassessment of the carrying value of certain assets within the International operating group. The impairment impacted the International (£13m), HQ & Other Businesses (£8m) and Land & Armaments (£2m) segments.

Assets in the course of construction

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Assets in the course of construction (including investment property (note 13))				
At 31 December 2010	67	77	–	144
At 31 December 2009	133	76	–	209

Finance leases

	Land and buildings £m	Plant and machinery £m	Aircraft £m	Total £m
Net book value of assets held as capitalised finance leases				
At 31 December 2010	–	–	–	–
At 31 December 2009	–	–	5	5

At 31 December 2009, none of the assets held under finance leases were sublet under operating leases.

Operating leases

The future aggregate minimum lease income from the non-cancellable elements of operating leases for assets capitalised (including investment property (note 13)) are as follows:

	2010 £m	2009 £m
Receipts due:		
Not later than one year	68	78
Later than one year and not later than five years	173	201
Later than five years	185	23
	426	302

Under the terms of the lease agreements, no contingent rents are receivable. The leases have varying terms including escalation clauses and renewal rights. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations. There is no lease income relating to assets held by the Group under capitalised finance leases within the above.

13. Investment property

	£m
Cost	
At 1 January 2009	153
Transfer from property, plant and equipment	2
At 31 December 2009	155
Additions	14
Transfer from property, plant and equipment	15
Disposals	(7)
At 31 December 2010	177
Depreciation and impairment	
At 1 January 2009	41
Depreciation charge for the year	3
At 31 December 2009	44
Depreciation charge for the year	3
Transfer from property, plant and equipment	1
Disposals	(5)
At 31 December 2010	43
Net book value of investment property	
At 31 December 2010	134
At 31 December 2009	111
At 1 January 2009	112
Fair value of investment property	
At 31 December 2010	233
At 31 December 2009	166

The fair values above are based on and reflect current market values as prepared by in-house professionals. The valuations were prepared by persons having the appropriate professional qualification, and with recent experience of valuing properties in the location and of the type being valued.

	2010 £m	2009 £m
Rental income from investment property	22	20

14. Equity accounted investments

Carrying value of equity accounted investments

	Share of net assets £m	Purchased goodwill £m	Carrying value £m
At 1 January 2009	374	660	1,034
Share of results after tax – continuing operations	187	–	187
Share of results after tax – discontinued operations (note 9)	16	–	16
Disposal	28	–	28
Reclassification to intangible assets (note 11)	–	(253)	(253)
Dividends – continuing operations	(74)	–	(74)
Dividends – discontinued operations	(3)	–	(3)
Market value adjustments in respect of derivative financial instruments, net of tax	5	–	5
Actuarial losses on defined benefit pension schemes, net of tax	(38)	–	(38)
Foreign exchange adjustment	(31)	(25)	(56)
At 31 December 2009	464	382	846
Share of results after tax – continuing operations	131	–	131
Share of results after tax – discontinued operations (note 9)	2	–	2
Acquisitions	2	–	2
Equity accounted investment funding	7	–	7
Disposal	(125)	(30)	(155)
Dividends – continuing operations	(67)	–	(67)
Dividends – discontinued operations	(4)	–	(4)
Market value adjustments in respect of derivative financial instruments, net of tax	3	–	3
Actuarial gains on defined benefit pension schemes, net of tax	28	–	28
Foreign exchange adjustment	4	(10)	(6)
At 31 December 2010	445	342	787

On 30 October 2009, the BVT Surface Fleet Limited (BVT) joint venture became a wholly-owned subsidiary of the Group after VT Group plc (VT) exercised its option to sell its 45% shareholding in BVT to BAE Systems (see note 29). As part of the transaction, the Group's shareholding in Fleet Support Limited also increased from 55% to 100%. On the date of the transaction, the Group gained full control of BVT, which was previously jointly controlled with VT.

Goodwill arising on the formation of the BVT joint venture in 2008 (£225m) and goodwill associated with the Group's initial 50% shareholding in Fleet Support Limited (£28m) was reclassified to intangible assets (see note 11) in 2009 in accordance with IFRS 3 (2004).

On 3 June 2010, the Group sold half of its 20.5% shareholding in Saab AB to Investor AB for a cash consideration of SEK1,041m (£92m) (see note 9). Following the loss of significant influence over the company, the Group has discontinued the use of the equity method and the remaining shareholding in Saab is shown within other financial assets as a financial asset at fair value through profit or loss at 31 December 2010 (see note 17). The Group's share of the results of Saab to the date of disposal is shown within discontinued operations for the current and prior periods.

Included within purchased goodwill is £59m (2009 £89m) relating to the goodwill arising on acquisitions made by the Group's equity accounted investments subsequent to their acquisition by the Group.

14. Equity accounted investments *continued*

Share of results of equity accounted investments by operating group – continuing operations

	2010 £m	Restated ¹ 2009 £m
Share of results excluding finance costs and taxation expense:		
Electronics, Intelligence & Support	1	1
Land & Armaments	8	(3)
Programmes & Support	24	77
International	143	135
HQ & Other Businesses	1	–
	177	210
Financial (expense)/income	(2)	2
Taxation expense	(44)	(25)
	131	187

Share of the assets and liabilities of equity accounted investments

	2010 £m	2009 £m
Assets:		
Non-current assets	803	990
Current assets	3,014	3,313
	3,817	4,303
Liabilities:		
Non-current liabilities	(466)	(678)
Current liabilities	(2,564)	(2,779)
	(3,030)	(3,457)
Carrying value	787	846

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

Contingent liabilities

The Group is not aware of any material contingent liabilities in respect of equity accounted investments.

Principal equity accounted investments

Joint ventures	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
Eurofighter Jagdflugzeug GmbH (Held by BAE Systems plc)	Management and control of the Typhoon programme	33% ordinary	Germany	Germany
MBDA SAS (Held via BAE Systems Electronics Limited and BAE Systems (Overseas Holdings) Limited)	Development and manufacture of guided weapons	37.5% ordinary	Europe	France

The Group comprises a large number of equity accounted investments and it is not practical to include all of them in the above list. The list therefore only includes those equity accounted investments which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2010 will be annexed to the Company's next annual return filed with the Registrar of Companies.

15. Other investments

	2010 £m	2009 £m
Non-current		
Available-for-sale financial assets		
Equity securities	11	6
	11	6
Current		
Available-for-sale financial assets		
Government bonds ¹	260	211
	260	211
Reconciliation of movements		
	2010 £m	2009 £m
Non-current		
At 1 January	6	6
Fair value movements	5	–
At 31 December	11	6
Current		
At 1 January	211	–
Additions	40	209
Fair value movements	9	2
At 31 December	260	211

1 The government bonds are held in a Trust in respect of the Group's UK pension schemes (see page 40).

16. Trade and other receivables

	2010 £m	2009 £m
Non-current		
Other receivables	218	156
Pension prepayment (note 21)	49	42
Prepayments and accrued income	15	3
	282	201
Current		
Long-term contract balances	6,586	7,034
Less: attributable progress payments	(5,680)	(5,941)
Amounts due from contract customers	579	482
Amounts due from customers for contract work ¹	1,485	1,575
Trade receivables	1,252	1,452
Amounts owed by equity accounted investments (note 31)	307	207
Other receivables	200	274
Prepayments and accrued income	315	256
	3,559	3,764

1 There are no retentions against long-term contracts (2009 £nil) and no amounts that are past due within amounts due from customers for contract work (2009 £nil).

The aggregate amount of costs incurred and recognised profits (less recognised losses) to date in respect of contracts in progress at 31 December 2010 are estimated to be £31.9bn (2009 £36.9bn).

16. Trade and other receivables *continued*

The ageing of trade receivables is detailed below:

	2010			2009		
	Gross £m	Provision £m	Net £m	Gross £m	Provision £m	Net £m
Not past due and not impaired	1,065	–	1,065	1,194	–	1,194
Up to 180 days overdue and not impaired	117	–	117	233	–	233
Up to 180 days overdue and impaired	1	(1)	–	9	(2)	7
Past 180 days overdue and not impaired	70	–	70	18	–	18
Past 180 days overdue and impaired	40	(40)	–	45	(45)	–
	1,293	(41)	1,252	1,499	(47)	1,452

Trade receivables are disclosed net of a provision for impairment losses. Movement on the provision is as follows:

	2010 £m	2009 £m
At 1 January	47	50
Created	23	36
Released	(22)	(27)
Exchange adjustments	1	(2)
Acquisitions	–	2
Utilised	(8)	(12)
At 31 December	41	47

Other receivables do not contain assets which are considered to be impaired.

The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered an issue. For the remaining trade receivables, the provision has been calculated taking into account individual assessments based on past credit history and prior knowledge of debtor insolvency or other credit risk.

17. Other financial assets and liabilities

	2010 Assets £m	2010 Liabilities £m	2009 Assets £m	2009 Liabilities £m
Non-current				
Cash flow hedges – foreign exchange contracts	57	(77)	100	(95)
Other foreign exchange/interest rate contracts	25	(178)	6	(166)
Debt-related derivative financial instruments – assets ¹	28	–	27	–
	110	(255)	133	(261)
Current				
Cash flow hedges – foreign exchange contracts	92	(68)	158	(54)
Other foreign exchange/interest rate contracts	53	(41)	46	(40)
Fair value of 10.25% shareholding in Saab AB	127	–	–	–
Debt-related derivative financial instruments – assets ²	17	–	12	–
	289	(109)	216	(94)

¹ Includes fair value hedges of £9m (2009 £26m).

² Includes fair value hedges of £17m (2009 £12m).

The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (see note 19).

The notional principal amounts of the outstanding contracts are detailed in note 30.

Cash flow hedges

The hedged, highly probable forecast transactions denominated in foreign currency are predominantly expected to occur at various stages during the next 12 months. The majority of those extending beyond 12 months are expected to have been transacted within five years of the balance sheet date.

Amounts debited to the hedging reserve in respect of cash flow hedges were £84m (2009 £393m).

The amount reclassified from equity to the income statement was £3m (2009 £nil). The amount credited from equity and included in contract-related non-financial assets and liabilities was £1m (2009 debit £39m). The ineffective portion recognised in the income statement that arises from cash flow hedges amounts to £3m (2009 £nil).

Fair value hedges

The net loss arising in the income statement on fair value hedging instruments was £6m which comprises gains of £17m, less losses of £23m (2009 loss £20m). The net gain arising in the income statement on the fair value of the underlying hedged items was £6m which comprises gains of £23m, less losses of £17m (2009 gain £20m). The ineffective portion recognised in the income statement that arises from fair value hedges amounts to a gain of £6m (2009 £4m).

18. Inventories

	2010 £m	2009 £m
Short-term work-in-progress	245	451
Raw materials and consumables	287	312
Finished goods and goods for resale	112	124
	644	887

The Group recognised £10m (2009 £35m) as a write down of inventories to net realisable value.

19. Loans and overdrafts

	2010 £m	2009 £m
Non-current		
US\$1bn 6.4% bond, repayable 2011	–	645
Class B and Class G certificates, final instalments 2013	266	379
Euro-Sterling £100m 10¾% bond, repayable 2014	100	100
US\$500m 4.95% bond, repayable 2014	318	308
US\$750m 5.2% bond, repayable 2015	477	463
Albertville Hangar Bond, repayable 2018	6	6
US\$1bn 6.375% bond, repayable 2019	645	608
US\$500m 7.5% bond, repayable 2027	317	307
Debt-related derivative financial instruments – liabilities	4	23
Obligations under finance leases	–	1
	2,133	2,840
Current		
Bank loans and overdrafts	11	15
US\$500m 4.75% bond, repayable 2010	–	322
US\$1bn 6.4% bond, repayable 2011	656	–
Class B and Class G certificates, final instalments 2011/2013	108	110
Debt-related derivative financial instruments – liabilities	1	–
US\$ Commercial Paper	144	–
Obligations under finance leases	–	6
	920	453

The maturity of the Group's borrowings is as follows:

	Less than one year £m	Between one and five years £m	More than five years £m	Total £m
At 31 December 2010				
Carrying amount ¹	920	1,171	962	3,053
Debt-related derivative financial instruments – assets	(17)	(9)	(19)	(45)
Carrying amount including debt-related derivative financial instruments – assets	903	1,162	943	3,008
Contractual cash flows, including future interest payments	1,052	1,548	1,390	3,990
At 31 December 2009				
Carrying amount ¹	453	1,453	1,387	3,293
Debt-related derivative financial instruments – assets	(12)	(26)	(1)	(39)
Carrying amount including debt-related derivative financial instruments – assets	441	1,427	1,386	3,254
Contractual cash flows, including future interest payments	583	1,849	1,890	4,322

1 The carrying amount of loans and overdrafts at 31 December 2010 excludes debt-related derivative financial assets of £45m (2009 £39m) presented as other financial assets.

Contractual cash flows in respect of all other financial liabilities are equal to the balance sheet carrying amount. Current contractual amounts relating to other financial liabilities, such as trade payables, are settled within the normal operating cycle of the business.

19. Loans and overdrafts *continued*

The US\$1bn 6.4% bond, repayable 2011, has been partially converted to a floating rate bond by utilising a series of interest rate swaps. US\$500m has been swapped to a floating rate until maturity of the bond in 2011. This has been overlaid by US\$300m of floating to fixed interest rate swaps that fix the interest payments at a lower rate than the original coupon. The effective interest rate during 2010 was 5.16% with an interest rate split on the bond at 31 December 2010 being US\$800m fixed and US\$200m floating.

The Class B and Class G certificates are repayable in 2011 and 2013, respectively, with fixed US\$ coupon rates of 7.16% and 6.66%, giving a weighted average interest rate of 6.88%. At 31 December 2010, the gross outstanding principal due is US\$571m. Of this balance, US\$197m has been converted to a sterling floating rate bond by utilising a series of cross-currency swaps. Subsequently, £114m has been re-fixed utilising a sterling interest rate swap. The overall effective rate during 2010 is 2.86% on these elements.

The US\$500m 4.95% bond, repayable 2014, was converted on issue to a floating rate bond utilising a series of interest rate swaps giving an effective rate during 2010 of 2.45%.

The Albertville Hangar Bond is a floating rate bond with an effective interest rate of 3.24%. This bond has been converted to a fixed rate using a floating to fixed rate swap, fixing the rate at 3.52%.

US\$500m of the US\$1bn 6.375% bond, repayable 2019, has been converted to a floating rate bond utilising a series of interest rate swaps that mature in December 2014 and give an effective rate during 2010 of 5.0%.

The US\$500m 7.5% bond, repayable 2027, was converted at issue to a sterling fixed rate bond by utilising a cross-currency swap and has an effective interest rate of 7.73%.

The US\$500m 4.75% bond, repayable 2010, was converted on issue to a floating rate bond by utilising interest rate swaps giving an effective rate during 2010 of 3.67%. The bond was repaid in August 2010.

The debt-related derivative financial instruments represent the fair value of certain interest rate and cross-currency derivatives relating to the US\$1bn 6.4% bond, repayable 2011, Class B and Class G certificates, final instalments 2011/2013, the US\$1bn 6.375% bond, repayable 2019, and the US\$500m 7.5% bond, repayable 2027. These derivatives have been entered into specifically to manage the Group's exposure to foreign exchange or interest rate risk.

Finance lease obligations

	2010 £m	2009 £m
Finance lease liabilities – minimum lease payments due:		
Not later than one year	–	7
Later than one year and not later than five years	–	1
	–	8
Future finance charges on finance leases	–	(1)
Present value of finance lease liabilities	–	7
Present value of finance lease liabilities – payments due:		
Not later than one year	–	6
Later than one year and not later than five years	–	1
	–	7

The average interest rate on finance lease payables at 31 December 2009 was 5%.

20. Trade and other payables

	2010 £m	Restated ¹ 2009 £m
Non-current		
Amounts due to long-term contract customers	181	142
Cash received on customers' account ² for long-term contracts	–	5
Other payables	339	332
Accruals and deferred income ³	174	43
	694	522
Current		
Amounts due to long-term contract customers	5,036	5,696
Amounts due to other customers	193	216
Cash received on customers' account ² :		
Long-term contracts	7	14
Others	9	1
Trade payables	1,114	1,063
Amounts owed to equity accounted investments (note 31)	1,232	1,353
Other taxes and social security costs	57	51
Other payables ⁴	636	851
Accruals and deferred income	1,068	1,136
	9,352	10,381

Included above:

	2010 £m	Restated ¹ 2009 £m
Amounts due to long-term contract customers	5,224	5,857
Advances from long-term contract customers, including progress payments in respect of work not yet performed	5,026	5,416

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

2 Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance.

3 Includes £125m at 31 December 2010 in respect of the three Offshore Patrol Vessels under the terminated Trinidad and Tobago contract.

4 Other payables at 31 December 2009 includes the regulatory penalties of £278m reflecting the global settlement of the regulatory investigations by the US Department of Justice (DoJ) and the UK's Serious Fraud Office (SFO). Other payables at 31 December 2010 includes £30m in respect of the global settlement with the UK's SFO following payment of the DoJ penalty during the year.

21. Retirement benefit obligations

Pension plans

BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans, and the assets are held in separate trustee administered funds. The plans in other countries are defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19, *Employee Benefits*, deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries as updated to take account of the requirements of IAS 19 to assess the deficits of the plans at 31 December each year. Plan assets are shown at the bid value.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2010. These plans were rolled forward to reflect the information at 31 December 2010. The method of accounting for these is similar to that used for defined benefit pension plans.

21. Retirement benefit obligations *continued*

The financial assumptions used to calculate liabilities for the principal plans are:

	UK			US		
	2010 %	2009 %	2008 %	2010 %	2009 %	2008 %
Discount rate	5.5	5.7	6.3	5.5	5.9	6.5
Inflation rate	3.4	3.5	2.9	3.0	3.0	3.0
Rate of increase in salaries	4.4	4.5	3.9	4.5	4.5	5.5
Rate of increase for pensions in payment	2.3 – 3.6	2.3 – 3.7	2.2 – 3.4	–	–	–
Rate of increase for deferred pensions ¹	2.8 – 3.4	3.5	2.9	–	–	–
Long-term healthcare cost increases	–	–	–	5.3	5.3	5.3

1 The assumption for the rate of deferred pension increases of 2.8% is in respect of those schemes which refer to the Consumer Prices Index as the relevant measure.

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid values of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present values of plan liabilities, which are derived from cash flow projections over long periods and therefore inherently uncertain, as at 31 December are shown in the tables below.

Discount rate assumptions are based on third-party AA corporate bond indices and yields that reflect the maturity profile of the expected benefit payments. The inflation rate assumptions are derived by reference to the difference between the yields on index-linked and fixed-interest long-term government bonds, or advice from the local actuary depending on the available information. The inflation assumptions are used to derive the rate of increase for pensions in payment and the rate of increase in deferred pensions where there is such an increase.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2010, continued to use PA 00 medium cohort tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of plan members. In addition, this mortality has been subject to a minimum assumed rate of future annual mortality improvements of 1%. For its US pension arrangements, the mortality tables used are RP 2000 projected to 2018 for pensioners and projected to 2025 for non-pensioners. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 19 to 23 years for current male pensioners at age 65 and 21 to 26 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 8.0% in 2011 reducing to 5% by 2017 for pre-retirement and 8.5% in 2011 reducing to 5% by 2018 for post-retirement.

A summary of the movements in the retirement benefit obligations is shown below. The full disclosures, as required by IAS 19, are provided in the subsequent information.

Summary of movements in retirement benefit obligations

	UK £m	US and other £m	Total £m
Total IAS 19 deficit at 1 January 2010	(5,006)	(610)	(5,616)
Actual return on assets above expected return	917	126	1,043
Decrease/(increase) in liabilities due to changes in assumptions	314	(259)	55
Additional contributions	301	–	301
Recurring contributions in excess of service cost	193	60	253
Past service cost	(39)	–	(39)
Curtailment gains	–	2	2
Net financing (charge)/credit	(118)	15	(103)
Exchange translation	–	(21)	(21)
Movement in US healthcare plans	–	22	22
Total IAS 19 deficit at 31 December 2010	(3,438)	(665)	(4,103)
Allocated to equity accounted investments and other participating employers	696	–	696
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers at 31 December 2010	(2,742)	(665)	(3,407)

The decrease in UK liabilities due to changes in assumptions includes a benefit of £348m arising from the change from the Retail Prices Index to the Consumer Prices Index as the measure of price inflation for the purposes of determining minimum statutory pension increases. With the exception of the BAE Systems 2000 Pension Plan (2000 Plan), this change has affected all of the Group's UK pension schemes for deferred pension increases, but has only affected two of the Group's smaller schemes for increases to pensions in payment.

21. Retirement benefit obligations *continued*

During the year, the Group contributed an additional £25m into Trust for the benefit of the Group's main pension scheme (2009 £225m). The cumulative contributions totalling £250m are reported within other investments (£260m after cumulative fair value gains of £11m) and cash and cash equivalents (£1m) at 31 December 2010, and the use of these assets is restricted under the terms of the Trust. The Group considers these contributions to be equivalent to the other lump sum contributions it makes into the Group's pension schemes and, accordingly, presents below a definition of the pension deficit including them.

	2010 £m	2009 £m
Group's share of IAS 19 deficit, net	(3,407)	(4,637)
Assets held in Trust	261	227
Pension deficit (as defined by the Group)	(3,146)	(4,410)

Amounts recognised on the balance sheet

	2010				2009			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Present value of unfunded obligations	(28)	(138)	(11)	(177)	(10)	(115)	(11)	(136)
Present value of funded obligations	(17,990)	(3,002)	(137)	(21,129)	(17,776)	(2,587)	(140)	(20,503)
Fair value of plan assets	14,580	2,496	127	17,203	12,780	2,135	108	15,023
Total IAS 19 deficit, net	(3,438)	(644)	(21)	(4,103)	(5,006)	(567)	(43)	(5,616)
Allocated to equity accounted investments and other participating employers	696	–	–	696	979	–	–	979
Group's share of IAS 19 deficit, net	(2,742)	(644)	(21)	(3,407)	(4,027)	(567)	(43)	(4,637)
Represented by:								
Pension prepayments (within trade and other receivables)	–	49	–	49	–	42	–	42
Retirement benefit obligations	(2,742)	(693)	(21)	(3,456)	(4,027)	(609)	(43)	(4,679)
	(2,742)	(644)	(21)	(3,407)	(4,027)	(567)	(43)	(4,637)

Group's share of IAS 19 deficit of equity accounted investments	(88)	–	–	(88)	(128)	–	–	(128)
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Amounts for the current and previous four years are as follows:

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Defined benefit pension plans					
Defined benefit obligations	(21,158)	(20,488)	(17,133)	(17,109)	(17,456)
Plan assets at bid value	17,076	14,915	12,978	15,110	14,289
Total deficit before tax and allocation to equity accounted investments and other participating employers	(4,082)	(5,573)	(4,155)	(1,999)	(3,167)
Actuarial gain/(loss) on plan liabilities	55	(3,342)	1,433	952	473
Actuarial gain/(loss) on plan assets at bid value	1,043	1,258	(3,724)	(156)	521

Total cumulative actuarial losses recognised in equity since the transition to IFRS are £2.5bn (2009 £3.4bn).

Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments. In the event that an employer who participates in the Group's pension schemes fails or cannot be compelled to fulfil its obligations as a participating employer, the remaining participating employers are obliged to collectively take on its obligations. The Group considers the likelihood of this event arising as remote.

21. Retirement benefit obligations *continued*

Assets of defined benefit pension plans

	2010							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,544	59	8.25	1,690	68	9.0	10,234	60
Bonds	4,765	33	4.7	613	25	6.0	5,378	31
Property ¹	1,084	7	6.0	108	4	7.0	1,192	7
Other	187	1	1.0	85	3	4.0	272	2
Total	14,580	100	6.8	2,496	100	8.0	17,076	100

	2009							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,195	64	8.25	1,384	65	9.25	9,579	64
Bonds	3,411	27	4.8	551	26	6.0	3,962	27
Property ¹	960	7	6.0	101	5	7.0	1,061	7
Other	214	2	1.0	99	4	4.0	313	2
Total	12,780	100	7.0	2,135	100	8.1	14,915	100

1 Includes £181m (2009 £168m) of properties occupied by Group companies.

When setting the overall expected rate of return on plan assets, historical markets are studied, and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

Changes in the fair value of plan assets are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Value of plan assets at 1 January 2009	11,159	1,819	92	13,070
Expected return on assets	765	141	6	912
Actuarial gain	994	264	13	1,271
Actual return on assets	1,759	405	19	2,183
Contributions by employer	421	216	13	650
Contributions by employer in respect of employee salary sacrifice arrangements	107	–	–	107
Total contributions by employer	528	216	13	757
Members' contributions (including Department for Work and Pensions rebates)	36	18	–	54
Currency loss	–	(198)	(10)	(208)
Benefits paid	(702)	(125)	(6)	(833)
Value of plan assets at 31 December 2009	12,780	2,135	108	15,023
Expected return on assets	883	180	8	1,071
Actuarial gain	917	126	8	1,051
Actual return on assets	1,800	306	16	2,122
Contributions by employer	653	113	8	774
Contributions by employer in respect of employee salary sacrifice arrangements	108	–	–	108
Total contributions by employer	761	113	8	882
Members' contributions (including Department for Work and Pensions rebates)	37	16	–	53
Currency gain	–	65	3	68
Benefits paid	(798)	(139)	(8)	(945)
Value of plan assets at 31 December 2010	14,580	2,496	127	17,203

21. Retirement benefit obligations *continued*

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Defined benefit obligations at 1 January 2009	(14,231)	(2,902)	(153)	(17,286)
<i>Current service cost</i>	(92)	(70)	(3)	(165)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(107)	–	–	(107)
Total current service cost	(199)	(70)	(3)	(272)
Members' contributions (including Department for Work and Pensions rebates)	(36)	(18)	–	(54)
Past service cost	(18)	(3)	–	(21)
Actuarial loss on liabilities	(3,120)	(222)	(8)	(3,350)
Curtailment gains	–	261	–	261
Interest expense	(884)	(167)	(9)	(1,060)
Currency gain	–	294	16	310
Benefits paid	702	125	6	833
Defined benefit obligations at 31 December 2009	(17,786)	(2,702)	(151)	(20,639)
<i>Current service cost</i>	(159)	(53)	(2)	(214)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(108)	–	–	(108)
Total current service cost	(267)	(53)	(2)	(322)
Members' contributions (including Department for Work and Pensions rebates)	(37)	(16)	–	(53)
Past service cost	(39)	–	–	(39)
Actuarial gain/(loss) on liabilities	314	(259)	6	61
Curtailment gains	–	2	5	7
Interest expense	(1,001)	(165)	(8)	(1,174)
Currency loss	–	(86)	(6)	(92)
Benefits paid	798	139	8	945
Defined benefit obligations at 31 December 2010	(18,018)	(3,140)	(148)	(21,306)

Contributions

The Group contributions made to the defined benefit plans in the year ended 31 December 2010 were £695m (2009 £546m) excluding those amounts allocated to equity accounted investments and participating employers (£71m). This includes contributions of £157m into the UK schemes relating to the £500m share buyback programme completed in July 2010 and £51m into the 2000 Plan following the triennial actuarial valuation of that scheme. In 2011, the Group expects to make regular contributions at a similar level to those made in 2010.

The Group incurred a charge in respect of the cash contributions of £110m (2009 £127m) paid to defined contribution plans for employees. It expects to make contributions of £108m to these plans in 2011.

21. Retirement benefit obligations *continued*

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2010				2009			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Included in operating costs:								
Current service cost	(130)	(53)	(2)	(185)	(80)	(70)	(3)	(153)
Past service cost	(29)	–	–	(29)	(14)	(3)	–	(17)
	(159)	(53)	(2)	(214)	(94)	(73)	(3)	(170)
Included in other income:								
Pension curtailment gains	–	2	–	2	–	261	–	261
US healthcare curtailment gains	–	–	5	5	–	–	–	–
	–	2	5	7	–	261	–	261
Included in finance costs:								
Expected return on plan assets	728	180	8	916	630	141	6	777
Interest on obligations	(823)	(165)	(8)	(996)	(724)	(167)	(9)	(900)
	(95)	15	–	(80)	(94)	(26)	(3)	(123)
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	(8)	–	–	(8)	(9)	–	–	(9)
Group's share of equity accounted investments' finance costs	(3)	–	–	(3)	(3)	–	–	(3)

A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	One percentage point increase £m	One percentage point decrease £m
(Increase)/decrease in the aggregate of service cost and interest cost	(0.2)	0.1
(Increase)/decrease in defined benefit obligations	(2.4)	1.7

A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect:

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Decrease/(increase) in defined benefit obligations	1.7	(1.7)

22. Provisions

	Aircraft financing £m	Warranties and after-sales service £m	Reorganisations – continuing operations £m	Legal, contractual and environmental £m	Other £m	Total £m
Non-current	20	99	21	169	68	377
Current	18	64	126	263	81	552
At 1 January 2010	38	163	147	432	149	929
Created	5	69	204	164	21	463
Released	(5)	(24)	(16)	(55)	(33)	(133)
Utilised	(20)	(34)	(104)	(47)	(31)	(236)
Provisions and fair values arising on acquisitions (note 29)	–	–	–	4	12	16
Discounting	2	–	–	16	3	21
Exchange adjustments	–	7	–	7	3	17
At 31 December 2010	20	181	231	521	124	1,077
Represented by:						
Non-current	–	107	7	242	69	425
Current	20	74	224	279	55	652
	20	181	231	521	124	1,077

22. Provisions *continued*

Aircraft financing

The provision includes probable exposures under residual value guarantees issued by the Group on previous sales transactions. The Group has provided residual value guarantees in respect of certain commercial aircraft sold. At 31 December 2010, the Group's gross exposure to make future payments in respect of these arrangements was £33m (2009 £48m). The Group's net exposure to these guarantees is covered by the provisions held of £18m (2009 £32m) and the residual values of the related aircraft of £18m (2009 £12m).

Warranties and after-sales service

Warranties and after-sales service are provided in the normal course of business with provisions for associated costs being made based on an assessment of future claims with reference to past experience. Such costs are generally incurred within three years post-delivery. Whilst actual events could result in potentially significant differences to the quantum but not the timing of the outflows in relation to the provisions, management has reflected current knowledge in assessing the provision levels.

Reorganisations – continuing operations

The costs associated with the reorganisation programmes are supported by detailed plans and based on previous experience as well as other known factors. Such costs are generally incurred within one to three years. There is limited volatility around the timing and amount of the ultimate outflows related to these provisions.

The reorganisation provisions totalling £204m created in 2010 include £60m for which the Group is contractually entitled to reimbursement from the customer. This amount is included in prepayments and accrued income at 31 December 2010 (see note 16).

Legal, contractual and environmental provisions

The Group holds provisions for expected legal, contractual and environmental costs that it expects to incur over an extended period.

These costs are based on past experience of similar items and other known factors and represent management's best estimate of the likely outcome.

Reflecting the inherent uncertainty within many legal proceedings, the timing and amount of the outflows could differ significantly from the amount provided.

There are no individually significant amounts included in the legal, contractual and environmental provisions created in 2010 totalling £164m.

Other provisions

There are no individually significant provisions included within other provisions.

23. Contingent liabilities and commitments

Guarantees and performance bonds

The Group has entered into a number of guarantee and performance bond arrangements in the normal course of business. Provision is made for any amounts that the directors consider may become payable under such arrangements.

Operating lease commitments – where the Group is the lessee

The Group leases various offices, factories, shipyards and aircraft under non-cancellable operating lease agreements. The leases have varying terms including escalation clauses, renewal rights and purchase options. None of these terms represent unusual arrangements or create material onerous or beneficial rights or obligations.

The future aggregate minimum lease payments under non-cancellable operating leases and associated future minimum sublease income are as follows:

	2010 £m	2009 £m
Payments due:		
Not later than one year	222	180
Later than one year and not later than five years	608	571
Later than five years	670	704
	1,500	1,455
Total of future minimum sublease income under non-cancellable subleases	254	286

Capital commitments

Capital expenditure contracted for but not provided for in the accounts is as follows:

	2010 £m	2009 £m
Property, plant and equipment	103	126
Intangible assets	4	7
	107	133

24. Share capital and other reserves

Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2009	3,582	90	1	1	90
Exercise of options	3	–	–	–	–
At 1 January 2010	3,585	90	1	1	90
Exercise of options	2	–	–	–	–
At 31 December 2010	3,587	90	1	1	90

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

Treasury shares

During the year, 143,951,447 ordinary shares of 2.5p each were repurchased under the buyback programme completed in July 2010.

As at 31 December 2010, 178,377,628 (2009 43,952,360) ordinary shares of 2.5p each with an aggregate nominal value of £4,459,441 (2009 £1,098,809) were held in treasury. During 2010, 9,526,179 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Share Matching Plan (2009 11,086,593 to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme).

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and November 2010.

At 31 December 2010, the ESOP held 2,202,800 (2009 3,644,598) ordinary shares of 2.5p each with a market value of £7m (2009 £13m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2010 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and November 2010 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

Capital

The Group funds its operations through a mixture of equity funding and debt financing, including bank and capital market borrowings.

At 31 December 2010, the Group's capital was £5,356m (2009 £4,550m), which comprises total equity of £5,403m (2009 £4,663m), less amounts accumulated in equity relating to cash flow hedges of £47m (2009 £113m). Net debt (as defined by the Group) was £242m (2009 net cash £403m).

The capital structure of the Group reflects the judgement of the directors of an appropriate balance of funding required. The Group's policy is to maintain an investment grade credit rating. The Group's dividend policy is to grow the dividend whilst maintaining a long-term sustainable earnings cover of approximately two times.

24. Share capital and other reserves *continued***Other reserves**

	Merger reserve £m	Statutory reserve £m	Revaluation reserve £m	Translation reserve £m	Hedging reserve £m	Total £m
At 1 January 2010 (restated ¹)	4,589	202	10	485	113	5,399
Currency translation on foreign currency net investments:						
Subsidiaries	–	–	–	160	–	160
Equity accounted investments	–	–	–	(6)	–	(6)
Amounts charged to hedging reserve	–	–	–	–	(84)	(84)
Recycling of cumulative currency translation reserve on disposal	–	–	–	(17)	–	(17)
Recycling of cumulative net hedging reserve on disposal	–	–	–	–	(4)	(4)
Current tax on items taken directly to equity	–	–	–	–	(2)	(2)
Deferred tax on items taken directly to equity	–	–	–	–	24	24
At 31 December 2010	4,589	202	10	622	47	5,470

¹ Revaluation reserve reduced by £64m following finalisation of the fair values recognised on acquisition of the 45% shareholding in BVT Surface Fleet Limited (see note 29).

Merger reserve

The merger reserve arose on the acquisition of the Marconi Electronic Systems (MES) business by British Aerospace in 1999 to form BAE Systems, and represents the amount by which the fair value of the shares issued by British Aerospace as consideration exceeded their nominal value.

Statutory reserve

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

Revaluation reserve

The revaluation reserve relates to the revaluation at fair value of the net assets previously held as an equity accounted investment relating to the BVT joint venture on the acquisition of the remaining 45% interest in 2009.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

25. Share-based payments

Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 96 to 119.

Executive Share Option Scheme (ExSOS)

Equity-settled options

	2010		2009	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	18,230	3.48	23,731	3.49
Exercised during the year	(3,242)	2.26	(1,931)	2.40
Expired during the year	(2,381)	4.13	(3,570)	4.14
Outstanding at the end of the year	12,607	3.67	18,230	3.48
Exercisable at the end of the year	12,607	3.67	13,506	3.09

Cash-settled share appreciation rights

	2010		2009	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	10,088	2.62	12,667	2.65
Exercised during the year	(1,531)	2.25	(1,420)	2.15
Expired during the year	(2,700)	3.74	(1,159)	3.54
Outstanding at the end of the year	5,857	2.20	10,088	2.62
Exercisable at the end of the year	5,857	2.20	10,088	2.62

	2010		2009	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	1.72 – 4.79	1.72 – 3.56	1.72 – 4.79	1.72 – 3.98
Weighted average remaining contracted life (years)	5	3	6	3
Expense/(credit) recognised for the year (£m)	2	(2)	2	(2)

Performance Share Plan (PSP)

Equity-settled options

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	26,195	20,880
Granted during the year	11,167	12,701
Exercised during the year	(3,123)	(4,445)
Expired during the year	(5,962)	(2,941)
Outstanding at the end of the year	28,277	26,195
Exercisable at the end of the year	1,029	2,212

Cash-settled share appreciation rights

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	817	3,143
Exercised during the year	(780)	(2,291)
Expired during the year	(12)	(35)
Outstanding at the end of the year	25	817
Exercisable at the end of the year	25	–

	2010		2009	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Weighted average remaining contracted life (years)	5	1	5	2
Weighted average fair value of options granted (£)	3.00	–	2.81	–
Expense recognised for the year (£m)	14	–	8	1

The exercise price for the PSP is £nil (2009 £nil).

25. Share-based payments *continued***Restricted Share Plan (RSP)**

All awards are equity-settled.

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	–	216
Exercised during the year	–	(216)
Outstanding at the end of the year	–	–

	2010	2009
Expense recognised for the year (£m)	–	–

The exercise price for the RSP is £nil (2009 £nil).

Share Matching Plan (SMP)

All awards are equity-settled.

	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	8,680	1,811
Granted during the year	5,881	7,661
Exercised during the year	(307)	(94)
Expired during the year	(1,229)	(698)
Outstanding at the end of the year	13,025	8,680
Exercisable at the end of the year	–	–

	2010	2009
Weighted average remaining contracted life (years)	2	2
Weighted average fair value of options granted (£)	3.80	3.43
Expense recognised for the year (£m)	2	3

The exercise price for the SMP is £nil (2009 £nil).

Save-As-You-Earn (SAYE)

Equity-settled options

	2010		2009	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	4	1.56	4,636	1.56
Exercised during the year	(4)	1.56	(4,550)	1.56
Expired during the year	–	–	(82)	1.54
Outstanding at the end of the year	–	–	4	1.56
Exercisable at the end of the year	–	–	4	1.56

25. Share-based payments *continued*

Cash-settled share appreciation rights

	2010		2009	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	–	–	2,895	3.56
Exercised during the year	–	–	(349)	3.56
Expired during the year	–	–	(2,546)	3.56
Outstanding at the end of the year	–	–	–	–

	2010		2009	
	Equity-settled	Cash-settled	Equity-settled	Cash-settled
Range of exercise price of outstanding options (£)	–	–	1.56	–
Credit recognised for the year (£m)	–	–	–	(1)

Details of options granted in the year

The fair value of both equity-settled awards granted in the year has been measured using the weighted average inputs below and the following valuation models:

PSP – Monte Carlo

SMP – Dividend valuation model

	2010	2009
Range of share price at date of grant (£)	3.23 – 3.80	3.23 – 3.43
Exercise price (£)	–	–
Expected option life (years)	3 – 4	3 – 4
Volatility	33 – 34%	34%
Spot dividend yield	–	4.2 – 4.6%
Risk free interest rate	1.0 – 1.8%	1.7 – 1.8%

Volatility was calculated with reference to the Group's weekly share price volatility, after allowing for dividends and stock splits, for the greater of 30 weeks or for the period until vest date.

The average share price in the year was £3.42 (2009 £3.44).

The liability in respect of the cash-settled elements of the schemes shown above and reported within liability provisions at 31 December 2010 is £5m (2009 £12m).

The intrinsic value of cash-settled options that have vested at 31 December 2010 is £6m (2009 £10m).

Share Incentive Plan

The Group also incurred a charge of £29m (2009 £31m) in respect of the all-employee free shares element of the Share Incentive Plan.

26. Reconciliation of operating business cash flow

	2010 £m	2009 £m
Cash inflow from operating activities	1,535	2,232
Assets contributed to Trust	(25)	(225)
Purchases of property, plant and equipment, and investment property	(408)	(483)
Purchases of intangible assets	(19)	(42)
Proceeds from sale of property, plant and equipment	68	36
Proceeds from sale of investment property	2	–
Equity accounted investment funding	(7)	–
Dividends received from equity accounted investments	71	77
Cash held for charitable contribution to Tanzania	(30)	–
Operating business cash flow	1,187	1,595
Electronics, Intelligence & Support	568	380
Land & Armaments	858	480
Programmes & Support	227	285
International	195	813
HQ & Other Businesses	(665)	(366)
Discontinued operations	4	3
Operating business cash flow	1,187	1,595

27. Net (debt)/cash (as defined by the Group)

	2010 £m	2009 £m
Debt-related derivative financial instrument assets – current	17	12
Debt-related derivative financial instrument assets – non-current	28	27
Other investments – current	260	211
Cash and cash equivalents	2,813	3,693
	3,118	3,943
Loans – non-current	(2,133)	(2,840)
Loans – current	(909)	(438)
Overdrafts – current	(11)	(15)
Loans and overdrafts – current	(920)	(453)
Less: Cash received on customers' account ¹	(16)	(20)
Less: Assets held in Trust	(261)	(227)
Less: Cash held for charitable contribution to Tanzania	(30)	–
	(3,360)	(3,540)
Net (debt)/cash (as defined by the Group)	(242)	403

Movement in net (debt)/cash (as defined by the Group)

	2010 £m	2009 £m
Operating business cash flow	1,187	1,595
Interest	(173)	(186)
Taxation	(352)	(350)
Free cash inflow	662	1,059
Acquisitions and disposals	(88)	(253)
Debt acquired on acquisition of subsidiary undertakings	–	(1)
Proceeds from issue of share capital	6	5
Equity dividends paid	(574)	(534)
Dividends paid to non-controlling interests	(32)	(5)
Purchase of own shares, including treasury shares	(526)	(25)
Cash (outflow)/inflow from matured derivative financial instruments	(123)	36
Cash inflow/(outflow) from movement in cash collateral	11	(11)
Movement in cash received on customers' account ¹	7	(12)
Foreign exchange translation	(20)	262
Other non-cash movements	32	(157)
Movement in net (debt)/cash (as defined by the Group)	(645)	364
Opening net cash (as defined by the Group)	403	39
Closing net (debt)/cash (as defined by the Group)	(242)	403

¹ Cash received on customers' account is the unexpended cash received from customers in advance of delivery which is subject to advance payment guarantees unrelated to Group performance. It is included within trade and other payables.

27. Net (debt)/cash (as defined by the Group) *continued*

Cash flows in relation to acquisitions and disposals

	Cash (consideration)/ proceeds £m	Cash and cash equivalents acquired £m	Total £m
Subsidiaries			
Atlantic Marine	(245)	18	(227)
Tenix Defence	65	–	65
OASYS	(15)	1	(14)
Other	(3)	–	(3)
Purchase of subsidiary undertakings	(198)	19	(179)
Equity accounted investments			
Other	(2)	–	(2)
Purchase of equity accounted investments	(2)	–	(2)
Other	1	–	1
Proceeds from sale of equity accounted investments – continuing operations	1	–	1
Saab	92	–	92
Proceeds from sale of equity accounted investments – discontinued operations	92	–	92
Total cash flows in relation to acquisitions and disposals	(107)	19	(88)

28. Dividends

Equity dividends	2010 £m	2009 £m
Prior year final 9.6p dividend per ordinary share paid in the year (2009 8.7p)	335	307
Interim 7.0p dividend per ordinary share paid in the year (2009 6.4p)	239	227
	574	534

After the balance sheet date, the directors proposed a final dividend of 10.5p (2009 9.6p). The dividend, which is subject to shareholder approval, will be paid on 1 June 2011 to shareholders registered on 26 April 2011. The ex-dividend date is 20 April 2011.

Shareholders who do not at present participate in the Company's Dividend Reinvestment Plan and wish to receive the final dividend in shares rather than cash should complete a mandate form for the Dividend Reinvestment Plan and return it to the registrars no later than 10 May 2011.

29. Acquisition of subsidiaries

Acquisition of subsidiaries for the year ended 31 December 2010

In 2010, the Group acquired Atlantic Marine Holding Company (Atlantic Marine) and OASYS Technology, LLC (OASYS). If the acquisitions had occurred on 1 January 2010, combined sales of Group and equity accounted investments would have been £22.5bn, revenue £21.2bn and profit £1,022m from continuing operations for the year ended 31 December 2010.

For all acquisitions made in the year, fair values remain provisional, but will be finalised within 12 months of acquisition.

Acquisition	Acquisition date	Percentage share	Total consideration £m	Goodwill £m	Consolidated results for the period from acquisition to 31 December 2010	
					Revenue £m	Profit after tax £m
Atlantic Marine	13 July 2010	100%	245	133	74	3
OASYS	19 October 2010	100%	33	28	7	1
			278	161	81	4

29. Acquisition of subsidiaries *continued*

Atlantic Marine

On 13 July 2010, the Group completed the acquisition of Atlantic Marine, a naval services and marine fabrication business, for \$372m (headline price of \$352m, plus purchase price adjustments of \$20m) (£245m). The business employs approximately 1,500 people at Mayport and Jacksonville, Florida, Moss Point, Mississippi, and Mobile, Alabama.

The acquisition complements BAE Systems' existing ship repair and upgrade capabilities serving the US Navy. The Group anticipates continued strong demand for naval support capabilities in the US and the acquisition is consistent with BAE Systems' strategy to address anticipated growth in Services activity in its home markets. Atlantic Marine operates two facilities in Jacksonville and Mobile, both of which are situated in deep water ports along some of the busiest trade routes in the US. Additionally, Atlantic Marine operates a facility located on the Mayport Naval Station near Jacksonville, the second largest homeport of US Navy surface combatants on the East and Gulf Coasts, and proposed as the new homeport for an aircraft carrier in the 2010 Quadrennial Defense Review. These opportunities do not translate into separately identifiable intangible assets, but represent much of the assessed value within Atlantic Marine supporting the recognised goodwill.

The goodwill is not expected to be deductible for tax purposes.

The Atlantic Marine acquisition had the following effect on the Group's assets and liabilities:

	Book value £m	Accounting policy alignments £m	Fair value adjustments £m	Fair value £m
Intangible assets	1	–	36	37
Property, plant and equipment	94	(1)	20	113
Inventories	–	1	–	1
Receivables	15	(1)	–	14
Deferred tax assets	1	–	–	1
Payables	(13)	(1)	(1)	(15)
Deferred tax liabilities	(23)	–	(18)	(41)
Provisions	(14)	–	(2)	(16)
Cash and cash equivalents	18	–	–	18
Net assets/(liabilities) acquired	79	(2)	35	112
Goodwill				133
Consideration – cash				245

The Group incurred acquisition-related costs of £5m related to external legal fees and due diligence costs. These costs have been included in operating costs.

The intangible assets acquired as part of the acquisition of Atlantic Marine of £37m primarily relate to customer relationships.

Receivables include trade receivables with a fair value and gross contractual value of £13m, which are expected to be fully recoverable.

OASYS

On 19 October 2010, the Group completed the acquisition of OASYS, a US manufacturer of electro-optical systems and sub-assemblies based in Manchester, New Hampshire, for cash consideration of \$24m (£15m) and a potential earn-out of up to \$29m (£18m). The fair value of the contingent consideration at the acquisition date is \$29m (£18m). Payment of the contingent consideration is dependent on the business achieving certain revenue targets for 2010 and 2011.

The net assets and goodwill included in the consolidated balance sheet as a result of this acquisition are £5m and £28m, respectively.

The acquisition of OASYS complements the existing Electronic Solutions business in the US and enhances the Group's product offerings in growing electro-optical markets. These opportunities do not translate to separately identifiable intangible assets, but represent much of the assessed value within OASYS supporting the recognised goodwill.

Adjustments to goodwill in respect of prior year acquisitions

Tenix Defence Holdings Pty Limited (Tenix Defence)

Outstanding issues concerning the acquisition of the Tenix Defence business in 2008, including the completion accounting process, have been resolved successfully with agreement of contingent payments totalling A\$127.5m (£74m, net of legal fees) from the former owners of the business. In September 2010, the Group received a payment of A\$112.5m (£65m, net of legal fees) with the remainder due in 2011. These payments reduce purchase consideration and, therefore, the amount of goodwill arising on consolidation is reduced by £64m (£74m, less £10m deferred tax) from £323m to £259m.

29. Acquisition of subsidiaries *continued*

Acquisition of subsidiaries for the year ended 31 December 2009

The most significant acquisition made by the Group during the year ended 31 December 2009 was of the 45% shareholding in BVT Surface Fleet Limited (BVT) held by VT Group plc (VT). If the acquisition had occurred on 1 January 2009, combined sales of Group and equity accounted investments, revenue and loss for the year ended 31 December 2009 from continuing operations would have been £22.4bn, £21.3bn and £74m, respectively.

BVT (now BAE Systems Surface Ships)

On 30 October 2009, the BVT joint venture became a wholly-owned subsidiary of the Group after VT Group plc exercised its option to sell its 45% shareholding in BVT to BAE Systems. Consideration paid including transaction costs for the remaining 45% interest was £348m. The now wholly-owned company has been renamed BAE Systems Surface Ships Limited (Surface Ships). The Group previously held a 55% interest in BVT, and accounted for its share of the results and net assets of BVT in accordance with IAS 31, *Interests in Joint Ventures*.

Total goodwill arising amounted to £584m, which comprised £225m on the initial formation of the BVT joint venture in the year ended 31 December 2008 and £359m arising on the acquisition of the 45% interest.

A final update of the fair values arising on acquisition has been undertaken, with the main adjustment being for additional losses identified on the export ship contracts amounting to £163m. The losses have arisen due to circumstances in existence prior to 1 July 2008, but those losses have only been identified in the current year. Goodwill has increased by £53m to £637m primarily reflecting 45% of the post-tax losses. In accordance with IFRS 3 (2004), the portion of these losses relating to the Group's original 55% interest in the joint venture has been reflected in the revaluation reserve (£64m), leaving a cumulative credit on that reserve of £10m. Comparatives for the year ended 31 December 2009 have been restated accordingly.

In the period from acquisition to 31 December 2009, Surface Ships contributed revenue and profit after tax of £338m and £34m, respectively, to the Group's consolidated results as a wholly-owned subsidiary.

The acquisition of BVT has had the following effect on the Group's assets and liabilities. The figures in the table below represent a 100% interest in BVT.

	Book value (30 October 2009) £m	Accounting policy alignments £m	Restated	
			Fair value adjustments £m	Fair value £m
Intangible assets	–	–	225	225
Property, plant and equipment	136	–	–	136
Inventories	61	–	–	61
Receivables	225	–	–	225
Deferred tax assets	2	–	22	24
Payables	(433)	–	(327)	(760)
Current tax (liabilities)/assets	(16)	–	27	11
Deferred tax liabilities	(6)	–	(63)	(69)
Provisions	(12)	–	–	(12)
Cash and cash equivalents	33	–	–	33
Net liabilities acquired	(10)	–	(116)	(126)
Goodwill				637
Fair value of net liabilities acquired and goodwill arising				511

Components of cost of acquisitions:

Fair value of consideration for initial 55% shareholding in 2008	189
Fair value of consideration for remaining 45% shareholding in 2009	348
Total cost of acquisition	537
Losses under equity method of initial 55% shareholding	(36)
Gain on revaluation of step acquisition	10
Fair value of net liabilities acquired and goodwill arising	511

Consideration satisfied by:

Cash paid on acquisition of remaining 45% shareholding in 2009	346
Directly attributable costs:	
Paid	2
Cash consideration	348
Fair value of net assets contributed to BVT joint venture for initial 55% shareholding in 2008	178
Directly attributable costs:	
Paid	11
Total cost of acquisition	537

29. Acquisition of subsidiaries *continued*

The intangible assets acquired as part of the acquisition of BVT of £225m represented order backlog.

Advanced Ceramics Research

The Group acquired Advanced Ceramics Research, Inc. in the US on 8 June 2009 for a consideration of \$14m (£9m). The net assets and goodwill included in the Group's consolidated balance sheet as a result of this acquisition were £1m and £8m, respectively.

30. Financial risk management

A discussion of the Group's treasury objectives and policies, and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net (debt)/cash (note 27) together with other financial assets and other financial liabilities (note 17), and other instruments deemed to be financial instruments under IAS 32, *Financial Instruments: Presentation*, including non-current receivables, non-current payables and non-current provisions.

Hedging instruments

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

	31 December 2010				31 December 2009			
	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Foreign exchange contracts								
Net forward (sales)/purchase contracts								
US dollar	(887)	5	15	(867)	(614)	202	53	(359)
Euro	1,851	495	8	2,354	1,882	392	17	2,291
Other	249	65	–	314	44	71	–	115
	1,213	565	23	1,801	1,312	665	70	2,047

	31 December 2010				31 December 2009			
	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Interest rate contracts								
Interest rate swap contracts								
US dollar	512	639	–	1,151	310	1,115	–	1,425
Sterling	31	84	–	115	31	115	–	146
	543	723	–	1,266	341	1,230	–	1,571

	31 December 2010				31 December 2009			
	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m	Not exceeding one year £m	Between one year and five years £m	More than five years £m	Total £m
Cross-currency swap contracts								
Net forward purchase contracts								
US dollar	51	945	320	1,316	51	965	310	1,326
	51	945	320	1,316	51	965	310	1,326

Fair value of financial instruments

The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;
- the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates; and
- the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

30. Financial risk management *continued*

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date¹.

	Net carrying amount 2010 £m	Estimated fair value 2010 £m	Net carrying amount 2009 £m	Estimated fair value 2009 £m
Assets				
Non-current				
Other receivables ²	233	233	159	159
Other financial assets	110	110	133	133
Current				
Available-for-sale investments	260	260	211	211
Other financial assets	289	289	216	216
Cash and cash equivalents	2,813	2,813	3,693	3,693
Liabilities				
Non-current				
Loans	(2,133)	(2,598)	(2,840)	(3,266)
Other financial liabilities	(255)	(255)	(261)	(261)
Current				
Loans and overdrafts	(920)	(940)	(453)	(454)
Other financial liabilities	(109)	(109)	(94)	(94)

1 The estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date.

2 Net carrying amount approximates to estimated fair value as there is no active market.

Fair value hierarchy

The fair value measurement hierarchy is as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – Inputs for the asset or liability that are not based on observable market data (i.e. unobservable inputs).

The following table presents the Group's assets and liabilities that are measured at fair value.

	2010				2009			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets								
Available-for-sale investments	260	–	–	260	211	–	–	211
Derivatives used for hedging	126	23	–	149	197	61	–	258
Financial assets at fair value through profit or loss	183	22	–	205	46	6	–	52
Debt-related derivative financial instruments	–	45	–	45	–	39	–	39
Total assets	569	90	–	659	454	106	–	560
Liabilities								
Loans	–	(801)	–	(801)	–	(1,118)	–	(1,118)
Derivatives used for hedging	(112)	(33)	–	(145)	(68)	(81)	–	(149)
Financial liabilities at fair value through profit or loss	(42)	(177)	–	(219)	(43)	(163)	–	(206)
Debt-related derivative financial instruments	–	(5)	–	(5)	–	(23)	–	(23)
Total liabilities	(154)	(1,016)	–	(1,170)	(111)	(1,385)	–	(1,496)

Level 1 includes foreign exchange hedges valued at unadjusted quoted prices at less than two years' maturity. Level 2 includes all other fair value items and foreign exchange hedges greater than two years' maturity.

Net financial liabilities of £8m measured at their 2010 balance sheet carrying value were transferred from Level 2 to Level 1 as a result of changes in maturity profile.

30. Financial risk management *continued***Interest rate risk**

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	2011 £m	2012 £m	2013 £m	2014 £m	Beyond 2014 £m
Assets					
Current					
Cash and cash equivalents	2,813	–	–	–	–
Liabilities					
Non-current					
Loans	(737)	(737)	(711)	(639)	–
Current					
Loans and overdrafts	(311)	–	–	–	–

Collateral

As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2010 totalled £nil (2009 £11m).

Interest rate risk

The Group's objective is to mitigate its exposure to interest rate fluctuations on borrowings and deposits through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps.

The Group's current interest rate management policy is that a minimum of 50% (2009 50%) and a maximum of 75% (2009 75%) of gross debt is maintained at fixed interest rates. At 31 December 2010, the Group had 65% (2009 62%) of fixed rate debt and 35% (2009 38%) of floating rate debt based on a gross debt of £3.0bn, including debt-related derivative financial assets (2009 £3.3bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2010, the Group had a total of \$1.5bn (2009 \$1.9bn) of this type of swap outstanding with a weighted average duration of 4.6 years (2009 4.2 years). In respect of the fixed rate debt, the weighted average period in respect of which interest is fixed was 5.7 years (2009 6.4 years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 3.3% (2009 3.4%), 2.7% on US dollars and 1.8% on sterling (2009 3.0% on US dollars and 2.3% on sterling). The cost of the fixed rate debt was 6.5% (2009 6.3%).

A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £12m (2009 £12m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £16m (2009 £17m).

Liquidity risk

Cash flow forecasting is performed by each line of business as part of the annual Integrated Business Planning process and as part of the monthly reporting cycle. The Group monitors a rolling forecast of liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities.

Surplus cash held by the operating groups over and above balances required for working capital management is loaned to the Group's centralised treasury department. Surplus cash is invested in interest bearing current accounts, term deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient headroom as determined by the line of business cash forecasts.

At 31 December 2010, the Group had a committed Revolving Credit Facility (RCF) of £2bn (2009 £1.455bn). The RCF is contracted until 2015, and was undrawn throughout the year.

30. Financial risk management *continued*

Credit risk

The Group is exposed to credit risk on its cash and cash equivalents to the extent of non-performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. The Group has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2010 of £2,813m (2009 £3,693m) was invested with 24 (2009 26) financial institutions. The system assigns a maximum exposure based on the counterparty's size, a composite credit rating and credit default swap price. These limits are regularly monitored and updated.

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has reduced its exposure to credit risk through this process.

The Group has material receivables due from the UK and US governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 5% of the balance (2009 5%).

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures.

The Group's objective is to reduce its exposure to volatility in earnings and cash flows as a result of movements in foreign currency exchange rates. The Group is exposed to a number of foreign currencies, the most significant being the US dollar.

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

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

31. Related party transactions

The Group has a related party relationship with its directors and key management (as disclosed in the Remuneration report on pages 96 to 119 and in note 7), its equity accounted investments (note 14) and the pension plans (note 21).

Transactions occur with the equity accounted investments in the normal course of business, are priced on an arm's-length basis and settled on normal trade terms. The more significant transactions are disclosed below:

Related party	Sales to related party		Purchases from related party		Amounts owed by related party		Amounts owed to related party		Lease income/ (expense) with related party		Management recharges	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Advanced Electronics Company Limited	–	–	149	–	1	–	–	–	–	–	–	–
BVT Surface Fleet Limited ¹	–	64	–	4	–	–	–	–	–	–	–	6
Eurofighter Jagdflugzeug GmbH	1,313	1,073	–	–	283	132	143 ³	159	–	–	–	–
FADEC International LLC	49	–	–	–	–	–	–	–	–	–	–	–
Gripen International KB	1	1	1	–	11	59	67 ³	98	–	–	–	–
MBDA SAS	36	46	162	302	10	4	1,010 ³	1,080	–	2	14 ³	18
Panavia Aircraft GmbH	40	52	92	103	1	9	12	15	–	–	–	–
Saab AB ²	3	5	20	17	–	–	–	1	–	–	–	–
CTA International SAS	–	–	–	–	–	3	–	–	–	–	–	–
Other	2	–	–	–	1	–	–	–	–	–	–	–
	1,444	1,241	424	426	307	207	1,232	1,353	–	2	14	24

1 To date of acquisition (30 October 2009).

2 To date of sale of half of the Group's 20.5% shareholding (3 June 2010).

3 Also relates to disclosures under Financial Reporting Standard 8, *Related Party Disclosures*, for the parent company, BAE Systems plc.

32. Group entities

Principal subsidiary undertakings	Principal activities	Group interest in allotted capital	Principally operates in	Country of incorporation
BAE Systems (Operations) Limited (Held via BAE Systems Enterprises Limited and BAE Systems (Overseas Holdings) Limited)	Defence and commercial aerospace activities	100% Ordinary	UK	England and Wales
BAE Systems Information and Electronic Systems Integration Inc. (Held via BAE Systems, Inc.)	Designs, develops and manufactures electronic systems and subsystems	100% Common	US	US
BAE Systems Land & Armaments LP 1300 North 17th Street, Suite 1400, Arlington VA 22209, USA (Partners: BAE Systems Land & Armaments Inc. and BAE Systems Land & Armaments Holdings Inc.)	Manufactures and supports military vehicles	100%	US	US
BAE Systems Tactical Vehicle Systems LP 5000 Interstate 10 West, Sealy, TX 77474, USA (Partners: BAE Systems TVS Holdings LLC and BAE Systems TVS Inc.)	Mobility and protection systems	100%	US	US

The Group comprises a large number of subsidiary undertakings and it is not practical to include all of them in the above list. The list therefore only includes those subsidiary undertakings which principally affected the Group accounts.

A full list of subsidiary, equity accounted investments and other associated undertakings as at 31 December 2010 will be annexed to the Company's next annual return filed with the Registrar of Companies.

No subsidiary undertakings are excluded from the Group consolidation.

33. Events after the balance sheet date

In January 2011, the Group entered into an agreement to acquire the 91.3% outstanding equity of Fairchild Imaging, Inc. for a cash consideration of \$86m (£55m). The California-based business provides solid-state electronic imaging components, cameras, and systems for aerospace, industrial, medical and scientific imaging applications. The acquisition complements the Group's electro-optics and night vision capabilities. The acquisition is conditional, among other things, upon receiving regulatory approval.

In January 2011, the Group announced a recommended €217m (£186m) cash offer for Norkom Group plc, a provider of innovative counter-fraud and anti-money laundering solutions to the global financial services industry.

On 15 February 2011, the Group acquired 100% of L-1 Identity Solutions, Inc.'s Intelligence Services Group, a leading provider of security and counter threat capabilities to the US government, for a cash consideration of approximately \$297m (£190m). The acquisition accounting exercise is yet to be undertaken.

Company balance sheet

as at 31 December

	Notes	2010 £m	2009 £m
Fixed assets			
Tangible assets	2	15	4
Investments in subsidiary undertakings	3	6,793	7,070
		6,808	7,074
Current assets			
Debtors due within one year	4	7,348	7,466
Debtors due after one year	4	10	14
Other financial assets due within one year	5	178	262
Other financial assets due after one year	5	157	179
Cash at bank and in hand		1,700	2,804
		9,393	10,725
Liabilities falling due within one year			
Loans and overdrafts	6	(39)	(37)
Creditors	7	(11,854)	(14,490)
Other financial liabilities	5	(157)	(255)
		(12,050)	(14,782)
Net current liabilities		(2,657)	(4,057)
Total assets less current liabilities		4,151	3,017
Liabilities falling due after one year			
Loans	6	(200)	(233)
Creditors	7	(6)	(3)
Other financial liabilities	5	(310)	(327)
		(516)	(563)
Provisions for liabilities and charges	8	(52)	(61)
		3,583	2,393
Capital and reserves			
Issued share capital	10	90	90
Share premium account	12	1,249	1,243
Statutory reserve	13	202	202
Other reserves	12	116	119
Profit and loss account	12	1,926	739
Equity shareholders' funds		3,583	2,393

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

I G King
Chief Executive

G W Rose
Group Finance Director

Notes to the Company accounts

1. Accounting policies

Basis of preparation

The financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss, and in accordance with applicable accounting standards in the United Kingdom (UK GAAP). The going concern basis has been applied in these 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 impairments. Dividends received and receivable are credited to the Company's profit and loss account. In accordance with Section 408(4) of the Companies Act 2006, the Company is exempt from the requirement to present its own profit and loss account. The amount of profit for the financial year of the Company is disclosed in note 12 to these accounts.

Relief under Sections 612 and 616 of the Companies Act 2006 is taken wherever possible. Accordingly, where such relief is available, the difference between the fair value and aggregate nominal value of shares is not recognised in either shareholders' funds or cost of investment.

Changes in accounting policies

The following amendments to existing standards have been adopted by the Company for the year ended 31 December 2010 and have not had a material impact on the Company's accounts:

- *Improvements to Financial Reporting Standards 2009* is a collection of amendments to five Financial Reporting Standards in order to maintain existing levels of convergence between UK GAAP and IFRS. In addition, the disclosure requirements in FRS 11, *Impairment of Fixed Assets and Goodwill*, have been strengthened;
- Amendment to FRS 25, *Financial Instruments: Presentation*, changes the classification from liabilities to equity of certain financial instruments;
- Amendment to FRS 20, *Share-based Payment: Group Cash-settled Share-based Payment Transactions*, which clarifies both the scope of the standard and the accounting for group cash-settled share-based payment transactions in the separate financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payment transaction; and
- Amendment to FRS 26, *Financial Instruments: Recognition and Measurement: Eligible Hedged Items*, clarifies how existing principles underlying hedge accounting should be applied to the designation of a one-sided risk in a hedged item and inflation in a financial hedged item.

The following amendments to existing standards are effective for the year ending 31 December 2011. They are not expected to have an impact on the Company's accounts.

- Amendment to FRS 25, *Financial Instruments: Presentation: Classification of Rights Issues*;
- Urgent Issues Task Force (UITF) Abstract 47, *Extinguishing Financial Liabilities with Equity Instruments*; and
- *Improvements to Financial Reporting Standards 2010*.

Cash flow statement

The Company is exempt under the terms of FRS 1 from the requirement to publish its own cash flow statement, as its cash flows are included within the consolidated cash flow statement of the Group.

Foreign currencies

Transactions in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated at the exchange rates ruling at the balance sheet date. These exchange differences are recognised in the profit and loss account unless they qualify for hedge accounting treatment, in which case the effective portion is recognised directly in a separate component of equity.

Tangible fixed assets

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

Buildings	up to 50 years, or the lease term if shorter
Computing equipment and short-life works equipment	3 to 5 years

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

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

Investments

The Company's investment in shares in Group companies are stated at cost less provision for impairment.

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. Deferred tax is recognised on an undiscounted basis in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date where there is an obligation to pay more tax, or a right to pay less tax, in the future.

Pensions and other post-retirement benefits

The Company contributes to Group pension plans operated in the UK. Details of the principal plans and the financial assumptions used are contained in the consolidated accounts of BAE Systems plc. As permitted by FRS 17, *Retirement Benefits*, the plans are accounted for as defined contribution plans, as the employer cannot identify its share of the underlying assets and liabilities of the plans. The employer's contributions are set in relation to the current service period and also to fund a series of agreed measures to address the pension scheme deficits.

Share options and own shares held

The Company issues equity-settled share options to Group employees. Equity-settled share options are measured at fair value at the date of grant using an option pricing model. The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of the number of shares that will actually vest.

1. Accounting policies *continued*

In accordance with UITF Abstract 25, *National Insurance Contributions on Share Option Gains*, the Company provides in full for the employer's national insurance liability estimated to arise on the future exercise of share options granted, except where the employee has agreed to settle the employer's national insurance liability as a condition of the grant of the options.

As required under UITF Abstract 38, *Accounting for ESOP Trusts*, the cost to the Company of own shares held is shown

as a deduction from shareholders' funds within the profit and loss account. Consideration paid or received for the purchase or sale of the Company's own shares in the ESOP trust is shown separately in the reconciliation of movements in shareholders' funds.

Dividends

Equity dividends on ordinary share capital are recognised as a liability in the period in which they are declared. The interim dividend is recognised when it has been approved by the Board and the final dividend is recognised when it has been approved by the shareholders at the Annual General Meeting.

2. Tangible fixed assets

	Land and buildings £m	Plant and equipment £m	Total £m
Cost			
At 1 January 2010	9	27	36
Additions	–	4	4
Disposals	–	(24)	(24)
Transfers from other Group companies	–	11	11
At 31 December 2010	9	18	27
Depreciation and impairment			
At 1 January 2010	6	26	32
Depreciation	1	3	4
Disposals	–	(24)	(24)
At 31 December 2010	7	5	12
Net book value			
At 31 December 2010	2	13	15
At 31 December 2009	3	1	4
	Land and buildings £m	Plant and equipment £m	Total £m
Net book value of:			
Long leasehold property	2	–	2
Fixtures, fittings and equipment	–	13	13
	2	13	15

3. Investments in subsidiary undertakings

	£m
Cost	
At 1 January 2010	7,131
Additions	14
Transfers to other Group companies ¹	(291)
At 31 December 2010	6,854
Impairment provisions	
At 1 January 2010 and 31 December 2010	61
Net carrying value	
At 31 December 2010	6,793
At 31 December 2009	7,070

1 Primarily comprises the transfer at book value of the Company's investment in BAE Systems Surface Ships Limited to BAE Systems Surface Fleet Solutions (Holdings) Limited.

4. Debtors

	2010 £m	2009 £m
Due within one year		
Corporation tax recoverable	260	243
Amounts owed by subsidiary undertakings	7,040	7,188
Amounts owed by Group joint ventures	5	3
Other debtors	20	6
Prepayments and accrued income	23	26
	7,348	7,466
Due after one year		
Other debtors	10	14
	10	14

Other debtors includes cash collateral of £nil (2009 £11m).

5. Other financial assets and liabilities

	2010 Assets £m	2010 Liabilities £m	2009 Assets £m	2009 Liabilities £m
Due within one year				
Cash flow hedges – foreign exchange contracts	5	–	4	–
Other foreign exchange/interest rate contracts	173	(157)	258	(255)
	178	(157)	262	(255)
Due after one year				
Cash flow hedges – foreign exchange contracts	1	–	5	–
Other foreign exchange/interest rate contracts	137	(310)	174	(327)
Debt-related derivative financial instruments – assets ¹	19	–	–	–
	157	(310)	179	(327)

1. The debt-related derivative financial instrument assets are presented as other financial assets. The debt-related derivative financial liabilities are presented as a component of loans and overdrafts (note 6).

Full disclosures relating to the Group's other financial assets and liabilities and financial risk management strategies are given in the Financial performance section of the Directors' report and note 30 to the Group accounts.

6. Loans and overdrafts

	2010 £m	2009 £m
Due within one year		
Bank loans and overdrafts	11	15
SYSTEMS 2001 Asset Trust Option Aircraft bond	27	22
Debt-related derivative financial instruments – liabilities	1	–
	39	37
Due after one year		
Euro-Sterling £100m 10¾% bond, repayable 2014	100	100
SYSTEMS 2001 Asset Trust Option Aircraft bond, final instalment 2013	96	119
Debt-related derivative financial instruments – liabilities	4	14
	200	233

Bank loans and overdrafts are at a floating rate of interest.

The SYSTEMS 2001 Asset Trust bonds are at a floating rate of interest, having been converted to a sterling floating rate bond by utilising a cross-currency swap which resulted in an effective interest rate during 2010 of 2.86% (2009 2.84%).

Loans and overdrafts are repayable as follows:

	Less than one year £m	Between one and two years £m	Between two and five years £m	More than five years £m	Total £m
At 31 December 2010					
Carrying amount	39	29	171	–	239
At 31 December 2009					
Carrying amount	37	29	204	–	270

The total amount of loans repayable by instalments, where any instalment is due after five years, is £nil (2009 £nil).

7. Creditors

	2010 £m	2009 £m
Due within one year		
Amounts owed to subsidiary undertakings	10,330	12,615
Amounts owed to Group joint ventures	1,220	1,325
Other creditors ¹	263	511
Accruals and deferred income	41	39
	11,854	14,490
Due after one year		
Other creditors ²	6	3
	6	3

1 Other creditors at 31 December 2009 includes the regulatory penalties of £278m reflecting the global settlement of the regulatory investigations by the US Department of Justice (DoJ) and the UK's Serious Fraud Office (SFO). Other creditors at 31 December 2010 includes £30m in respect of the global settlement with the UK's SFO following payment of the DoJ penalty during the year.

2 Other creditors includes unfunded pension liabilities transferred from other Group companies.

8. Provisions for liabilities and charges

	Contracts and other £m
At 1 January 2010	61
Created	1
Transfers from other Group companies	1
Reclassified to other creditors	(6)
Utilised	(9)
Released	(1)
Discounting	5
At 31 December 2010	52

9. Contingent liabilities and commitments

Company guaranteed borrowings

Borrowings by subsidiary undertakings totalling £2,548m (2009 £2,646m) which are included in the Group's borrowings have been guaranteed by the Company.

10. Share capital

	Equity		Non-equity		Total
	Ordinary shares of 2.5p each		Special Share of £1		
	Number of shares m	Nominal value £m	Number of shares	Nominal value £	Nominal value £m
Issued and fully paid					
At 1 January 2009	3,582	90	1	1	90
Exercise of options	3	–	–	–	–
At 1 January 2010	3,585	90	1	1	90
Exercise of options	2	–	–	–	–
At 31 December 2010	3,587	90	1	1	90

Special Share

One Special Share of £1 in the Company is held on behalf of the Secretary of State for Business, Innovation and Skills (the Special Shareholder). Certain provisions of the Company's Articles of Association cannot be amended without the consent of the Special Shareholder. These provisions include the requirement that no foreign person, or foreign persons acting in concert, can have more than a 15% voting interest in the Company, the requirement that the majority of the directors are British, and the requirement that the Chief Executive and any executive Chairman are British citizens. The effect of these requirements can also be amended by regulations made by the directors and approved by the Special Shareholder.

The Special Shareholder may require the Company at any time to redeem the Special Share at par or to convert the Special Share into one ordinary voting share. The Special Shareholder is entitled to receive notice of and to attend general meetings and class meetings of the Company's shareholders but has no voting right, nor other rights, other than to speak in relation to any business in respect of the Special Share.

10. Share capital *continued*

Treasury shares

During the year, 143,951,447 ordinary shares of 2.5p each were repurchased under the buyback programme completed in July 2010.

As at 31 December 2010, 178,377,628 (2009 43,952,360) ordinary shares of 2.5p each with an aggregate nominal value of £4,459,441 (2009 £1,098,809) were held in treasury. During 2010, 9,526,179 treasury shares were used to satisfy awards and options under the Share Incentive Plan and the Share Matching Plan (2009 11,086,593 to satisfy awards and options under the Share Incentive Plan and the Save-As-You-Earn Share Option Scheme).

11. Employee share schemes

Options over shares of the ultimate parent undertaking, BAE Systems plc, have been granted to employees of the Company under various schemes. Details of the terms and conditions of each share option scheme are given in the Remuneration report on pages 96 to 119 of this report.

	Executive Share Option Scheme				Save-As-You-Earn			
	2010		2009		2010		2009	
	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £	Number of shares '000	Weighted average exercise price £
Outstanding at the beginning of the year	8,745	3.41	11,262	3.48	–	–	142	1.56
Exercised during the year	(1,778)	2.22	(663)	2.37	–	–	(142)	1.56
Expired during the year	(792)	3.99	(1,854)	4.19	–	–	–	–
Outstanding at the end of the year	6,175	3.68	8,745	3.41	–	–	–	–
Weighted average remaining life (years)		5		6		–		–
Range of exercise price of outstanding options (£)		1.72 – 4.79		1.72 – 4.79		–		–
(Credit)/expense recognised for the year (£m)		(1)		1		–		–

	Share Matching Plan		Performance Share Plan		Restricted Share Plan	
	2010 Number of shares '000	2009 Number of shares '000	2010 Number of shares '000	2009 Number of shares '000	2010 Number of shares '000	2009 Number of shares '000
Outstanding at the beginning of the year	3,308	987	10,687	8,508	–	80
Granted during the year	1,972	2,490	3,831	4,765	–	–
Exercised during the year	(192)	(94)	(1,338)	(2,083)	–	(80)
Expired during the year	(90)	(75)	(2,123)	(503)	–	–
Outstanding at the end of the year	4,998	3,308	11,057	10,687	–	–
Weighted average remaining life (years)	1	2	5	5	–	–
Weighted average fair value of options granted (£)	3.80	3.43	2.93	2.81	–	–
Expense recognised for the year (£m)	1	2	4	4	–	–

The exercise price for the Share Matching Plan, Performance Share Plan and Restricted Share Plan is £nil (2009 £nil).

Information on options granted in the year can be found on page 171 (note 25 to the Group accounts).

12. Reserves

	Share premium account £m	Other reserves £m	Profit and loss account £m
At 31 December 2009	1,243	119	739
Profit for the year	–	–	2,223
Dividends paid	–	–	(574)
Share-based payments	–	–	54
Exercise of options	6	–	–
Purchase of own shares	–	–	(13)
Purchase of treasury shares	–	–	(503)
Movements in hedging reserve	–	(3)	–
At 31 December 2010	1,249	116	1,926

Other reserves

Other reserves for the Company comprise: capital reserve £24m (2009 £24m); hedging reserve £6m (2009 £9m); and non-distributable reserve arising from property disposals to other Group undertakings £86m (2009 £86m). The non-distributable reserve arising from property disposals to other Group undertakings relates to the revaluation surplus realised by the Company on properties which were sold to other Group companies as part of operational reorganisations in prior years. Amounts within this reserve will be transferred to the profit and loss account as distributable when the related properties are disposed of outside the Group, or written down following impairment.

Profit and loss account

The Company's profit for the financial year was £2,223m (2009 loss £777m). The non-distributable portion of the profit and loss account is £736m (2009 £736m).

Own shares held

Own shares held, including treasury shares and shares held by BAE Systems ESOP Trust, are recognised as a deduction from retained earnings.

BAE Systems ESOP Trust

The Group has an ESOP discretionary trust to administer the share plans and to acquire Company shares, using funds loaned by the Group, to meet commitments to Group employees. A dividend waiver was in operation for shares within the ESOP Trust, other than those owned beneficially by the participants, for the dividends paid in June and November 2010.

At 31 December 2010, the ESOP held 2,202,800 (2009 3,644,598) ordinary shares of 2.5p each with a market value of £7m (2009 £13m). The shares held by the ESOP are recorded at cost and deducted from retained earnings until such time as the shares vest unconditionally to employees.

A dividend waiver was in operation during 2010 and remains over shares within the Company's Share Incentive Plan Trust other than those shares owned beneficially by the participants. A dividend waiver was also in operation for the dividends paid in June and November 2010 over shares in the Group All-Employee Free Shares Plan Trust other than those shares owned beneficially by participants.

13. 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.

14. Other information

Employees

The total number of employees of the Company at 31 December 2010 was 846 (2009 721). Total staff costs, excluding charges for share options, were £116m (2009 £93m).

Total directors' emoluments, excluding Company pension contributions, were £6,741,000 (2009 £6,683,000). These emoluments were paid for their services on behalf of the BAE Systems Group. No emoluments related specifically to their work for the Company.

Company audit fee

Fees payable to the Company's auditor for the audit of the Company's annual accounts totalled £1,484,000 (2009 £1,486,000).

Five-year summary

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Income statement^{1,2,3}					
Continuing operations					
Sales including Group's share of equity accounted investments					
Electronics, Intelligence & Support	5,653	5,637	4,459	3,916	4,007
Land & Armaments	5,930	6,738	6,407	3,538	2,115
Programmes & Support	6,680	6,298	4,638	5,327	4,615
International	4,534	3,828	2,926	3,009	3,102
HQ & Other Businesses	278	254	235	243	295
Intra-operating group sales	(683)	(765)	(529)	(673)	(695)
	22,392	21,990	18,136	15,360	13,439
Underlying EBITA⁴					
Electronics, Intelligence & Support	668	575	506	437	429
Land & Armaments	604	604	566	324	168
Programmes & Support	529	670	491	456	331
International	478	419	417	403	387
HQ & Other Businesses	(65)	(71)	(101)	(203)	(146)
	2,214	2,197	1,879	1,417	1,169
Profit on disposal of businesses	1	68	238	40	13
Pension curtailment gains	2	261	–	–	–
Regulatory penalties	(18)	(278)	–	–	–
Uplift on acquired inventories	–	–	–	(12)	–
EBITA⁵	2,199	2,248	2,117	1,445	1,182
Amortisation and impairment of intangible assets	(517)	(1,259)	(303)	(297)	(139)
Finance costs including share of equity accounted investments	(194)	(698)	701	93	(174)
Profit before taxation	1,488	291	2,515	1,241	869
Taxation expense including share of equity accounted investments	(461)	(352)	(636)	(366)	(243)
Profit/(loss) for the year – continuing operations	1,027	(61)	1,879	875	626
Profit/(loss) for the year – discontinued operations	54	16	(111)	47	1,013
Profit/(loss) for the year	1,081	(45)	1,768	922	1,639
Balance sheet	2010 £m	2009 ⁶ £m	2008 £m	2007 £m	2006 £m
Intangible assets	11,216	11,306	12,306	9,559	7,595
Property, plant and equipment, and investment property	2,848	2,663	2,558	1,887	1,869
Non-current investments	798	852	1,040	787	678
Inventories	644	887	926	701	395
Assets held in Trust	261	227	–	–	–
Payables (excluding cash on customers' account) less receivables	(6,159)	(6,918)	(5,866)	(5,373)	(4,298)
Other financial assets and liabilities	(10)	(45)	240	52	6
Retirement benefit obligations	(3,456)	(4,679)	(3,365)	(1,629)	(2,499)
Provisions	(1,077)	(929)	(845)	(809)	(695)
Net tax	580	896	256	63	648
Net (debt)/cash (as defined by the Group)	(242)	403	39	700	435
Disposal groups held for sale	–	–	–	64	–
Non-controlling interests	(71)	(72)	(55)	(36)	(17)
Total equity attributable to equity holders of the parent	5,332	4,591	7,234	5,966	4,117

Movement in net (debt)/cash (as defined by the Group)	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Cash inflow from operating activities	1,535	2,232	2,009	2,162	778
Net capital expenditure ⁷	(364)	(489)	(503)	(262)	(141)
Dividends received from equity accounted investments	71	77	89	78	145
Assets contributed to Trust	(25)	(225)	–	–	–
Cash held for charitable contribution to Tanzania	(30)	–	–	–	–
Operating business cash flow	1,187	1,595	1,595	1,978	782
Acquisitions and disposals	(88)	(254)	(1,038)	(2,112)	1,330
Interest	(173)	(186)	(98)	(65)	(207)
Tax and dividends	(958)	(889)	(750)	(509)	(431)
(Purchase)/issue of equity shares	(520)	(20)	(27)	603	(71)
Preference share conversion	–	–	–	245	6
Exchange movements	(20)	262	(374)	36	323
Other movements ⁸	(80)	(132)	5	57	(11)
Net (decrease)/increase in net funds	(652)	376	(687)	233	1,721
Movement in cash on customers' account	7	(12)	26	32	(9)
Movement in net (debt)/cash (as defined by the Group)	(645)	364	(661)	265	1,712
Opening net cash/(debt) (as defined by the Group)	403	39	700	435	(1,277)
Closing net (debt)/cash (as defined by the Group)	(242)	403	39	700	435

Other information	2010	2009	2008	2007	2006
Continuing operations					
Basic earnings/(loss) per share – total (pence)	28.9	(2.3)	52.7	25.2	19.3
Basic earnings per share – underlying ⁹ (pence)	40.8	40.1	36.8	29.4	22.9
Order book including the Group's share of equity accounted investments (£bn)	39.7	46.3	45.7	37.9	30.9
Including discontinued operations					
Dividend per ordinary share (pence)	17.5	16.0	14.5	12.8	11.3
Number of employees, excluding share of employees of equity accounted investments, at year end	92,000	98,000	94,000	88,000	79,000
Capital expenditure including leased assets (£m)	437	522	552	341	538

1 For the year ended 31 December 2006, Airbus SAS is presented as a discontinued operation.

2 For the year ended 31 December 2006, the operating group information has been restated to reflect changes made to the Group's organisational structure.

3 For the years ended 31 December 2006 to 2010, Saab AB is presented as a discontinued operation.

4 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense (EBITA) excluding non-recurring items. From 2006 to 2008, non-recurring items are profit on disposal of businesses and uplift on acquired inventories. In 2009 and 2010, non-recurring items are profit on disposal of businesses, pension curtailment gains and regulatory penalties.

5 Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.

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

7 Includes expenditure on property, plant and equipment, investment property, intangible assets and other investments, and equity accounted investment funding.

8 Other movements include cash flows from matured derivative financial instruments, cash collateral and other non-cash movements (see page 172).

9 Earnings excluding amortisation and impairment of intangible assets, non-cash finance movements on pensions and financial derivatives, and non-recurring items. From 2006 to 2008, non-recurring items are profit on disposal of businesses and uplift on acquired inventories. In 2009 and 2010, non-recurring items are profit on disposal of businesses, pension curtailment gains and regulatory penalties.

Shareholder information

Registered office

6 Carlton Gardens
London SW1Y 5AD
United Kingdom
Telephone: +44 (0)1252 373232

Company website: www.baesystems.com

Registered in England and Wales, No. 1470151

Registrars

Equiniti Limited (0140)
Aspect House, Spencer Road, Lancing
West Sussex BN99 6DA
United Kingdom

Email: BAESystems@equiniti.com

Telephone: 0871 384 2044

Calls to the above number are charged at 8p per minute from a BT landline. Other telephony providers' costs may vary. Lines are open from 8.30am to 5.30pm Monday to Friday.

Telephone number from outside the UK: +44 121 415 7058

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

Dividend mandate

Shareholders can arrange to have their dividends paid directly into their bank or building society account, by completing a bank mandate form. The benefits of this are:

- Cleared funds are received into their bank account on the payment date – avoiding a trip to the bank, or a cheque lost in the post;
- One consolidated tax voucher, covering both dividend payments made in the financial year; and
- BAE Systems saves money and less paper is used – which is good for shareholders and the environment.



With the 2010 interim dividend, paid in November 2010, to encourage the mandating of dividends and to support the Company's work with UK armed forces charities, for each new bank mandate instruction we received we undertook to donate £1 to St Dunstan's, a charity that supports and cares for blind ex-service men and women. The response to date has been extremely good, with a £2,000 donation being made to St Dunstan's in December 2010. A further donation will be made during 2011.

To take advantage of the benefits of having dividends paid directly into a bank account, as well as supporting the work of St Dunstan's, a mandate form can be obtained from our website, by contacting Equiniti, or by using the one that would have been attached to the tax voucher for the last dividend payment. Alternatively, mandate instructions can be submitted via Shareview or, if the shareholding is held in a sole name, Equiniti can take instructions over the telephone.

Overseas shareholders can also arrange for dividends to be paid in their local currency and more information can be obtained from www.shareview.com/overseas

Electronic shareholder communications

An increasing number of shareholders receive communications from the Company using e-mail and web-based communications.

The use of electronic communications, rather than printed paper documents, helps us reduce the environmental impact of our activities and assist us in managing our costs.

We regularly consult with shareholders to check how they wish to receive information from us. Shareholders may receive electronic communications in one of two ways:

- via e-mail – This option is available through Shareview. Shareholders receive an e-mail notification when a new document is made available.
- via our website – Shareholders receive a notification by post when a new document is made available.

A shareholder is taken to have agreed to website communications if a response has not been received. Any document or information required to be sent to shareholders is made available on the Company's website and a notification of availability is sent. Shareholders who receive such a notification are entitled to request a hard copy of the document at any time and may also change the way they receive communications at any time by contacting Equiniti.

Notwithstanding any election, the Company may, at its sole and absolute discretion, send any notification or information to shareholders in hard copy form.

Shareview services

Shareview is a portfolio service offered by Equiniti to investors which gives shareholders online access to more information on their investments, including balance movements, indicative share prices and information on recent payments. It can also be used to sign up to receive all shareholder communications electronically, or arrange for dividends to be mandated.

To take advantage of Shareview, register online at www.shareview.co.uk. Click on 'Register' and follow the four easy steps. Once registered, Shareview is:

- Easy to use. To log on, all that is needed is the user ID, password and the user's date of birth. Information regarding shareholdings is regularly updated.
- Secure. Data transferred to a shareholder's browser is encrypted and not accessible to other internet users without the log on information.
- Free. Equiniti make no charge to shareholders for providing this service.

Please visit www.shareview.co.uk for more details. Details of software and equipment requirements are given on the website.

Dividend reinvestment plan

The Company offers holders of its ordinary shares the option to elect to have their dividend reinvested in shares purchased in the market instead of cash. To make this election, please request a dividend reinvestment plan mandate from our registrars:

Equiniti Financial Services Limited
Aspect House, Spencer Road, Lancing
West Sussex BN99 6DA
United Kingdom

Telephone: 0871 384 2268

Calls to the above number are charged at 8p per minute from a BT landline. Other telephony providers' costs may vary. Lines are open 8.30am to 5.30pm Monday to Friday.

Telephone number from outside the UK: +44 121 415 7058

Alternatively, a copy of the Terms and Conditions of the dividend reinvestment plan, along with the mandate form, can be downloaded from our website.

ShareGift

The Orr Mackintosh Foundation operates a charity donation scheme for shareholders with small parcels of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at www.sharegift.org or by telephone on 020 7930 3737.

Share price information

The middle market price of the Company's ordinary shares on 31 December 2010 was 330.0p and the range during the year was 294.7p to 388.8p.

American Depositary Receipts

BAE Systems plc American Depositary Receipts (ADRs) are traded on the Over The Counter market (OTC) under the symbol BAESY. One ADR represents four BAE Systems plc ordinary shares.

JPMorgan Chase Bank, N.A. is the depositary.

If you should have any queries, please contact:

JPMorgan Chase & Co
PO Box 64504
St Paul
MN 55164-0504
USA

Email: jpmorgan.adr@wellsfargo.com

Telephone number for general queries: (800) 990 1135

Telephone number from outside the US: +1 651 453 2128

Warning to shareholders – boiler room scams

Many companies have become aware that their shareholders have received unsolicited phone calls or correspondence concerning investment matters. These are typically from overseas-based 'brokers' who target UK shareholders, offering to sell them what often turn out to be worthless or high-risk shares in US or UK investments. These operations are commonly known as 'boiler rooms'. These 'brokers' can be very persistent and extremely persuasive, and a 2006 survey by the Financial Services Authority (FSA) has reported that the average amount lost by investors is around £20,000.

It is not just the novice investor that has been duped in this way; many of the victims had been successfully investing for several years. Shareholders are advised to be very wary of any unsolicited advice, offers to buy shares at a discount or offers of free company reports. If you receive any unsolicited investment advice:

- make sure you get the correct name of the person and organisation;
- check that they are properly authorised by the FSA before getting involved by visiting www.fsa.gov.uk/register/ and contacting the firm using the details on the register;
- report the matter to the FSA either by calling 0845 606 1234 or visiting www.moneymadeclear.fsa.gov.uk; and
- if the calls persist, hang up.

If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme. The FSA can be contacted by completing an online form at www.fsa.gov.uk/pages/doing/regulated/law/alerts/overseas.shtml

Details of any share dealing facilities that the Company endorses will be included in Company mailings.

More detailed information on this or similar activity can be found on the Consumer Financial Education Body website www.moneymadeclear.fsa.gov.uk

Financial calendar

Financial year end	31 December
Annual General Meeting	4 May 2011
2010 final ordinary dividend payable	1 June 2011
2011 half-yearly results announcement	28 July 2011
2011 interim ordinary dividend payable	30 November 2011
2011 full year results – preliminary announcement	February 2012
– report and accounts	April 2012
2011 final ordinary dividend payable	June 2012

Analysis of share register at 31 December 2010

	Ordinary shares of 2.5p			
	Accounts		Shares	
	Number '000	%	Number million	%
By category of shareholder				
Individuals	102.3	92.2	98.8	2.8
Nominee companies	7.6	6.9	3,262.3	90.9
Banks	0.0	0.0	0.3	0.0
Insurance and pension funds	0.0	0.0	0.1	0.0
Other	1.0	0.9	225.9	6.3
	110.9	100.0	3,587.4	100.0
By size of holding				
1 – 99	23.2	20.9	1.1	0.0
100 – 499	31.5	28.4	8.4	0.2
500 – 999	22.4	20.2	16.0	0.4
1,000 – 9,999	31.5	28.4	74.8	2.1
10,000 – 99,999	1.4	1.3	35.3	1.0
100,000 – 999,999	0.6	0.5	193.9	5.4
1,000,000 and over	0.3	0.3	3,257.9	90.9
	110.9	100.0	3,587.4	100.0

Glossary

ADF	Australian Defence Force.
AGM	Annual General Meeting.
ATV	All-Terrain Vehicle.
BvS10 Viking	Amphibious armoured ATV.
C4ISR	Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance.
CR	Corporate Responsibility.
CV90	Combat Vehicle 90.
DASS	Defensive Aids Sub-System.
EBITA	Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense.
EC	Executive Committee.
EPS	Earnings per Share.
EU	European Union.
FMTV	Family of Medium Tactical Vehicles.
FPE	Final Pensionable Earnings.
FPP	Final Pensionable Pay.
FRES	Future Rapid Effect System.
FRS	Financial Reporting Standard.
GAAP	Generally Accepted Accounting Practice.
GDP	Gross Domestic Product.
IAS	International Accounting Standard.
IBP	Integrated Business Plan.
IDIQ	Indefinite Delivery, Indefinite Quantity.
IFRIC	International Financial Reporting Interpretations Committee.
IFRS	International Financial Reporting Standard.

KPI	Key Performance Indicator.
KSA	Kingdom of Saudi Arabia.
LCM	Lifecycle Management.
LRIP	Low-Rate Initial Production.
LTA	Lifetime Allowance.
LTIP	Long-Term Incentive Plan.
M777	A lightweight 155mm field howitzer.
MEADS	Medium Extended Air Defence System.
MoD	Ministry of Defence.
MRAP	Mine Resistant Ambush Protected.
MSMO	Multi-Ship, Multi-Option.
OAS	Operational Assurance Statement.
OF	Operational Framework.
OPV	Offshore Patrol Vessel.
QBR	Quarterly Business Review.
QDR	Quadrennial Defense Review.
RAF	Royal Air Force.
RCF	Revolving Credit Facility.
RG31	Mine protected armoured personnel carrier.
RSAF	Royal Saudi Air Force.
RSNF	Royal Saudi Naval Forces.
SBDCP	Saudi British Defence Co-operation Programme.
SDSR	Strategic Defence and Security Review.
SMM	Safety Maturity Matrix.
STOVL	Short Take-Off and Vertical Landing.
TSR	Total Shareholder Return.
UAV	Unmanned Air Vehicle.

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Shareholder feedback

If you would like to give us any feedback on this year's Annual Report, please send your written comments to our investor relations team at:


BAE Systems plc
6 Carlton Gardens
London SW1Y 5AD
United Kingdom

or by e-mail to investors@baesystems.com

Production of this report

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